The Expansion of Corporate Groups in the Financial Services Industry: Trends in Financial Conglomeration in Major Industrial Countries

December 28, 2005
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*The original Japanese-language version of this paper was released in April 2005 by the former Financial Systems Department.
Summary

In recent years, a growing number of financial services companies in major industrial countries have begun to make inroads into each other’s sectors, spurred by changing financial needs, innovations in financial engineering, deregulation, and a variety of other trends and developments. These companies include banks, securities companies, insurers, and even consumer finance and asset management/advisory firms. Among the most significant developments is the expansion of financial conglomerates, groups of financial institutions and firms that offer a wide range of services. Financial conglomerates have become notable in recent years for their growing size and the increasingly global nature of their operations.

Financial conglomerates raise new issues in terms of the stability and efficiency of financial systems. Many of the new issues raised by financial conglomerates stem from the fundamental nature of financial conglomerates themselves, which is the fact that they handle a wide range of financial services within a single corporate grouping.

As traditional regulation has divided financial services providers more or less along strict sectoral lines, financial conglomerates, which allows single groups to offer an increasingly diverse range of services, has brought significant changes, especially to their risk management practices, and thus has prompted financial authorities and safety net administrators to respond to these changes.

Financial conglomerates do not provide a single model for financial services providers seeking to expand their range of business. They vary greatly in terms of the scope and structure of their business, depending on factors such as the management strategies of their core financial services providers and the financial systems of the countries in which they operate. In addition, all of these factors change over time.

However, financial authorities and relevant parties need to be aware that conglomeration will likely remain a strong option for financial services providers. When financial services providers choose to expand their business by conglomeration, the financial
authorities and relevant parties need to pursue dual objectives of maintaining the soundness of the financial system and allowing financial services providers to operate smoothly.

There is no set of universal guidelines for dealing with financial conglomeration in place around the world. Nonetheless, on the regulatory side, financial conglomeration has been the subject of active discussions in international settings, and a common awareness is being formed regarding the need to monitor what is occurring in the financial conglomerate as a whole and the importance of making active use of market discipline.

A movement toward financial conglomeration has also been taking place in Japan. Financial conglomeration has emerged and expanded since the 1990s, when banks and securities companies were allowed to enter each other’s sectors. The years since 2000 have seen a series of mergers and integrations among the major banks that has led to the formation of “mega-bank” groups.

Further financial conglomeration will likely occur in Japan under current economic conditions. Japanese banks are now laying the groundwork for more forward-looking business development with their progress in the cleanup of nonperforming loans and reduction of their excessive equity holdings. They are also becoming aware that strengthening their profitability is an increasingly important task. Deregulation is moving forward as well. As this trend will likely grow, financial authorities need to closely monitor not only domestic financial conglomerates but also foreign financial conglomerates that operate in Japan.

The Bank of Japan, as a central bank, will respond to financial conglomeration to effectively carry out the Bank’s operations, including current account deposits and other transactions with financial institutions, bank examinations and monitoring, as well as the “lender of last resort” function. Of special importance from the perspective of avoiding systemic risks will be accurately grasping conditions in individual groups, focusing particularly on the flow of funds and integrated risk management.
Introduction

The global financial system has undergone significant transformations over the past few years, and at the core of these transformations is the emergence of “financial conglomerates,” i.e., groups of financial institutions and firms that offer a wide range of services. Japan has likewise seen management strategy move in the direction of financial conglomeration, with major banks, which have expanded to become “mega-banks,” taking capital stakes in consumer finance companies.

The development of financial conglomeration is the result of a complex interplay of many factors, including changes in financial needs, innovations in financial technology, and deregulation. As economies globalize, we are seeing financial conglomeration actively extend itself across national borders, particularly in the United States and Europe.

One aspect of financial conglomeration is that the dynamic process involved requires new action from a wide range of interested parties. For example, the financial conglomerate itself must build appropriate risk management systems suited to the diversification of its business. Likewise, the financial authorities must respond with new initiatives in regulation, utilization of market disciplines, and supervisory systems.

As they try to adapt to the changing financial needs of their customers, financial services providers have many options for the kinds of services they offer and the forms in which they offer them. The advances in IT and progress in deregulation have been expanding the range of options available. This makes it extremely difficult at the present time to foresee the direction, as a worldwide trend, that financial services providers will take in the development of their business. Nonetheless, it is highly likely that conglomeration will remain an option for financial services providers seeking to expand their range of business.

Financial conglomeration contributes to the advancement of financial services and the convenience of customers, and strengthens the overall dynamism of the financial system
through entries of various financial services providers into a number of different services.

On the other hand, conglomeration also raises many new issues from the perspective of ensuring the soundness of the financial system.

Working from these perspectives, this paper attempts to review the background and current situation in financial conglomeration and identify some of the issues that must be addressed in the future.
I. Overview of Financial Conglomeration

1. Basic Concepts

(1) A typical example and definitions

While the term “financial conglomerate” is generally used to refer to a financial group, in many cases large in size, that engages in a wide range of financial services, individual financial conglomerates tend to vary greatly in their structure, size, and degree of globalization. In addition, there is no single, agreed-upon definition of “financial conglomerate” itself, and the usage differs slightly between countries or regions (see Box).

To clarify the discussion of a “financial conglomerate,” a typical example of the HSBC Group, which is a group formed around the core institution of the Hongkong and Shanghai Banking Corporation Limited, is presented in Figure 1.

Distinguishing characteristics of the group are as follows.

(1) A wide range of financial services offered
In addition to its core banking services, the group offers a wide variety of other financial services such as securities, asset management, consumer finance, and insurance.

(2) A complex organizational structure
At the core of the group is a holding company, under which there are banking subsidiaries and intermediate holding companies, and under them a variety of subsidiaries of subsidiaries.

(3) Global operations
The core holding company is located in the United Kingdom, but the group operates approximately 10,000 offices in 76 countries in Europe, the U.S., Latin America, Asia, the Middle East, and elsewhere.

(4) Massive scale
The financial conglomerate’s assets were approximately 1 trillion U.S. dollars in 2003.
While this paper focuses on the increasing complexity and size of financial groups in the European Union (EU) and the U.S., it also discusses briefly such groups in Japan. In doing so, the paper employs the following concept of “financial conglomerate” that has been used by regulators at international forums:  

1. The range of group operations encompasses at least two different financial sectors from banking, securities, and/or insurance (although in practice, services tend to be even broader, extending for example into asset management), and  
2. The core business of the group is finance, namely, banking, securities, or insurance.

There are also some examples of nonfinancial commercial companies entering into financial services. Cases from the U.S. include General Electric and American Express, which do not have finance as their principal business but provide a variety of financial services. In Japan, telecommunications companies provide securities brokerage services or other financial services, and there are even cases of electrical equipment manufacturers entering into banking and insurance.

This paper does not directly cover such nonfinancial corporate groups, because in many cases it is not clear whether their businesses encompass at least two major financial sectors from banking, securities, and insurance, or whether their principal business is actually finance. Nonetheless, it is obvious that they should be observed carefully no less than financial conglomerates, because they too represent a direction in the grouping

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1 Another term that has considerable conceptual overlap with “financial conglomerate” is “large and complex financial institutions” (LCFIs). While there is no clear definition for LCFIs, they are generally considered to possess one or both of the following characteristics: (1) significant size of operations across a wide range of activities in different countries and different financial sectors; and (2) large participation in international financial markets and/or in payments, settlements, and clearing systems.

2 General Electric considers itself a “diversified technology, media and financial services company,” while American Express calls itself a “global travel, financial and network services provider.”
and diversification of financial services providers.

3 See Attachment 1.
<table>
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<tr>
<th>Box  Definition of a “Financial Conglomerate”</th>
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1. The European Union


1. The group has at least one company engaged in either banking or securities and at least one company engaged in insurance.

2. A company engaged in banking, securities, or insurance is at the head of the group or the ratio of the balance-sheet total of the financial-sector entities in the group to that of the group as a whole (the total amount outstanding of banking, securities, and insurance services) exceeds 40 percent.

3. For each financial sector (banking/securities and insurance), the average of the ratio of the balance-sheet total of that financial sector to the balance-sheet total of the financial-sector entities in the group and the ratio of the solvency requirements of the same financial sector to the total solvency requirements of the financial entities in the group exceeds 10 percent or the balance-sheet total of the smallest financial sector in the group exceeds 6 billion euros.

As financial groups in the EU have been traditionally permitted to directly engage in both banking and securities, the directive requires them to engage in either banking or securities plus insurance to qualify as financial conglomerates. The directive also requires that financial services account for the majority of the group’s business in order for the group to qualify as a financial conglomerate, and is notable for setting numerical criteria for the balance sheet and net worth.

Under the directive, a financial group identified as a “financial conglomerate” is subject

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*a The EU directive is binding on the EU members in terms of the results to be achieved but leaves to the national authorities the choice of form and methods.

*b The Second Banking Directive (Directive 89/646/EEC of 15 December, 1989) extended Germany’s universal banking system (under which banks themselves were also allowed to engage in securities business) to the entire EU.
to the ordinary sectoral regulations concerning the banking, securities, and insurance sectors, and also to supplementary rules dealing with the capital adequacy on a group-wide basis; risk concentration; intra-group transactions; and other matters including appointment of coordinator and exchange of information, among supervisory entities.

2. The U.S.

U.S. financial laws do not use the term “financial conglomerate.” The Financial Services Modernization Act of 1999 (known as the Gramm-Leach-Bliley Act or GLB Act) allows bank holding companies that meet certain requirements in terms of capital adequacy and other measurements to act as “financial holding companies” that are allowed to establish subsidiaries which engage in a broader range of businesses than those permitted to bank holding companies, including securities, insurance, and mutual funds. However, the term “financial conglomerate” is not used.

“Financial holding company” is merely a status that allows the bearer to hold other companies offering a broad range of financial services. It does not in fact require the company to offer services. Therefore, it cannot be assumed that the financial group held by a financial holding company actually owns companies engaged in two or more of banking, securities, and/or insurance businesses.

Because of this, the financial group held by a financial holding company may not necessarily constitute a “financial conglomerate” as stated in the EU directive.

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c However, the scope of operations open to financial groups held by holding companies is limited to (1) activity financial in nature (banking, securities, insurance, and other businesses), (2) activity financial in nature or incidental to such activity, and (3) complementary to financial activity. Financial services must be the primary business of financial holding companies.

d The Joint Forum was established in early 1996 under aegis of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) to take forward the work of its predecessor, the Tripartite Group to deal with issues common to the banking, securities, and insurance sectors, including the regulation of financial conglomerates. The Joint Forum consists of an equal number of senior bank, insurance, and securities supervisors representing each supervisory constituency. Thirteen countries are represented in the Joint Forum: Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the U.K., and the U.S. The EU Commission attends in an observer capacity.

c Joint Forum (1999a).
3. Japan
Japanese financial laws likewise do not use the term “financial conglomerate.”

Individual sectoral laws govern the scope of business open to holding companies and their subsidiaries, making Japanese financial laws more similar to the U.S. model than the European ones.

4. Discussions at the Joint Forum\textsuperscript{d} and Other International Meetings
Prior to enhancements of the legal systems in the U.S. and Europe, the supervisory issues raised by the emergence of financial conglomerates were discussed at the Joint Forum and in other international venues.

At the international discussions, “financial conglomerates” are considered to be groups that meet the following requirements:

(1) Groups that cover at least two of the major financial sectors from banking, securities, and insurance, and
(2) Groups whose core business is finance, i.e., banking, securities, and/or insurance.

Discussions at international forums, and particularly the Joint Forum, are thought to have had a significant impact on the formulation of the EU Financial Conglomerates Directive, and as shown below, their definitions of “financial conglomerate” overlap on many points. However, had the EU adopted the Joint Forum requirement of covering at least two major financial sectors from banking, securities, and insurance, almost every bank in Europe would have been considered a “financial conglomerate” because of the EU’s universal banking system. The EU therefore revised the definition to conducting either banking or securities and insurance, and then added numerical standards to the Joint Forum requirement that the core business consist of finance.

“any group of companies under common control whose exclusive or
predominant activities consist of providing significant services in at least two
different financial sectors (banking, securities, insurance).

(2) “Supervision of Financial Conglomerates,” papers prepared by the Joint Forum on
Financial Conglomerates (1999a):
“heterogeneous financial conglomerates are conglomerates whose primary
business is financial, whose regulated entities engage to a significant extent in at
least two of the activities of banking, insurance, and securities business, and
which are not subject to uniform capital adequacy requirements.”
(2) Organizational structure

In terms of organizational structure, conceptual models for financial conglomerates can be categorized into the following three groups (Figure 2):

(1) Universal banking, in which one company engages in all financial services.

(2) Parent-subsidiary relationships, in which a parent financial services provider in banking, securities, or some other business owns subsidiaries in different financial sectors.

(3) Holding companies, which own financial services providers and subsidiaries in various financial sectors. One example is the HSBC Group described above.

In parent-subsidiary relationships and holding companies, overall group management is generally the function of the topmost company in the capital relationship. Holding companies can establish subsidiaries as provided for in national and sectoral regulations, and there are also other advantages; for example, their managers are freed from the need to operate individual businesses and are able to concentrate on formulating strategies for the group as a whole. Such advantages are, however, diminished in some cases of parent-subsidiary relationships, where executives serve on both the boards of the bank holding company and the core banking subsidiary.\(^4\)

(3) Organizational structure by country/region

An overview of the organizational structure of financial conglomerates by country/region is as follows.

In Europe, the universal banking system allows banks to also provide securities services. However, even in Europe, universal banks are prohibited from directly engaging in insurance services as part of the operations of the bank proper. Entities engaged in insurance are generally in the form of a parent-subsidiary relationship or a holding company. In other words, none of the major industrial countries allow a single corporate entity to provide services in all three financial sectors of banking, securities, and insurance services.

\(^4\) However, one could also make the case that concurrent service on both boards strengthens the integration of management between the holding company and major subsidiaries.
In the U.S. and Japan, the traditional practice has been to separate banking and securities, and therefore no single entity is allowed to engage in both businesses. That is why parent-subsidiary or holding company systems are widely adopted.

In recent years, the practice in Europe, the U.S., and Japan has been to rely primarily on holding companies to form financial conglomerates covering businesses in multiple financial sectors. In a number of cases, intermediate holding companies are also established as a means to delegate a certain extent of business management and risk management of different sectors or geographical areas.

(4) Differences between financial conglomeration and strategic alliances

There is another method of business diversification besides financial conglomeration: that of alliances, particularly strategic alliances in which companies collaborate to achieve strategic objectives. Like conglomeration, strategic alliances may cover multiple sectors, but they differ basically from financial conglomeration in that they maintain the legal independence of the collaborators. In other words, they do not use mergers or acquisitions (including the holding of major capital stakes) to consolidate capital relationships.  

Strategic alliances are generally thought to have three major advantages: they can be launched at relatively low cost because they do not require any new capital to be raised; they can be achieved quickly; and they allow participants to choose multiple partners simultaneously. In contrast, the advantages of financial conglomeration are that capital relationships enable more centralized management of collaborators, and it is easier to develop a brand strategy that reflects the advantages stemming from integration.

2. The Aims and Backgrounds of Financial Conglomeration

This section discusses the aims and backgrounds of financial conglomeration, which are shared commonly around the world, from the perspective of financial services

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5 See, for example, Hamel and Doz (2001).
providers.

In summary, the aims of financial conglomeration are to (1) respond to increasingly diverse and sophisticated financial needs, (2) strengthen profitability, (3) adapt to globalizing economies, and (4) develop brand strategies. Supporting these trends are (5) innovations in financial technology, and (6) deregulation.

(1) Responding to changes in financial needs

Structural changes in the economy are producing changes in individuals’ and companies’ needs for financial services, and such needs for increasingly diverse and sophisticated financial services are one of the basic factors behind financial conglomeration. For individuals, there is growing interest in asset management, against a background of their accumulated financial assets and increasingly diverse lifestyles. For companies, there is a strong need for more varied and global financial services, as changes in economic structures force them to review business strategies, the emergence of new economies increases global competition, and information technology becomes more advanced and international in scope.

The changes in financial needs have led to the emergence of new financial services providers, for example, asset management services, and have also caused existing financial services providers to expand their organizations by integrating with other providers in different sectors, so that they can better respond to diversifying customer needs.

a. One-stop shopping

According to a survey by the Group of Ten, the primary objectives and motivations

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7 Other aims of financial conglomeration are said to be (1) expansion in size to attract interest among potential customers, and (2) the ensuring of survival for the managers themselves (Watanabe [2001]).
8 “One-stop shopping” is defined as “the provision of a full line of merchandise so that all shopping can be accomplished at once.” In a financial context, it means access to a variety of financial services at one office.
10 A meeting of the finance ministers and central bank governors of ten industrial countries. The Group of Ten provides an opportunity for the International Monetary Fund (IMF) and eleven leading countries (Japan,
for financial services providers in choosing to merge across sectoral lines are the improvement of customer convenience by being able to offer “one-stop shopping,” and the consequent increase in revenues for the financial services provider itself.\textsuperscript{11,12,13} One-stop shopping is also a common technique in the retail sector, where synergy is generally expected on the sales side.\textsuperscript{14}

\textbf{(2) Strengthening profitability}

One of the reasons for progress in financial conglomeration among European and U.S. banks is their effort to seek out new sources of revenue. To respond to decreasing profitability of traditional banking services like lending, they have become more aggressive in their purchases of other financial services providers.\textsuperscript{15} Even financial services providers with no immediate concern for decreasing profitability face the same challenge of stabilizing earnings through diversification, and this too is presumably one of the aims of financial conglomeration.

the U.S., the U.K., Germany, France, Italy, Canada, the Netherlands, Belgium, Sweden, and Switzerland) to exchange opinions on issues in the international monetary system and world economy and, when necessary, set long-term objectives.

\textsuperscript{11} According to this survey, different motivating factors for a merger are emphasized depending on whether the merger involves different companies in the same sector (for example, two banks) or companies in different sectors (for example, a bank and an insurance company).

In other words, when the merger involves companies in the same industry, the strongest motivating factor is using the expanded scale to reduce costs, while a merger among different sectors (including a financial conglomerate) emphasizes revenue enhancement due to product diversification or the ability to offer customers “one-stop shopping.” Other factors that are emphasized include (for mergers among companies in the same sector) revenue enhancement due to increased size and increased market power and (for mergers across sector lines) cost reductions from an expanded range of business and risk reductions due to product diversification.

\textsuperscript{12} On the other hand, in consumer surveys conducted by U.S. research institutions, about 30 percent of all consumers indicated they already used one-stop shopping for financial services or would potentially use it in the future, while about 40 percent of respondents rejected the idea of a single provider (Synergistics survey [1998] introduced in England [1999]). They expressed worry about losing the opportunity to engage in more advantageous transactions by concentrating all of their transactions with a single financial services provider.

\textsuperscript{13} Numata (2002) points to several factors behind the preference on the part of financial services providers for cross-selling, which includes one-stop shopping; for example, the fact that it is more efficient from a business standpoint to provide multiple products to existing customers than it is to attract new customers. On the other hand, Fuchita (2004) argues that it is difficult to generalize because the degree to which cross-selling will expand revenues is highly dependent upon individual circumstances.

\textsuperscript{14} England (1999) interviewed senior managers at banks pursuing one-stop shopping about the innovations that they had achieved. Among the highlights were (1) a “bundled approach” (creating bundles of products such as checking account, overdraft protection, and savings options at discounted prices); (2) a “portal” strategy (listing of group products on net portals to reduce customers’ fear of relying on just one financial services provider); and (3) use of “private” financial advisers (providing a package of financial advice and one-stop shopping for affluent customers).
In the U.S., the growth of capital markets has increased the weight of direct finance in the financing of major corporations. In consumer finance as well, the progress in securitization of mortgages and auto loans has brought about an increase in competition between banks and securities companies on one hand and banks and non-bank financial institutions on the other. As a result, the percentage of corporate and personal financing accounted for by bank loans has fallen substantially in recent years (in the U.S., from 30.9 percent in 1974 [the most recent peak] to 24.1 percent in 2003; and in Japan, from 39.5 percent in 1992 [the most recent peak] to 33.2 percent in 2003). Greater competition is assumed to be one factor reducing the profitability of traditional banking services.

Advances in information technology have led to sophistication of financial services and substantial reduction of costs, but they have also increased the investment burdens borne by financial services providers. For example, annual average investment by U.S. banks in information technology increased by more than 50 percent from the 1990-1994 period to the 2000–2001 period (Figure 3). Reducing these investment burdens is thought to be another factor promoting financial conglomeration.

15 For further discussion on “economies of scale” and “economies of scope,” see Attachment 2.
16 In the U.S., bank lending extended to large corporations is shifting to setting of commitment lines.
18 Comparing the situation in Japan and the U.S. in recent years, Japanese financial institutions have made the disposing of nonperforming loans their top management priority and have been relatively restrained in their overall expenditures on information technology. If anything, their priority in this area has been on system maintenance, with investments in new system development tending to be limited (investments in new system development only accounted for about 30 percent of total investments in information technology [the 1995–2000 average] according to a survey by the Center for Financial Industry Information Systems [2003]). By contrast, the tendency in the U.S. has been for financial institutions to make more strategic and more flexible investments in development of new systems (investments in development of new systems accounted for 38 percent of the total in 2003, with maintenance spending just 2 percent [Center for Financial Industry Information Systems (2003)])

In the “Program for Further Financial Reform” announced in December 2004, the Financial Services Agency (FSA) aims to “promote strategic use of IT, taking into consideration the fact that the relative importance of Internet transactions has increased while, compared to other countries, Japanese financial institutions have fallen behind in IT investments and IT costs remain high.” The “Basic Policies for Economic and Fiscal Management and Structural Reform 2004,” published in June 2004, incorporate the “Program for Further Financial Reform” as the “Program for Concentrated Consolidation of the Financial System” (tentative name) and mandate the formulation of guidelines by the end of 2004 to provide a roadmap for the reforms to be implemented by the financial authorities over a two-year period from fiscal 2005 to fiscal 2006 after the conclusion of the “Program for Financial Revival” (end of March 2005).
It should be noted, however, that the development of information technology is also providing impetus for companies in the telecoms and information business to enter into financial services. This means that competition exists not just among the traditional providers of financial services—banks, securities companies, and insurance companies—but also between financial services providers and nonfinancial companies. The growing number of competitors in the financial services market is yet another factor giving financial services providers a strong impetus to raise the efficiency of their operational management.

(3) Responding to economic globalization

The operations of financial services providers are becoming more global as a consequence of greater cross-border movements of funds and information and also the increasingly aggressive developments of financial brands. Financial services providers are also moving to higher-growth regions overseas as a means of improving their profitability.

This overseas expansion can take many forms. While utilizing existing operational bases, financial services providers also merge with or acquire local financial services providers because doing so facilitates adaptation to local financial systems and business practices.

When seen by region, trans-national operations are fairly easy for financial services providers in Europe, as the EU adopts the single banking license system. In the emerging economies such as Latin America, Eastern Europe, and Asia, European and U.S. banks began to actively acquire large local banks in the 1990s. This trend was triggered by the desire to find new markets as increasing competition in existing markets reduced or threatened to reduce the profitability of deals for financial services providers. Other factors that encouraged active entry into emerging economies included (1) reforms

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19 This analysis relies primarily upon Hishikawa and Uchida (2004).
20 European and U.S. banks began expanding their business into Asian countries somewhat later than they did into Latin America and Eastern Europe. This is because Asian countries adopted a somewhat more leisurely pace in enhancing market infrastructure including privatization of national banks and establishment of legal and regulatory frameworks, and in liberalizing the entry of foreign capital than Latin American and Eastern European countries did (Hishikawa and Uchida [2004]).
in Latin America and Eastern Europe in the 1980s and after, such as the liberalization and privatization of financial transactions; and (2) improvements in country risk management techniques due to both the progress made in financial technology and the development of the requisite infrastructure, for example, data availability.

The above trend is seen in the share of foreign banks in total bank assets in emerging economies. In 1990, foreign banks had less than 10 percent in most countries and regions; by 2002, they had grown substantially on the whole, and particularly in Latin America and Eastern Europe (Figure 4). Looking at individual regions in more detail, it is clear that geographical proximity played a major role in investments, with the U.S. being the larger investor in Latin America, and Western Europe the larger investor in Eastern Europe. Asia stands in contrast, with active investments coming from financial services providers in many different regions. The range of operations expanded as well. In the past, it was primarily trade finance, but today it has expanded into retail banking, securities services, financial derivatives, and other products.

(4) Developing brand strategy

When a company wins the trust of its customers and maintains ongoing relations with them, the company’s brand has a positive impact on customers when they purchase products and services; in other words, the company’s brand gains a competitive advantage.

When financial services providers use the competitive advantages of their brand loyalty for their products in other financial services sectors, financial conglomeration can be more advantageous than strategic alliance because the earnings of collaborators are returned to the group in the form of stock dividends. In practice, conglomerates often use the name and/or logo of the core company in the names of all or part of the

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21 In this context, “brand” refers to different marks used by a company to distinguish its products and services from those of its competitors (Ministry of Economy, Trade and Industry [2002]).

22 The competitive advantage on brands takes such forms as (1) price advantages (consumers are willing to pay higher prices for an equivalent product that bears a desirable brand); (2) high loyalty (consumers become ongoing/repeat buyers of products from the same brand); and (3) potential for expansion (a strong brand makes it easier to expand into similar industries, different industries, and overseas markets) (Ministry of Economy, Trade and Industry [2002]).
subsidiaries and their services so that the competitive advantages of the brand extend throughout the group. This brand strategy is another aim of financial conglomeration.

Brand strategy is particularly effective in the retail sector. Part of this is because the main customers in the retail sector are individuals, who are more easily influenced by the competitive advantages of a brand, but part of it is also conceivably because of the synergy effects produced in sales through “one-stop shopping.”

(5) Advances in information and financial technology

Advances in telecommunications and information processing have significantly reduced transaction and management costs by making it possible to process and communicate large volumes and wide varieties of customer data and management information both effectively and at low cost.

With lower transaction costs, the profitability of retail business has improved, and as a result, many financial services providers have placed a strategic emphasis on this area.

Financial services providers’ efforts to strengthen retail business have pointed in the same direction as financial conglomeration, which aims to enhance the range of financial services available and reduce the transaction costs associated with them.

Lower management costs have enabled financial services providers to expand beyond the framework of existing sectoral boundaries and adopt organizational structures more suited to the nature of their customers, for example, one-stop shopping. Lower management costs have also contributed substantially to management efficiency gains in financial conglomerates, which by their nature have a very broad management span.

The development of information technology has given rise to financial technology innovation, as can be seen in trading of financial derivatives and securitization.

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23 See Attachment 3.
24 For example, a survey estimates that it costs about one cent to conduct a banking transaction using the Internet and more than one dollar if the transaction is handled by a teller at a bank branch (Matsumoto and Iwashita [2000]).
Trading of financial derivatives has encouraged the “unbundling”\textsuperscript{25} of financial functions by breaking up, processing, and restructuring risks. These innovations in financial technology have substantially blurred the relationship between the providers of financial functions and traditional sectoral classifications. And this, in turn, has contributed to the development of financial conglomerates aiming to adopt a management style with greater emphasis on the customer base rather than sectoral classifications.

Innovations in financial technology have also promoted financial conglomeration by providing more sophisticated and more integrated risk management techniques for financial services providers. Specific techniques in this regard include the quantification of risk using “value at risk” (VAR) and stress testing.

\textbf{(6) Deregulation}

Financial authorities have also helped to create an environment conducive to the integration of financial services providers and the diversification of business by relaxing the regulations mandating sectoral divisions (Figure 5). Improvements in risk management technology and disclosure have enabled the financial authorities to achieve their objectives without imposing broad, standardized regulations, which then paved the way for deregulation.\textsuperscript{26}

In the U.S., the relaxation and elimination of regulations on interstate banking and the introduction of the holding company system have encouraged consolidation of the financial industry.

The regulations on interstate banking had been gradually relaxed at the state level beginning in the 1980s and eliminated with amendments to federal laws in 1994.\textsuperscript{27}

\textsuperscript{25}“Unbundling” refers to breaking apart the functions that used to be handled by a single financial institution so that they can be taken over by those who are most competitive in each area (Ogaki [2004]).

\textsuperscript{26}There was no separation of banking and securities business in the U.S. prior to the Glass-Steagall Act or in Japan prior to World War II. The reason why both countries have allowed banks and securities companies to enter into each other’s businesses in recent years is that improvements in risk management systems and disclosure have reduced the potential damage from integrated banking and securities services and enabled reintegration of the two businesses.

\textsuperscript{27}The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 permitted bank holding
This deregulation spurred consolidation among banks that had been members of the same group and encouraged mergers between banks within the sector (there were 3,517 within-sector mergers between 1994 and 2003).

As for cross-sector consolidation, however, tight restrictions had been maintained for decades. The Glass-Steagall Act of 1933 banned any sort of participation by banks and securities companies in each other’s sectors, whether by the companies themselves or by the ownership of subsidiaries. It also prohibited, in principle, banks and their subsidiaries from providing insurance services.

In the late 1970s, however, bank regulators responded to declining bank competitiveness by interpreting the law more flexibly in regulatory rulings to allow banks to enter new business areas. This resulted in a gradual expansion in the scope of business open to banks and, after a long debate, the Gramm-Leach-Bliley Act (GLB Act)\(^{28}\) was passed in 1999, allowing banks, securities companies, and insurance companies to participate in each other’s sectors through financial holding companies and similar vehicles.

In Europe, the Second Banking Directive of 1989 extended Germany’s universal banking system to the entire EU. EU member states could also, at their discretion, allow banks to own insurance subsidiaries.\(^{29}\) The introduction of the single licensing system for insurance companies in 1994 spurred new integration in the European insurance market and active cross-border acquisitions and mergers among insurance companies in the late 1990s. In 2002, the EU issued a uniform directive on financial conglomerates covering the banking, securities, and insurance industries.

Japan first allowed banks and securities companies to enter into each other’s sectors by establishing sector-specific subsidiaries in 1993 and then gradually relaxed and

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\(^{28}\) See Attachment 4.

\(^{29}\) Schedules for allowing cross-sector entry of banks and insurance companies into each other’s sectors vary by country. For example, the Netherlands amended its national laws at almost the same time as the EU’s Second Banking Directive (1989) to allow banks and insurance companies to enter each other’s
eliminated restrictions on the scope of business open to those subsidiaries. It has also phased in competition between banks and insurance companies on one hand and securities companies and insurance companies on the other. In 1998, it lifted the ban on holding companies and allowed the first to be established.  

The consolidation of financial services providers in Japan was also aided by amendments to the Commercial Code and other laws that facilitated corporate consolidation and the establishment of holding companies. For example, Japan introduced share exchanges and transfers in 1999 and divisions of companies in 2001, both of which facilitate corporate restructuring.

II. Financial Conglomerates Today

Organizational structures and scopes of business vary substantially by individual financial conglomerate, and they also change over time. Nevertheless, some common distinguishing features allow us to paint a rough picture of financial conglomerates.

1. Organization

The first feature is that financial conglomerates are comprised of a number of different incorporated entities. As mentioned earlier, even in the EU where universal banking is already implemented, financial conglomerates are only allowed to own the insurance sector through separate legal entities. And in many cases, they establish different corporations in each of the countries in which they provide financial services. One of the reasons for this has to do with the regulatory framework for financial services. While efforts aimed at international convergence continue, in reality each country has a different regulatory regime. As a result, conglomerates find it easier to comply if they

30 Unlike Japan, neither Europe nor the U.S. had legal prohibitions on holding companies, and they were used in the formation of financial groups. Similarly, the U.S. also permitted divisions of companies, as did some countries in Europe. For example, France codified it in its 1966 Companies Law.

31 In 1976, the U.S. introduced share exchanges as part of the Model Business Corporation Act, and they were incorporated in the corporate law of most states thereafter. However, it is more common to use a “triangular merger” system than share exchanges in the formation of holding companies because the State of
have separate companies established in each of the countries. One example is capital adequacy ratios, which is one of the most fundamental regulatory tools used. Even in the banking sector, where much progress has been made in international convergence, a significant portion of regulatory discretion is left to individual countries.

A second feature is the common use of holding companies, which gives advantages in terms of management as discussed earlier (Figure 2). In many cases, intermediate holding companies are established to oversee specific regions or sectors. Part of the reason for this has to do with the potential for reduction in management costs in cases where adjacent geographical regions or similar financial services are managed together; in some cases, it also has to do with regulation, accounting standards, and taxation.

Holding companies seem to have been gaining a wider range of functions in recent years. Large bank holding companies in the U.S. provide an illustration. The structure of their balance sheets shows that in the mid-1990s these holding companies focused on using the capital taken in from shareholders to invest in banking subsidiaries. But more recently, they have substantially increased the weight of financial and capital transactions with non-banking subsidiaries, which is an indication that the functions of the holding company itself are changing (Figure 6).

A third feature is that many of the financial conglomerates are led by banks. This probably reflects banks’ increased motivation to enter into other sectors due to decreases in profitability of lending and other traditional banking services. Banks’ relatively broad capital bases and their advantages in financing also explain why bank-led conglomereration is so common.

Banks’ entry into insurance services tends to start with over-the-counter insurance sales. At present, bank involvement in insurance underwriting is very limited, as it has little similarity to banking services and incurs high costs of acquiring expertise. For example, the integration of a bank and an insurance company results in extraordinarily difficult risk management issues.

Delaware, where many companies are legally established, has no provisions for share exchanges.
2. Services

(1) Operations

The operations and services of financial conglomerates are shifting from the traditional focus on sectors (i.e., banking, securities, and insurance) to a new focus on customers, for example, individuals, small businesses, medium-sized enterprises, large firms, and wealthy individuals. In some cases, this takes the form of “operational divisions” targeting specific clienteles: retail (individuals and small businesses), wholesale (large firms), and private banking (wealthy individuals) (Figure 7).

The shift in operations is due to the breakdown of the corresponding relationship between the providers of financial services and their nominal sectors, the consequent decline in the significance of sector-specific operations and internal management, and the creation of customer-oriented marketing channels like one-stop shopping.\(^{32}\)

(2) Services

Individual financial conglomerates tend to offer a somewhat unique range of services reflecting their own histories and management strategies. These differences stem, for example, from whether the conglomerate’s main customer target comprises large firms (wholesale) or individuals (retail), or whether it is domestically or internationally active. The services offered also tend to change over time (Figure 8).\(^{33}\)

Generally speaking, however, the trend is to emphasize retail, and to be internationally active businesses.

European conglomerates are much more prominent in international operations than are their U.S. counterparts.\(^{34}\) This reflects the fact that the leading financial conglomerates

\(^{32}\) Numata (2002).
\(^{33}\) See attachments 5 and 6.
\(^{34}\) However, cross-border M&A within the euro-area banking industry constituted only 10-25 percent of total M&A activity, which compares to around 40 percent for other industrial sectors over the same period, ECB (2004a).
in the U.S. are pursuing domestic integration targeted on their comparatively larger domestic market. As domestic market sizes are relatively limited in Europe, European conglomerates are active not only within the EU, but also in the U.S., where deregulation has progressed in recent years, and even in the countries of Asia and Eastern Europe, where much progress has been made in establishing financial infrastructure and high growth can be expected.

3. Using M&A to Form Financial Conglomerates

The formation and expansion of financial conglomerates has been driven by active M&A, particularly in Europe and the U.S. since the 1990s. For example, the Group of Ten survey shows that in a 13-country group comprised of the G-10 plus Spain and Australia, 1,376 out of a total of 7,304 M&A deals involving financial institutions between 1990 and 1999, which was almost 20 percent of the total, were cross-sector deals. Cross-sector financial consolidation has made marked progress in Europe; during the same period, almost 30 percent (678) of all M&A involving European financial institutions (2,549) were cross-sector in nature.

In Japan, there were 526 M&A deals between 1985 and October 2004 in which banks were involved (of which 74 were for the purpose of reorganization within an existing group). Up until early 1990, M&A primarily took the form of domestic Japanese banks acquiring foreign banks (out of a total of 99 bank-related M&A deals between 1985 and 1990, 75 were for the purchase of foreign firms), but then the number of M&A deals itself experienced a significant fall (with only 85 between 1991 and 1997). With the lifting of the ban on holding companies and enhancements to the corporate legal framework at the end of the 1990s, Japan saw a surge in the number of M&A deals (with 342 between 1998 and October 2004).35

4. Features by Country

(1) The U.S.

The U.S. is in the process of forming financial conglomerates engaged in both banking
and securities businesses. As for the insurance service, conglomerates primarily sell insurance products, and only a very small number of groups actually engage in insurance underwriting. For example, there were 644 holding companies established after the enactment of the GLB Act, but only 30 or so engage in underwriting and the total assets of underwriting subsidiaries is only about 500 billion U.S. dollars (as of November 2004). Under these circumstances, bank-led conglomerates have opted for a strategy of specializing in selling insurance products rather than entering into underwriting. They are both strengthening their over-the-counter sales of insurance products and acquiring insurance agencies. Particularly noteworthy is the active handling of savings-type insurance products, which are highly similar to the traditional products offered by the banking industry and for which demand is growing. More recently, some financial conglomerates have sold the insurance companies that they previously acquired and moved to specialize in over-the-counter sales of insurance products instead.

(2) Europe

In Europe where universal banking, in which banks themselves also provide securities services, has been allowed since 1989, most countries do not place any restrictions on

36 According to the American Bankers Insurance Association (ABIA), 1,351 bank holding companies in the U.S. filed reports of insurance revenue with the Federal Reserve Board (FRB), representing 63 percent of the total (at the end of 2003). Revenue from selling insurance now accounts for an average of 5.7 percent of bank holding companies’ total non-interest income.

However, only 7 percent of the bank holding companies reporting insurance revenue reported earning insurance premium income. The vast majority of insurance-related revenues are estimated to come from sales of insurance products rather than underwriting.

Also note that only a very small number of bank holding companies are engaged in insurance underwriting. According to another study (Michael White’s Bank Holding Company Insurance & Investment Fee Income Report, 2002 Year-End Edition), the top two financial holding companies (MetLife and Citigroup) accounted for 92.6 percent of all insurance underwriting revenues generated by financial holding companies, and the top seven financial holding companies accounted for 98.6 percent (2002). In January 2005, Citigroup agreed to sell its Travelers Life & Annuity arm to MetLife (it had already sold Travelers Property Casualty in 2002). It was also agreed that Citigroup would sell MetLife products for the next ten years. This is yet another example illustrating the shift in favor of over-the-counter sales for insurance operations undertaken by U.S. financial conglomerates.

37 According to the ABIA 2002 survey, of the 447 institutions surveyed, 87 responded that they had acquired an insurance agency within the last few years, and of that number, approximately half said that the acquisition had been made in either 2000 or 2001. It is common practice for banks themselves to handle life insurance and personal annuities, which are similar in nature to banking products, and 92 percent of banks responded that they used the insurance agencies they acquired primarily to sell casualty insurance.
banks and insurance companies holding each other’s shares. Banking and insurance have been integrating throughout Europe ever since the late 1980s (Figure 9). This trend is sometimes referred to as “bancassurance” or “bankassurance,” which are terms that refer to the fusion of banking and insurance, or sometimes as “Allfinanz,” a term that means “comprehensive financial services” (Figure 10). More specifically, the trend in the early 1990s was to form business alliances (sales of insurance products by banks), but later on banks began to establish insurance subsidiaries or acquire existing insurance companies, developing their insurance arms in many different forms according to their business strategy.

Behind the integration of banks and insurance companies in Europe is the fact that the profitability of traditional banking services is declining and banks seek to strengthen their private banking services, which they provide to wealthy individuals, by expanding their line of insurance products.

There have also been some cases of insurance companies acquiring banks. The intention behind this seems to be to use the bank within the group to provide asset management services, including payment services, thereby keeping the insurance money and annuity benefits paid to customers within the group and boosting overall efficiency. As populations age and the society/financial environment begins to change, insurance companies seem to be trying to expand their marketing channels and to strengthen their product lines, just like banks.

As previously noted, the integration of the EU has made it easier to develop business

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38 However, the EU prohibits a single entity, whether bank or insurance company, from engaging in both banking and insurance services.
40 For example, ING provides an Internet banking service called “ING Direct” in many countries, and the low-cost payment services it offers enable it to keep funds within its group.
41 One example is the purchase of the Dresdner Bank in 2001, the third-largest bank in Germany, by the German Allianz insurance group. In its annual report, Allianz said, “[as a result of the purchase of Dresdner Bank] we are poised to capitalize on the enormous opportunities in the growth market for long-term insurance and investment products . . . We have a diversified product portfolio that offers a complete array of solutions for insurance, retirement benefits, asset management and banking needs. Plus we are setting up a multi-channel distribution network that will make us a unique single-source provider of integrated financial services and allow us to address any and all needs that our customers might have.”
across the entire European region, and cross-border mergers have become active as a result.

(3) Japan

Japan first lifted its ban on cross-sector entry in 1993 by allowing banks, trust banks, and securities companies to participate in each other’s sectors via sector-specific subsidiaries. It later allowed life and casualty insurance companies to compete against each other in a similar manner. This was followed by the introduction of financial holding companies and revisions to the corporate law codified in the Commercial Code, causing the major banking groups to lead the formation of holding company-based financial groups. Groups led by large banks have banks, securities companies, and more recently other financial services providers such as consumer finance companies as subsidiaries, but as yet none has an insurance subsidiary.

III. Issues Raised by Financial Conglomeration and Measures Taken to Address Them

1. Overview

Financial conglomeration is expected to bring many benefits in terms of economies of scale and scope.

42 Both Japan and the U.S. use holding company systems, but the historical processes leading up to this differed greatly. Holding companies first appeared in the U.S. in the 19th century as a means of avoiding regulations on interstate banking. Later, holding companies were used as a means to expand operations into areas not traditionally allowed to banks themselves, for example, securities, insurance, and even nonfinancial commercial businesses, such as real estate. Legislators tried to put an end to the use of holding companies as a means of expanding bank operations in 1956 by passing a law on bank holding companies that limited the interstate operations of bank holding companies and required the separation of banking and commerce. However, the initial legislation only covered bank holding companies that owned several banks as subsidiaries, so in the late 1960s large banks began establishing single-bank holding companies with the intention of expanding geographically and extending operations into non-banking areas. In response, the bank holding companies law was amended in 1970 to extend its coverage to single-bank holding companies, and FRB regulations (Regulation Y) clarified the scope of non-banking operations allowed to bank holding companies.

By contrast, Japan banned the establishment of holding companies under its competition policy, but in the 1990s began allowing financial institutions to enter into each other’s sectors under the parent-subsidiary system, which was seen as providing a degree of risk insulation while also maintaining fair terms of competition. It was only later that the ban on holding companies was lifted and Japan
On the other hand, it also raises new issues in terms of the efficiency and stability of the financial system, as conglomeration results in wider and more complex operations and correspondingly vast scales of business.

As discussed earlier, financial conglomerates tend to have their own unique forms and scopes of operation, and they reorganize, integrate, and consolidate their subsidiaries according to their business strategies from time to time. These characteristics make it essential for financial authorities and relevant parties to take account of the diversity and variability of conglomerates when dealing with issues raised by conglomeration.

Some of the issues raised by financial conglomeration and measures taken to address them at the current point in time are reviewed below.

2. Impact on Financial Systems and Markets

(1) Impact on the structure of the financial system

Let us begin by considering the likely impact of financial conglomeration on the structure of the financial system.

First, the conglomeration of major financial services providers may induce conglomeration of other financial services providers as well.

An example comes from the Netherlands, which is one of the most advanced countries in the area of financial conglomeration. The Rabobank Group is a cooperative financial institution that opted on its own to become a large financial conglomerate as part of a business strategy designed to ensure its competitiveness. The group is comprised of a central institution and a large number of subsidiary financial services providers. Together they offer comprehensive financial services via the marketing channels of the individual cooperative financial institutions that hold close ties with local customers.
On the other hand, a financial services provider with limited resources (i.e., capital or customer base) will in many cases opt for a business strategy of specializing in services to a particular geographical region or specializing in providing a specific range of services. Therefore, financial conglomeration may also push other financial services providers toward regional or service specialization.

In other words, financial conglomeration is highly likely to polarize the financial system into gigantic financial groups on one hand and independent financial services providers or smaller-scale groups with regional or service specialties on the other.

(2) Impact on financial market trading

It is not clear what kind of impact an increase in intra-group transactions led by financial conglomeration will have on the overall financial markets. Were it to reduce trading volumes in the markets, market functions, for example, the markets’ ability to discover prices, would likely deteriorate. This is examined in more detail below.

In view of capital transactions, financial conglomeration may have the effect of reducing the scale of transactions on capital markets, or at least of incorporating part of the capital market within the financial conglomerate. Financial conglomerates usually have a core company—in most cases, a holding company—at the top of their structure, with investment relations extending out. Likewise, it is often the case that when a financial conglomerate acquires a company, it uses either a cash transaction or a share exchange to acquire all of the shares in the target. In such cases, the acquired financial institution is delisted from the stock exchange.

Similar points can be made about non-capital financial transactions. For example, an increase in funds transactions within the financial conglomerate may have the effect of reducing trading volumes on the money markets, as the funds do not go through the markets.

Reduction in market size caused by conglomeration may have a potentially detrimental effect on market functions. Generally, financial markets lose the ability to discover
prices effectively when only small numbers of participants exist.

Intra-group transactions should not be over-regulated, as their ability to reduce financing costs is one of the primary attractions of financial conglomeration in the first place. Nonetheless, we must be fully aware that excessively large amounts of intra-group transactions caused by financial conglomeration may undermine market functions.

(3) Issues for competition policy

Competition policy issues, for example, restriction of competition or unfair trading practices, arise within independent financial services providers as well as conglomerates. However, financial conglomeration generally heightens the possibility for restricting competition, as it results in coordinated group activities and expansions in scale.

(a) Excessive concentration of power over multiple markets

When a single financial conglomerate has a high degree of market power over a number of markets in complementary or substitutional relationships, for example, bank loans and bond issues, there is a possibility that it will restrict competition across those markets.43

(b) Excessive concentration of power over corporations

To avoid dominance of finance over commerce, most countries limit the percentage of shares that financial services providers can hold in nonfinancial companies.44 However, even if each financial services provider does not exceed the limit, the possibility for an excessive concentration of power vis-à-vis nonfinancial companies still exists, when individual providers decide to form a financial conglomerate. Capital stakes are not the only issue; a similar risk also exists for the nomination of directors and financial transactions.

(c) Unfair trading practices

43 See Attachment 7 for empirical research on the relationship between market power and prices in the banking sector.
44 For example, in Japan, banks are limited to hold a stake of no more than 5 percent, and insurance companies to no more than 10 percent.
Financial conglomerates may attempt to use their superior position over their clients as the providers of credits in order to coerce them into unfair deals. A typical example is that of “tying arrangements.”\textsuperscript{45}

The above issues fall under the jurisdiction of competition authorities rather than financial authorities. They seem to evaluate the overall balance between the possibility for restricting competition and the expected positive effects, such as the promotion of competition or reduction of prices,\textsuperscript{46,47} rather than imposing broad, uniform bans on potential competition-restricting activities.

Guidelines published by competition authorities are also being utilized. For example, the guidelines to help reduce the uncertainties inherent in management decisions and prevent over-regulation\textsuperscript{48} from counteracting the positive effects by providing examples

\textsuperscript{45} For example, the Citibank, N.A. Japan branch combined solicitations for the acquisition of structured bonds with proposals to lend the funds to acquire the bonds, and indeed made acquisition of the bonds one of the conditions for receiving the loan. This was found to be “the act of handling a private placement as a condition of granting credit” in violation of the Securities and Exchange Law, and FSA took administrative action against the Citibank as a result (“Administrative Actions on Citibank, N.A. Japan Branch,” FSA, September 17, 2004).

\textsuperscript{46} For example, analysts find it to be common practice in the U.S. and EU to permit mergers that result in an increase in market power in price setting as long as prices decline compared to pre-merger levels (Takeda [2003]).

\textsuperscript{47} There has been a great deal of research and analysis, including empirical research, on the impact that greater market power in the financial industry has on market functions. However, these researches have tended to focus on specific sectors only, particularly banking. There has been little research on the significance for competition policy of the emergence of financial conglomerates that span multiple sectors.

\textsuperscript{48} For example, the guidelines formulated and published by the Department of Justice in the U.S. regarding merger reviews. The GLB Act also requires the Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), and other banking regulators to formulate rules to protect insurance customers. These rules include rules on the sale and marketing of insurance products by depository institutions, prohibitions on “tying arrangements” between loans and insurance products, and requirements for physical segregation of the routine acceptance of deposits and insurance product activity (Federal Deposit Insurance Act §47 [a]).

In Japan, the Fair Trade Commission also uses guidelines. In the area of corporate integration reviews, it has published “Guidelines to Application of the Antimonopoly Act Concerning Review of Business Combination,” an overhaul of existing guidelines that was completed in May 2004. Guidelines on unfair trading practices have also been amended and published in conjunction with the expanded scope of operations engaged in by financial institutions. Specifically, the startup of mutual entry by banks and securities companies into each other’s sectors via subsidiaries led to the publication in April 1993 of “Guidelines Concerning Unfair Trade Practices Associated with Mutual Entry By and Between Banks and Securities Companies” and then the lifting of the ban on holding companies, the startup of the over-the-counter sales of insurance and investment trust by banks, the startup of securities intermediation services, and other changes led to a full revision of these guidelines, which was published in December
of illegal activities in relation to excessive concentration of market and corporate dominance or unfair trading practices.

As for regulation of unfair trading practices, the financial authorities also play an important role (“firewalls” between sectors are one example). This is because unfair trading practices may not only restrict competition in the markets where the trading takes place but also increase dominance of finance over commerce. When financial services providers adopt improper advantages for their affiliates, they impair fair competition in nonfinancial markets (see the events leading up to the amendments of Article 106 of the Bank Holding Companies Act of 1970 in the U.S.). Therefore, many stress the importance of appropriate coordination between competition authorities and financial authorities in order to achieve the twin goals of not undermining the positive effects of financial conglomeration while also ensuring adequate competition.

3. Management Issues

An expansion in scale due to financial conglomeration is generally expected to bring economies of scale, for example, by reducing investments in information technology. However, financial conglomeration creates more complexity in terms of management because of the need to administer the group as a whole, including monitoring of the subsidiaries. The larger a conglomerate grows, the less efficient its management becomes in some respects.

2004 as “Guidelines Concerning Unfair Trade Practices Resulting from Relaxation of Sectoral Divisions and Expanded Scopes of Business for Financial Institutions.”
Organisation for Economic Co-operation and Development (1993) calls this phenomenon “dispersion of management control.” As financial conglomerates often consist of a number of group companies, it may be particularly difficult to strike a proper balance between the desirability of a certain measure of centralized control and the need to ensure sufficient autonomy of, and accountability for, the management of the component companies. Dispersion of management control can be counterproductive by opening opportunities for excessive risk-taking by non-regulated affiliates or manipulation of intra-corporate transactions.
50 Theoretically, as the size of a company increases, the greater the number of organizational levels it will have and the higher the volume of information it must deal with, which then increases the “agency costs,” or the costs of monitoring agents to ensure that they act appropriately and in the interests of the party commissioning them (Jensen and Meckling [1976]).
51 This decline in management efficiency is sometimes referred to as an organization being “too big to
Financial conglomeration also has the effect of weakening the monitoring functions by outside shareholders and markets. External monitoring functions are further undermined by the fact that many of the financial services providers that comprise financial conglomerates are non-listed companies, and they are able to raise funds within the conglomerate itself. For example, the companies within financial conglomerates are usually wholly owned subsidiaries of the topmost company, and most of them are non-listed companies. This means that the opinions of outside shareholders are not directly reflected in the management of subsidiaries, nor are subsidiaries subject to direct monitoring by the markets in the form of falling share prices or the potential to become M&A targets.

Under these circumstances, financial conglomerates need to voluntarily enhance their information disclosure, extending it to subsidiary companies in the group, not just the topmost company and the group in general. Given the risk that financial conglomeration can create management inefficiencies, financial conglomerates also need to create measures to strengthen governance that enable them to manage organizations that have become larger and more complex in an appropriate manner.

Management has an even greater role to play in the large, complex organizations of financial conglomerates. It is from this perspective that the Joint Forum argues that the “probity” and “competence” of the top managers at banks, securities companies, and insurance companies in financial conglomerates are an essential factor in achieving

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52 It is not uncommon for financial conglomerates to establish reporting lines for each business section in order to improve management efficiency. For example, common practice is to organize the reporting lines of subsidiaries, foreign offices, foreign subsidiaries, and other front-office sections to the management and control sections in the core company along business lines such as retail, wholesale, and asset management. However, overemphasis on these sectoral reporting lines may undermine the ability to manage and monitor subsidiaries and other front-office sections. The risks from reduced management and monitoring functions are most likely to emerge when the management stance is excessively weighted in the direction of profitability and earnings. One example comes from the administrative actions taken against the Citibank, N.A. Japan Branch by the FSA in September 2004. In its ruling, the FSA said, “The management committee of the Citibank, N.A. Japan Branch (“Japan Branch”) does not have authority to direct and supervise the business operation of various departments at the Japan Branch, and operations are not controlled in an integrated manner. The supervisory system thus exhibits serious flaws.” It also said, as another reason for the administrative punishment, “The Bank Headquarters . . . presses for sales while emphasizing profits and deprecating compliance. However, the top management of the Bank Headquarters is found to be not fulfilling its supervisory responsibility over the business operation of the Japan Branch.”
regulatory objectives. It also emphasizes the need for managers, directors, and major shareholders to pass the “fit and proper tests” set up by authorities.\textsuperscript{53}

4. Risk Management Issues

(1) Changes in the nature of risk

The total risk to which financial conglomerates are exposed is not equal to the arithmetical total of the risk exposure of all the individual financial services providers that comprise it. Indeed, the total can increase or decrease. While financial conglomeration may increase risk exposure due to the increase in risk concentration, it may also diversify and reduce risk as the conglomerate is engaged in a wide range of businesses (Figure 11).

(a) Risk diversification and reduction effects

Financial conglomeration generally involves an expansion in the scope of business, and can therefore diversify risk. For example, conglomeration enables a bank to transfer part of the credit risks to external investors by offering its customers in need of funds a combination of bank loans and bond issuance, rather than just offering bank loans alone.

Conglomeration also enables reduction of risk exposure of the entire group by combining different risks that have negative correlations. An example would be two portfolios that have a negative correlation in their expected returns. By holding both portfolios within the conglomerate, it is possible for the group as a whole to reduce its market risk exposure.\textsuperscript{55}

\textsuperscript{53} Among the “fit and proper tests,” fitness tests usually seek to assess the competence of managers and directors and their capacity to fulfill the responsibilities of their positions while propriety tests seek to assess their integrity and suitability. To determine competence, formal qualifications, previous experience, and track record are some of the elements focused on by supervisors. To assess integrity and suitability, elements considered include criminal records, financial position, civil actions against individuals to pursue personal debts, refusal of admission to, or expulsion from, professional bodies, sanctions applied by regulators of other similar industries, and previous questionable business practices (Joint Forum [1999b]).

\textsuperscript{54} Joint Forum (1999b).

\textsuperscript{55} There have been several studies on the risk diversification and reduction effects of financial conglomeration, but with mixed results.

One study pointed out potential diversification gains from virtually all combinations involving banking
(b) Risk accretion

On the other hand, financial conglomerations also has the potential to increase risks, as discussed below.

a. Concentration of risk

Risk management and control is important for all of the sectors within a financial conglomerate—banking, securities, and insurance. However, within a financial conglomerate, risks borne by individual institutions will interact so that risks associated with individual transactions emerge en masse within the group, causing unusually large losses to be incurred.\textsuperscript{56}

b. Transmission of risk

When a financial services provider within a conglomerate incurs excessive risks, those risks are transmitted to all other members of the conglomerate regardless of whether the provider with which they originated is subject to regulation. This is because the components of a conglomerate are linked by intra-group transactions, brands, and reputation.\textsuperscript{57}

One of the reasons why countries set firewalls between sectors is to mitigate the

\textsuperscript{56} The Joint Forum (1999c) had this to say about risk concentration:

“Losses at the conglomerate level can reflect the aggregate of losses on similar types of exposures across the sectors. These are the types of major losses which large exposure rules have traditionally tried to prevent. Losses cannot only strain overall capital resources, but short-term liquidity may also be impaired if the position is very large relative to market size or market-making capacity. Positions can reach a large size relative to the market, even if the conglomerate adheres to large exposure rules at group level, because of the large capital base of some conglomerates.”

\textsuperscript{57} Joint Forum (1999c).
transmission of risk within financial conglomerates.\textsuperscript{58}

Obviously, the transmission of reputational risk occurs any time an institution loses the confidence of customers or market participants, regardless of whether monetary losses have actually been incurred and transmitted within the group. Reputational risk may also be transmitted when an institution within a financial conglomerate is involved in illegal or illicit activities, or is even rumored to be involved.

Financial conglomeration brings other changes to risk profiles as well, which are described below.

c. Double gearing and excessive leverage
It is common for the components of a financial conglomerate to have mutual capital ties, which makes it important to evaluate the capital adequacy of the group as a whole. There is a risk of overvaluing the capital of the group or its components in cases in which the same capital is used simultaneously as a buffer against risks in two or more entities (double or multiple gearing) and when the funds raised by parent company bond issues are invested in subsidiary companies in the form of equity (excessive leverage). This risk increases as the capital relationships become more complex, for example, when intermediate holding companies are used.

d. Regulatory arbitrage
There are two categories of financial services providers within a financial conglomerate: (1) those that are strictly regulated, such as banks; and (2) those that are loosely regulated or unregulated, such as leasing companies and consumer finance firms. In some cases—consumer finance is an example—either a bank or a non-bank could provide services, but on a nonconsolidated basis, capital costs may be lower if it is the non-bank that acts as the provider since it does not come under capital regulations. Regulators around the world therefore concentrate on supervision on a consolidated basis to avoid

\textsuperscript{58} For example, in the U.S., banks are subject to ceilings on their credit extension to affiliates as follows: (1) no more than 10 percent of the bank’s capital per affiliate, and (2) no more than 20 percent of the bank’s capital in total credit extension to all affiliates. In Europe, the EU directive requires regular reporting to regulators in the event that credit extension to affiliates exceeds 5 percent of the conglomerate’s required capital.
Even among regulated sectors, there may be substantial differences in how risk is measured and capital requirements are imposed. This can lead to yet another form of regulatory arbitrage if risk assets are allocated to sectors within the conglomerate to minimize regulatory restrictions and burdens. Finding appropriate means of addressing this problem was behind the Joint Forum’s call for cooperation among regulators.

(2) Importance of risk measurement and integrated risk management

As financial conglomerations have the effect of both increasing and decreasing risk, measurement of the risk exposure of the group as a whole as well as the exposure of its component financial services providers becomes crucial in maintaining stable operations, optimizing risk/return, and properly allocating “economic capital” to components.

Advances in financial technology have enabled many of the leading financial services providers to use the same concept to quantify different varieties of risk. Many other financial services providers have also begun to quantify risk and to prepare the data they need.

Financial conglomerates have begun to reduce their overall risk by analyzing quantified risk to diversify risks and by combining different risks with negative correlations. They have also begun to review the appropriateness of allocation of capital and resources to their components by comparing quantified risk against revenues (Figure 12).

Banks and other individual financial services providers are also implementing integrated risk management. Integrated risk management is much more significant for financial conglomerates, which are by nature exposed to a wide variety of risks.61,62

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59 For example, Jackson (2002).
60 The capital required to cover unexpected losses generated by risks incurred in the course of business (Bank of Japan [2001a]).
61 The Joint Form studied integrated risk management from this perspective and found that, while there had
Organizational structure for risk management has been changing, and it is becoming increasingly common for financial conglomerates to establish a section responsible for centralized risk management on a group-wide basis (usually given a name such as “Group Risk Management Committee”). The actual functions of this section differ significantly from conglomerate to conglomerate, but they need to be expanded and enhanced in order to provide appropriate management for the group as a whole. It is also desirable for financial conglomerates to evaluate their revenues on a risk-adjusted basis and use those evaluations to formulate and review their management strategies.

Several financial conglomerates have started to publish regularly an outline of their integrated risk management techniques in their annual reports or other investor relations documents. This contributes to the enhancement of disclosure and the advancement of risk management techniques throughout the financial services industry.

(3) Risks related to outsourcing

A growing number of financial services providers are outsourcing functions they have traditionally performed in-house to third parties. While it is not uncommon for the

<table>
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<th>Activities Outsourced (Joint Forum [2005]) (%)</th>
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<tr>
<td>Information Technology</td>
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<td>Administration</td>
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<td>Distribution and logistics</td>
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been great progress in management techniques, there was still room for improvement. This is particularly the case with risk in the insurance sector, which differs from the risks in the banking and securities sectors and is extremely difficult to incorporate into integrated risk management. One of the reasons the Basel Accord deducts the entire amount of investments in insurance subsidiaries from bank capital is because it recognizes these differences in risk.

One example of integrated risk management that incorporates insurance sector risks can be found in Henrard and Olieslagers (2004). The authors are risk management executives of the Fortis Financial Group (FFG), a Belgian financial conglomerate that owns an insurance component, and the paper provides an overview of the integrated risk management system that the group uses. The authors emphasize the importance to risk management of knowledge sharing and communication efforts between the banking and insurance components and on the technical side argue that a common risk measurement framework (i.e., specification of a common time horizon, and confidence interval) needs to be established at the group level.

62 See Attachment 8 for the findings of the Joint Forum survey of integrated risk management at financial institutions.

63 In the U.S., “shadow” service providers have appeared to undertake back-office processing for smaller financial institutions that find it hard to enjoy economies of scale or the benefits of computerization. This is yet another example of outsourcing. The functions that are most commonly outsourced are check processing in banks’ deposit-taking, processing in credit cards, clearing services in securities, account management in asset management, and policy management in insurance (Numata [2002]).

64 Activities Outsourced (Joint Forum [2005]) (%)
services provider to be an affiliate within the conglomerate itself, many are also outside companies, for example, IT firms.

Outsourcing has several advantages. It reduces costs, allows institutions to take advantage of outside expertise, and transfers operational and related risks to unrelated parties. On the other hand, outsourcing makes it difficult to capture and manage related risks and increases legal risks in conjunction with the signing of contracts with the service provider.

To address these issues, the Bank of Japan published a sound practices paper on risk management related to outsourcing in April 2001. Somewhat later, the Joint Forum published “Outsourcing in Financial Services,” which contains a set of principles to be applied in conjunction with outsourcing. Basic principles such as these should be adhered to even when work is outsourced to companies within the same financial conglomerate.

5. Accounting, Taxation, and Disclosure Issues

(1) Accounting

To capture the financial condition of the entire conglomerate, one should be aware that each sector has its own unique accounting practices. For example, in insurance companies, liability reserves account for a large proportion of liabilities. These are “reserves” that are calculated under certain assumptions to ensure sufficient funds to pay future claims, and they differ from liabilities of other sectors such as bank deposits or CP.

<table>
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<th>Sector</th>
<th>Percentage</th>
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<tr>
<td>Finance</td>
<td>20</td>
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<tr>
<td>Human resources</td>
<td>19</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>18</td>
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<tr>
<td>Call centers</td>
<td>15</td>
</tr>
<tr>
<td>Sales/marketing</td>
<td>13</td>
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<tr>
<td>Real estate/facilities management</td>
<td>11</td>
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<tr>
<td>Transportation</td>
<td>9</td>
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Note: Figures are percentage shares in total respondents (based on responses to a survey conducted by the Outsourcing Institute).

Accounting practices differ from country to country as they reflect commercial law, tax codes, other legal systems, and business practices. Because of this, there can be differences in accounting treatment depending on the country in which a conglomerate’s financial transactions are posted.\(^{67}\)

Economic globalization has inspired efforts at converging financial accounting standards internationally.\(^{68}\) However, the convergence process is far from complete.

One particularly important issue is to improve the way that accounting systems deal with corporate reorganization, including financial conglomeration. For example, Japan refocused toward consolidated accounting in 2000 and in 2003 amended its Commercial Code to enhance accounting standards for corporate integration.\(^{69}\)

(2) Taxation

The priority with regard to taxation is to develop a tax system that allows flexible corporate reorganization including conglomeration, while also preventing improper tax...

\(^{67}\) An example is derecognition of financial assets. In the words of the Ministry of Economy, Trade and Industry (2004): “According to Japanese accounting standards, financial assets are derecognized when control over contractual rights is transferred. Like U.S. accounting standards, this transfer of control requires complete separation from the risk of bankruptcy, etc., of the transferee. By contrast, the International Financial Reporting Standards (IFRS) consider whether substantially all risks and rewards of the financial asset are transferred or, if that judgment is not possible, whether there is control and continuing involvement, no legal isolation is required.”

\(^{68}\) Regarding the international convergence of accounting standards, in 2002 the Financial Accounting Standards Board (FASB) of the U.S. and the International Accounting Standards Board (IASB), reorganized in 2001 from the International Accounting Standards Committee (IASC), agreed to work toward an international convergence of financial accounting standards (the “Norwalk Agreement”). Similarly, in January 2005 the Accounting Standards Board of Japan (ASBJ) and the IASB also agreed to work toward convergence. Meanwhile, the EU has expressed its intention to limit financial accounting standards within the region to the International Financial Reporting Standards (IFRS) formulated by the IASB or to equivalent standards, beginning in 2005 (with application to non-EU companies delayed until 2007). During this period, and particularly since 1998, Japan has been reviewing and enhancing many of its accounting rules in light of the IFRS and U.S. accounting standards; for example, scope of consolidation, tax-effect accounting, retirement benefit accounting, financial instrument accounting, and impairment (of assets) accounting (this is known in Japan as the “Accounting Big Bang”).

\(^{69}\) For M&A accounting, Japan allows both the “pooling of interests method” and the “purchase method,” but there is a strong tendency to utilize the former method, which values assets and liabilities at book value, in part because it makes it possible to preserve unrealized profits. In 2003, the Corporate Accounting Council of Japan published accounting standards for business combinations, which in principle require the application of the “purchase method,” which values assets and liabilities at market values. The Accounting Standards Board of Japan is now in the process of formulating application guidelines for the corporate integration accounting standards and business division accounting standards.
avoidance. Japan has made amendments to its tax system in recent years, including the introduction of a new tax system relating to corporate restructuring in 2001 and a consolidated taxation system in 2002, and these developments have to some extent facilitated corporate reorganization. In addition, measures in the tax code to promote international investment exchange are expected to give further impetus to corporate globalization.

(3) Importance of disclosure

Sufficient and timely disclosure of information improves market disciplines and contributes to the sound management of the financial services provider itself. Financial conglomerates tend to have complex organizational structures and use management and control lines that differ from traditional sectoral classifications. For example, the companies within financial conglomerates are usually not listed and therefore are not subject to the same disclosure obligations as are listed companies.

Under these circumstances, financial conglomerates need to enhance their voluntary disclosure. For example, many have noted the need to enhance component-by-component disclosure (e.g., wholesale and retail) as the breadth of a financial conglomerate’s services expands.

In addition, financial conglomerates with complex capital structures need to disclose, as clearly as possible, the investment relationships within their group in order to provide a clear indication of the path by which risk is transmitted and avoid the possibility of excessive leverage or double gearing, as they rarely disclose, for example, tree

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70 The U.S. and France also have consolidated taxation systems, but require lower equity percentages in consolidated subsidiaries than Japan. The percentages are as follows: Japan requires 100 percent, the U.S. requires 80+ percent, and France requires 95+ percent. The Japanese Bankers Association is currently seeking a relaxation of restriction on the use of carried-forward losses when consolidated taxation is adopted (“JBA Requests for Fiscal 2005 Tax Reform,” published in September 2004).

71 There are cases in which tax treaties waive taxes withheld at source on dividends paid between parent companies and subsidiaries as long as the equity stake is above a certain level (see the U.S.-Japan Tax Treaty of March 2004).

72 The Joint Forum (1999c) acknowledges that it only studied a small sample of risk concentration disclosure, but advises that “disclosures of risk concentrations are minimal and could be considerably enhanced.” The Joint Forum uses the market turmoil of 1998 to point out that “prompt, detailed information on particular exposures disclosed by some conglomerates outside of the normal financial reporting cycle and in response to market concerns were widely seen as effective and constructive.”
diagrams indicating investment relationships within the group in their annual reports.

6. Privacy Concerns

For financial conglomerates, sharing customer information within the group is an important element in achieving economies of scope by providing, for example, “one-stop shopping.” This is sometimes referred to as “information capital.” However, there is also the risk of unauthorized disclosure of the customer’s personal information and invasions of privacy as more information is shared among financial services providers. The impact of unauthorized disclosure is particularly large because financial services providers hold a wide range of very important personal data, not the least of which is credit information.\(^\text{73}\) The major industrial countries therefore impose certain restrictions on the sharing of information between financial services providers and third parties, attempting to strike a balance between the need to share information within a financial group and requirements to maintain privacy.

(1) The U.S.

In the U.S., a comprehensive privacy protection law does not exist. Instead, individual laws for specific areas and types of information have been formulated as necessary. In other words, the legal framework for the U.S. privacy law is “segmented.”

The handling of personal information by financial institutions\(^\text{74}\) is governed by the GLB Act of 1999, which contains an independent chapter on “privacy.”\(^\text{75}\) The law

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\(^{73}\) Misuse of the information could result in crimes such as impersonating someone to receive a credit card in his or her name.

\(^{74}\) Defined as all companies engaged in financial services (“financial services in nature” pursuant to article 4(k) of the Bank Holding Companies Act).

\(^{75}\) The GLB Act prohibits financial institutions from disclosing nonpublic personal information to nonaffiliated parties* unless (GLB Act §502 [b] [1]):

1. Such financial institution clearly discloses to the consumer that such information may be disclosed to such third party.
2. The consumer is given the opportunity to direct that such information not be disclosed to such third party (“opt-out” rights**).
3. The consumer is given an explanation of how the consumer can exercise that nondisclosure option.

* Note that a “nonaffiliated party” in the act refers to “any entity that is not an affiliate of, or related by common ownership or affiliated by corporate control with, the financial institution” (GLB Act§509 [5]).

** The rules for sharing personal information with third parties provide for two ways for the customer to express consent: “opt-in” and “opt-out.” Under the former, information cannot be provided to third
authorizes the Federal Reserve Board (FRB) and other federal regulators to formulate regulations that embody its principles.

It should be noted however that in the GLB Act’s provisions on protection of customer privacy: (1) the financial institutions are allowed to share information with affiliated companies; and (2) in principle they are allowed to share information with nonaffiliated companies as well (this is prohibited only when the customer “opts out” of information sharing).  
(2) Europe

In 1995, the “Directive 95/46/EC on the protection of individuals with regard to the processing of personal data and on the free movement of such data” (referred to in this paper as the “EU privacy directive”) was passed. The directive stipulates comprehensive privacy protection rules for both the private and public sectors (and is therefore referred to as an “omnibus” approach in contrast to the “segmented” approach of the U.S.).

The EU privacy directive stipulates the basic rules for the processing of information, including its dissemination. Under the directive, personal data can be processed only with the consent of the individual (and this is therefore an “opt-in” system).

76 The state laws of Alaska, Connecticut, New Mexico, North Dakota, and Vermont provide for more stringent protection of personal information than does the GLB Act. These states only allow personal information to be shared with third parties, including affiliated companies, when the customer gives prior consent (“opt-in”).

77 The full name is “Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.”

78 EU-member countries establish their own domestic laws based on the EU Personal Data Protection Directive.
(3) Japan

In 1988, the “Act for Protection of Computer Processed Personal Data held by Administrative Organs,” which covered only government institutions, was passed. Rules for the private sector were left up to the self-governing bylaws of individual industries. However, the growing sophistication and widespread use of information technology brought protection of personal information to the fore as an important policy challenge. This led to the first codification of rules governing the handling of personal information by the private sector, i.e., the Law concerning the Protection of Personal Information (Personal Information Protection Law).

The Personal Information Protection Law requires companies of a certain size or larger to obtain the prior consent of individuals (“opt-in”) when providing personal information to third parties. It also defines three exceptional situations in which prior consent is not required.

The U.K. passed its Data Protection Act in 1998, which took effect in March 2000. In accordance with the law, six finance industry associations, including the British Bankers’ Association, Association of British Insurers, Finance and Leasing Association, Council of Mortgage Lenders, and Association of Unit Trust and Investment Fund, jointly published “Data Protection Guidance: A Practitioner’s Handbook,” which clarifies the practical responses required of financial institutions. The handbook attempts to be comprehensive in its coverage of the possibilities, including the use of information for credit transfers, direct mail, and marketing, advising institutions that they need to obtain explicit prior consent from parties.

Germany amended its Federal Data Protection Act in 2001 to incorporate the EU privacy directive into domestic legislation.

The law in principle requires the written consent of the person covered in data in order to use personal data (including transfers) other than in exceptional circumstances defined in the law. With regard to cross-selling, which is the major purpose for which customer information would be shared within a financial group, the act provides an exception to the consent principle for use for marketing, but the scope of the data is limited to the party’s name, address, profession, and similar information (Federal Data Protection Act Section 28 (3) 3). Even for personal information that the Federal Data Protection Act allows to be shared, bank transaction contracts define all “facts and evaluations regarding the customer” as being subject to bank confidentiality and require consent of the customer prior to disclosure.

According to French Monetary and Financial Code, information concerning customers is regarded as professional secrets, and banks are not allowed to share it with third parties, including members of the same group, without an explicit expression of intent to permit information sharing on the part of the customer (Monetary and Financial Code, L511-33). However, it does obligate the sharing of confidential information within the group in order to prevent money laundering and to capture the financial situation of the group on a consolidated basis.

For financial institutions, the Center for Financial Industry Information Systems formulated “Guidelines for the Protection of Personal Data for Financial Institutions” in 1987.

This law was promulgated on May 30, 2003 and took effect the same day. However, the provisions for obligations of private companies handling personal information did not take effect until April 1, 2005.

The three cases in which personal information can be provided to third parties without requiring the prior consent are:

1. For the purpose of cross-selling.
2. For the purpose of providing services related to the account.
3. For the purpose of conducting market research.

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What is important about the law in relation to financial conglomeration is that it allows the provision of personal data to “joint users” within a set scope, in order to provide for information sharing mainly within a group. In short, the law allows personal data such as items to be jointly used with other designated parties as long as the person is given prior notice or this information must be in a state allowing the individual to easily learn it. However, the guidelines on the protection of personal information in the financial sphere formulated by the FSA states that it is advisable to individually list the scope of “joint users,” and if only a summary statement is provided, institutions are obligated to provide specific identification using a method easily understood by the individual.

IV. Regulatory Issues

1. Basic Concepts

(1) Policy responses

Financial conglomeration is one option for financial services providers to expand types of businesses and areas of operation. It is indeed important for financial authorities to appropriately widen options available to financial services providers in their business strategies, and such options are not just limited to financial conglomeration. At the same time, the authorities should be aware that financial conglomeration has raised various new issues as already described in the previous chapter. From this perspective, financial authorities need to consider the following points when dealing with financial conglomeration.

82 A “state in which the individual can easily learn it” refers to a state in which a person, if he or she wished to learn this information, could easily learn it in terms of both time and methods. Guidelines on the protection of personal information in the financial sphere states, “This requires ongoing publication using methods appropriate to the business sector, for example, methods appropriate to the marketing methods for the financial products being sold. This could conceivably include such things as attaching a permanent notice to teller windows, etc., in an office or placing information permanently on an Internet web site.”

83 Like the provisions for obligations of private companies handling personal information in the Personal Information Protection Law, these guidelines did not take effect until April 1, 2005.

84 For example, “the company and its subsidiaries as listed in the financial report, etc.” or “the company and
First, possible negative effects arising from financial conglomeration must be avoided by policy measures. In doing so, the authorities need to be aware that imposing across-the-board transaction restrictions to avoid the negative effects such as conflicts of interest or restriction of competition may not be a good regulatory option. This is because the positive aspects of conglomeration may be offset by imposing such restrictions as needed to cover a broad range of transactions considering the diversity of financial conglomerates.

Instead, financial authorities are encouraged to use other policy frameworks to achieve the above objective. In addition to the dialogue between financial services providers and financial authorities advocated in the new capital accord known as Basel II, incentive-based mechanisms are needed, such as the one adopted in the GLB Act that offers a wider scope of business and more relaxed sectoral walls to financial services providers which have high capital adequacy ratios. There will also need to be guidelines that help reduce uncertainties in interpreting the competition policy.

Second, financial authorities must maintain the principle of separation of banking and commerce in order to promote the sound development of the financial system. In practice, various rules based on this principle are established in the major industrial countries. For example, major bank shareholders are required to give financial authorities prior notice of their intent to acquire shares and to receive permission. Nonfinancial companies that acquire banks as subsidiaries are deemed to be bank holding companies and may be subject to bank supervision. On the other hand, many countries restrict the scope of business and the ownership (e.g., ratios and amounts of holdings) of companies that can be owned by banks and bank holding companies, because a bank controlling or owning a subsidiary involved in nonfinancial activities is considered inappropriate.

The separation of banking and commerce is a principle that has been given great credence both historically and internationally. Maintaining this principle is
important in the policy response to financial conglomereration, as it will help to ensure the fairness of funds allocations and the effectiveness of supervision and monitoring while also preventing safety net spillover.

Third, financial authorities must prevent the emergence of systemic risks. While it is important to make regulatory efforts to maximize positive effects of financial conglomereration, a higher priority should be placed on preventing the emergence of systemic risks. It must be noted that there is a potential to seriously affect not only a country’s economy but also the world economy in the event that systemic risks emerge from a large, global financial conglomerate.

(2) Preventing the emergence of systemic risks

Let us elaborate the third point made above, which is the relationship between financial conglomerates and systemic risks.

Compared to the traditional financial system, which comprises a large number of relatively small-scale financial services providers each engaged in a single sector, potential systemic risks increase in financial systems where financial conglomereration has progressed. In addition, the speed with which risks are transmitted within a financial conglomerate will increase, and the paths of transmission will become more complex, rendering it more difficult to respond. These points are reviewed below.

(1) Factors such as complex governance structures increase the costs required to monitor the overall status of a financial conglomerate that also increase the risk that both the financial services provider and the authorities may overlook problems.

(2) Financial conglomerates are normally participants in a wide range of financial transactions and markets, so a deterioration of management in even a single financial conglomerate may immediately affect the entire financial system.

(3) In most cases, financial conglomerates are enormous in size, giving them larger market shares in each of their business areas. The deterioration of a conglomerate’s management therefore exerts a strong impact on the overall financial system.

(4) The wider the range of domestic and international regulators and safety net operators

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85 For example, Corrigan (1986). Also, see Attachment 9.
involved, the greater the coordination costs required to determine how regulators will respond when a financial conglomerate’s management deteriorates.

Given the above, the most important challenge for financial conglomerates themselves is to make their own efforts to ensure sound management, including securing an adequate level of capital. It is also important that they are subject to a wide range of checks from the markets where information and opinions from various sources are gathered.

The domestic and foreign financial authorities need to make changes in the way they conduct day-to-day monitoring. They need to develop closer mutual coordination, so that they can respond not only during normal times but also when a conglomerate’s management deteriorates significantly.

For central banks, which are responsible for maintaining the stability of the payment systems, it will be extremely important to accurately understand the flow of funds both inside and outside conglomerates. The banking division of a conglomerate will generally be at the core of the payment systems, and therefore deserves particular attention from the perspective of preventing and avoiding the emergence of systemic risks. With these basic perspectives in mind, a more detailed review of the responses commonly made by financial authorities will be discussed below.

2. Coordinating Regulatory Functions with Other Financial Authorities

Each financial authority has its own functions based on respective regulatory objectives. For example, the primary regulatory objective of central banks and banking regulators is to maintain financial system stability; that of securities regulators is to maintain fairness, transparency, and efficiency of markets and to protect investors; and that of insurance regulators is to protect policyholders (Figure 13).86

However, it has become more difficult for regulatory bodies to respond individually to

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many new issues that can be produced by financial conglomeration, for example, increasing complexity and concentration of risk, transmission of risk, regulatory arbitrage through transfer of risk, and erosion of capital positions by double gearing. Indeed, it is quite easy for them to overlook these issues, and very hard for them to respond appropriately. Further exacerbating the problem is the fact that a financial conglomerate can have banks, securities companies, insurance companies, and other financial services providers that are subject to regulatory oversight, and consumer finance and similar companies that are not subject to oversight or subject to only very limited oversight.

Traditionally, financial services have been delivered in neatly segmented sectors, which are banking, securities, and insurance. But the significance of regulation based on traditional sectoral classifications is becoming increasingly blurred due to the emergence in recent years of financial derivatives and other technical innovations and also due to the progress that has been made in deregulation.  

Given this situation, banking, securities, and insurance regulators now have a common understanding that they should appropriately regulate financial services providers over which they have direct jurisdiction, including their parent companies and subsidiaries, and also closely coordinate their regulatory functions with each other.

This approach attempts to effectively supervise financial conglomerates while also retaining the advantages of sectoral supervision, for example, the ability of financial authorities to focus on comparatively limited areas, make effective use of their resources, and maintain their specialization. This is a practical approach in view of maintaining consistency with the regulatory regime for financial services providers that are not part of financial conglomerates. Sector-based regulation is retained, but coordination among sectoral regulators helps to overcome its deficiencies by, for example, preventing regulatory arbitrage. Financial authorities often sign memorandums of understanding (MOUs) when they coordinate their regulatory functions, but even when MOUs are not signed, it is common for financial

87 See Attachment 10.
authorities to take realistic steps to achieve their regulatory objectives.\textsuperscript{88}

The GLB Act of the U.S. and the EU Financial Conglomerates Directive provide examples of this coordinated approach being codified into law.\textsuperscript{89,90}

3. Changes in Regulatory Techniques

Regulatory techniques used with financial services providers have experienced major changes recently, much of them inspired by financial conglomerations.

(1) Evaluating risks of a financial conglomerate as a whole

Banking, securities, and insurance regulators are very much aware of the importance of evaluating the overall risk exposure of financial conglomerates, because conglomerations change the nature of those risks. Concentration, dispersion, and reduction of risks within a conglomerate change the risk exposure of the group as a whole, while risks themselves are becoming more complex and taking different transmission paths. The GLB Act of the U.S. and the EU Financial Conglomerates Directive provide the primary regulators with a legal mandate to evaluate the total risk exposure of a financial conglomerate as a group and to check its risk management framework. The U.S. and the EU also require financial conglomerates to enhance their group-wide regulatory capital.

Integrated risk management throughout a financial conglomerate is important not only from the perspective of allocating economic capital, but also from the perspectives of maintaining cash flow and legal compliance. In some cases, integrated management

\textsuperscript{88} Joint Forum (2003).
\textsuperscript{89} In Japan, the FSA announced that it would take the following steps in its “Program for Further Financial Reform” released in December 2004.

• Study toward financial legislation for financial conglomerates.
• Establish a system addressing the inspection and supervision of financial conglomerates and the treatment of cross-sectoral problems.
• Ensure appropriate regulation, inspection, and supervision of international financial conglomerates.
• Strengthen cooperation with overseas supervisory authorities.

In Japan, regulations cover different scopes by sector. One example is the scope of business allowed to subsidiaries. Bank holding companies are only allowed to hold subsidiaries within a predefined scope, while insurance holding companies can hold a broader range of subsidiaries as long as they are approved by the FSA.
will be required not only for risks, but also for revenues and personnel. It is not, however, clear in which subsidiary within a financial conglomerate to place divisions responsible for integrated management, and the decision on where to locate these units will differ according to the circumstances of the group. For example, a group may wish to locate its cash flow management unit in its banking subsidiary rather than the topmost company in the capital relationship, because it is the bank that handles large funds transactions on a day-to-day basis.

Once integrated management units are established within a conglomerate, it becomes easier and more effective for central banks and regulators to monitor the overall financial conglomerate, because they are able to communicate with its management units.

(2) Formulation of cross-sectoral rules
Some activities of financial conglomerates are sector-oriented toward banking, securities, insurance, etc., and others are cross-sectoral in nature. The highly cross-sectoral activities of financial conglomerates require the formulation of similarly cross-sectoral rules for financial services providers, which helps simplify the rules and makes them more practical. For instance, uniform rules could be easily introduced in areas such as solicitation, advertising, and disclosure in relation to financial services marketing.\(^{91}\)

(3) Advancing regulatory techniques
Financial authorities around the world have been actively trying to advance regulatory techniques over the past several years. While these efforts are not unique in

\(^{90}\) See attachments 11 and 12.

\(^{91}\) In 1986, the U.K. passed the Financial Services Act, which provides a comprehensive set of rules governing everything from investor protection to regulation and oversight. In 2000, the Financial Services and Markets Act expanded it to include deposits and some insurance products. This law provides for the integration of investment, insurance, and banking supervision, the formulation of uniform regulations and the centralization of self-governing bodies into the Financial Services Authority. Japan, for its part, passed the Law on Sales of Financial Products in 2000 to provide cross-cutting customer protection rules, including the accountability of financial product providers for almost all financial products, deposits and insurance among them. Legislators are now discussing the formulation of an investment services law, which would substantially amend the current Securities and Exchange Law and extend its coverage to all financial
addressing the issues raised by financial conglomeration, they are an extremely important component of the regulatory response to conglomeration.

(a) Risk-sensitive capital adequacy ratios
Financial authorities are currently making efforts to formulate more risk-sensitive standards for capital adequacy ratios. Examples would include Basel II, which is being prepared by the Basel Committee in the area of banking regulation, and the Solvency II Project, which is being prepared by the EU in the area of insurance. Both have the improvement of the risk sensitivity of capital adequacy regimes as one of their objectives.

(b) Incentives for financial institutions
Financial authorities are strengthening efforts on the side of financial institutions to improve their risk management systems. For example, Basel II allows banks to use internal models to calculate capital for regulatory purposes, which gives them a strong incentive to voluntarily improve their risk management technology.

(c) Market disciplines
Market disciplines have been given more emphasis in regulations in recent years. For example, markets reduce risk premiums for sound financial services providers that practice appropriate risk management, allowing them to raise capital and funds at lower costs, while the opposite occurs for institutions whose risk management is deemed inadequate. Basel II also lists use of market disciplines as one of its “three pillars.” Market disciplines have many advantages from the perspective of preventing both financial services providers and financial authorities from overlooking management problems.

The effective use of market disciplines, however, will require sufficient disclosure of information from financial services providers, part of which will be voluntary.

(d) Emphasis on verifying risk management systems
In view of the growing importance of risk management in financial markets and services and the extremely complex and technical nature of the processes involved, the authorities are starting to place emphasis on verifying the systems used by financial services providers to manage their risks.

4. Banking Regulations and Supervision

Banks are prominent sources of systemic risk for two reasons. Their liabilities are used as means of payment, i.e., money, and they are at the center of the payments system, which is one of the most important parts of the economic infrastructure. Because of this, banks have been subject to stricter regulations and supervision, and also provided with more extensive safety nets as discussed below than other financial services providers such as securities companies and insurance companies.

(1) Regulations on capital adequacy ratios

Regulations on capital adequacy provide a tool to measure the adequacy of a financial institution’s capital relative to its risk exposure. They are seen as an important regulatory tool in all of the primary sectors: banking, securities, and insurance (Figure 14).

Only the regulations on bank capital adequacy, however, are subject to the uniform international standards known as the Basel Accord, under which member countries are required to impose standards at least as strict as or stricter than the uniform standards on all banks that are internationally active. There were several reasons why banking became the first sector to have uniform international standards on capital adequacy. A part of the impetus came from demands to ensure the fairness of international competition, and another from the risk that insolvency in internationally active banks could easily spread through financial markets and payment systems affecting other countries. Consolidated capital adequacy requirements have also been applied because of the potential for negative impact on bank assets through the transmission of risk within a group.

92 See Attachment 13 for further information on how capital adequacy regulations apply to investments by holding companies or banks in other financial services providers.
By contrast, regulators in member countries of International Organization of Securities Commissions (IOSCO) in the securities sector and International Association of Insurance Supervisors (IAIS) in the insurance sector are expected to enforce capital adequacy regulations, but there are no uniform international standards like those in the Basel Accord. Particularly in the insurance sector, it is pointed out that there are large differences in insurance accounting by legal jurisdiction, and this has made implementation of uniform international standards difficult.

(2) “Source of strength doctrine”

The U.S. “source of strength doctrine” is an important exceptional provision stipulated particularly for the banking sector in response to the emergence of conglomerates and other financial groups. This doctrine states that bank holding companies must serve as a source of financial and managerial strength to their subsidiary banks.\(^{93}\)

The doctrine contributes to (1) ensuring the soundness of banks, which have special functions in the sense that they provide payment services using their own liabilities; and (2) acting to avert the possibility of safety net spillover or an increase in burdens.

(a) Cross-guarantee provisions regarding sister banks and subsidiary banks

The Federal Deposit Insurance Corporation (FDIC) can hold solvent banks affiliated with a failing bank (sister banks under the same holding company and subsidiary banks) liable for the losses associated with the failure.\(^{94}\)

(b) Guarantees required of bank holding companies

When a bank’s capital falls below the required ratio, the prompt corrective measures require the bank to submit a capital restoration plan within a certain period of time, and its holding company to provide guarantees that the subsidiary bank will comply with the plan.\(^{95}\)

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\(^{93}\) [Code of Federal Regulations](CFR)§225.4 (a) (1).

\(^{94}\) Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

\(^{95}\) Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).
This doctrine has been criticized not only for its abstractness, but also for the following concerns: whether holding companies should bear liabilities in excess of their investments against the principle of limited liability for shareholders; and whether creditors of subsidiary banks and of holding companies are treated against the principle of equal treatment of creditors. As a result, recent legislation has attempted to address these concerns.  

Japanese laws require bank holding companies to ensure the sound and appropriate management of their banking subsidiaries. To this end, regulators may require bank holding companies to take necessary measures, including the submission of management improvement plans for their banking subsidiaries.

By contrast, Europe does not have any regulatory provisions requiring companies within a financial conglomerate to provide support to banks within the same group. However, there is a common awareness that bank shareholders may be required to bear burdens when doing so will help ensure the soundness of bank operations.

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96 This doctrine is also used in the GLB Act. It should be noted that the decision of a functional regulator is respected when the FRB asks financial institutions under the jurisdiction of Securities and Exchange Commission (SEC), state insurance regulators, or other functional regulators to provide support to subsidiary depository institutions. While the FRB, as the umbrella supervisor for financial holding companies, has the power to order a holding company and its affiliated companies to provide support for a subsidiary bank, the SEC or state insurance regulators have a veto power if affiliated companies of such holding company are under their jurisdiction (Bank Holding Company Act § 5 [g]).

97 Under the GLB Act, the FRB is required to make full use of inspections and supervisory information of functional regulators for the individual institutions under a financial holding company. However, the GLB Act allows the FRB to impose regulations, operational restrictions, and other measures directly on a functionally regulated subsidiary financial services provider, when the action is necessary to prevent an unsafe or unsound practice by a subsidiary that poses a material risk to the financial safety, soundness, or stability of an affiliated depository institution or the domestic or international payment system. From a similar perspective, the GLB Act allows the FRB, OCC, and FDIC to impose certain restrictions and conditions on transactions between depository institutions and their affiliated companies when deemed necessary to avoid any significant risk to the safety and soundness of insured depository institutions or deposit insurance fund.

98 See articles 52-21 and 52-33 of the Banking Law of Japan.

99 For example, in France, when it appears that the situation of a credit institution warrants it, the Governor of Banque de France can invite the shareholders or members to provide it with the support that it requires after seeking the opinion of the Banking Commission (Article 511-42 of the Monetary and Financial Code). Should a bank’s capital adequacy ratio not meet standards, the holding company that owns its shares can be fined an amount up to the capital requirement (Article 613-32). The U.K. and Germany sometimes require parent companies and other bank shareholders to prepare “comfort letters” indicating their intention to provide the bank with assistance.
5. Safety Nets

Many countries have safety nets to protect customers of troubled or failed financial services providers, and thereby prevent any adverse spillover effects to the extent possible. General practice is to establish separate safety nets for each major sector, i.e., banking, securities, and insurance, and the purposes of safety nets will differ accordingly.

In all countries, deposit insurance systems offer far more generous protection than safety nets for other sectors (Figure 15). This reflects the importance of both protecting depositors and preventing the emergence of systemic risk.

One of the most common and important issues concerning safety nets that arises with financial conglomerations is the so-called “safety net spillover,” the potential for the safety net for one sector to incur burdens that go beyond its defined scope of coverage.

The potential for safety net spillover will, of course, differ according to the nature of each conglomerate.

(1) The combination of operations

The potential for safety net spillover will differ according to the types of businesses operated by a financial conglomerate. The banking sector has the most generous safety net provisions, so there is a higher potential for safety net spillover among financial conglomerates that have banking units than among those that do not, for example, a conglomerate comprised only of securities and insurance units.\(^\text{100}\)

(2) The structure of financial conglomerates

The potential for safety net spillover also depends on the structure of a financial conglomerate—whether it has a holding company or a parent-subsidiary structure. For example, holding companies generally have less potential for safety net spillover than a parent-subsidiary structure in which a parent bank owns a non-banking subsidiary.

\(^{100}\) Berger, Demsetz, and Strahan (1999).
(3) The degree of regulation through firewalls and “source of strength doctrine”

The potential for safety net spillover also varies according to the scope and strength of the firewalls between sectors. The “source of strength doctrine” described above focuses on the payment services offered by banks, but it also attempts to prevent safety net spillover and mitigate burdens.

By contrast, if a company within a financial group is on the verge of bankruptcy, there is a strong incentive for the group as a whole to avoid the consequent decline in reputation, and some point out that firewalls will not be able to effectively prevent safety net spillover in these situations.\textsuperscript{101}

How to avoid safety net spillover is a difficult problem. In a marginal sense, firewalls may not always provide an effective means of protection when a company inside a group is in danger. However, we should not conclude that firewalls are useless or, conversely, that they should be raised to extremely high levels.

The most realistic policy framework for the prevention of safety net spillover will be a combination of preventive measures such as firewalls with careful monitoring by the regulators of internal transactions in view of the diversity of the financial conglomerate, and enhanced disclosure to improve discipline.

V. Actions Taken by the Bank of Japan

In recent years, Japanese banks have been making substantial progress in dealing with nonperforming loans and excessive stock holdings. Along with this progress, the capital restrictions on banks from credit risks and market risks arising from stock price fluctuations are gradually declining, laying the groundwork for more forward-looking business activities. Deregulation has been moving forward as well, as can be seen

\textsuperscript{101} See Wilmarth (2002a). To protect the deposit insurance system from the cost of “too big to fail” rescues, the author proposes creation of a two-tiered structure of bank regulation and deposit insurance. The first tier would consist of “traditional” banking organizations that limit their activities to accepting insured deposits and incur restrictions on asset investments, serving as a kind of “narrow bank.”
from the lifting of the ban on securities intermediation services.

Meanwhile, Japanese banks are facing increasingly important challenges of improving their profitability. Given that one of the aims of financial conglomerations in Europe and the U.S. has been to boost profitability, the changing business environment in Japan will raise the potential for conglomerations to progress as well. Recent efforts by Japanese mega-bank groups to actively participate in consumer finance appear to be a part of this trend.

Financial conglomerations will affect and raise many new issues for business operations of the Bank. In the following sections, major challenges in conducting financial system policy are discussed.

1. **Prevention of the Emergence of Systemic Risk**

   One of the Bank of Japan’s primary missions is to maintain financial system stability, and therefore, prevention of the emergence of systemic risk by taking into account the possible progress in financial conglomerations is an important task.

   In this context, the Bank pays particular attention to banks, as they are positioned at the center of the payment system and are directly related to systemic risk. However, as described earlier, there are differences in the locus and form of risk depending upon whether banks are acting independently or whether they are part of a financial conglomerate. Added to this is the fact that the position of banks within financial conglomerates is not necessarily identical in all cases. As the Bank works to avoid systemic risks, it must be fully aware of the importance of banks in the payment system and also the diversity of financial conglomerates.

2. **Appropriate Exercise of the “Lender of Last Resort” Function**

   The Bank of Japan’s “lender of last resort” function is one important tool for ensuring the stability of the financial system. “Lender of last resort” refers to the Bank’s role of providing temporary liquidity to viable banks and other financial institutions.
Generally, the “lender of last resort” function is a tool for ensuring financial system stability, and it is not appropriate to be used for any other purpose, as this would lead to spillover of the “lender of last resort” function. To prevent a spillover, the Bank needs to have an accurate picture of how funds flow and are used within a financial conglomerate. In this regard, the Bank intends to emphasize dialogue with the unit responsible for overall cash flow within the conglomerate generally placed in the core bank or the topmost company in the group, but that differs from conglomerate to conglomerate.

When there are concerns about the emergence of systemic risk, the Bank may provide special loans under Article 38 of the Bank of Japan Law. When providing the special loans, the Bank makes decisions based on the four principles underlying extension of special loans to maintain financial system stability which contain highly universal principles. The Bank considers that these principles can be applied to conglomerates as well and intends to adhere strictly to these principles.

3. Capturing the Financial Situation of Conglomerates
To exercise its “lender of last resort” function, the Bank of Japan needs to accurately understand the financial situation of financial conglomerates.

One of the most important means that the Bank has in order to capture the financial situation of financial services providers is the on-site examination of financial institutions which hold current accounts at the Bank. However, with the establishment of holding companies and an increase in outsourcing, organizations and operations of current accounts holders have been changing. For example, functions that used to be carried out within an organization are now performed outside and therefore removed from the scope of direct examination. In such cases, the Bank requires the holding company or other parent company that has management and control functions to sign an on-site examination agreement when starting or continuing current account transactions with the Bank. When necessary to capture the situation of current account holders, the Bank also exchanges individual agreements with major shareholders and outside services providers of current account holders to concur to submitting requested documents or to letting the Bank conduct on-site examinations. The Bank intends to
continue using these methods to monitor the functions that have been transferred and operated outside institutions as part of financial conglomereration.

The Bank pays attention to foreign financial conglomerates that operate within Japan’s borders, and will continue to monitor closely these conglomerates’ situation in cooperation with foreign financial authorities, as well as through on-site examinations and off-site monitoring.

4. Coordination with Other Parties
One of the Bank of Japan’s most important responsibilities is to encourage the advancement of risk management at financial services providers, including financial conglomerates. The Bank is prepared to contribute to this advancement through dialogue with financial services providers, drawing on the insights gained through its on-site examinations and off-site monitoring.

Market functions can also be used to strengthen and supplement risk management systems of financial services providers and supervisory frameworks of the Bank and other financial authorities. The Bank will continue to work with all interested parties to see how these functions can be further utilized.

Finally, another important challenge for the Bank is to maintain close coordination with other domestic and foreign financial authorities and participate actively in international forums where issues arising from financial conglomereration are discussed. In this respect, the Bank will continue to take active part in forums such as the Joint Forum.


Demirguc-Kunt, Asli, Luc A. Laeven, and Ross E. Levine, “Regulations, Market Structure,


Wilmarth, Arthur E., Jr., “How Should We Respond to the Growing Risks of Financial

Materials Available Only in Japanese


Institute, pp. 173–196.
Ochiai, Daisuke, “Credit Suisse to Winterthur Hoken no Gappei (The Merger of Credit Suisse and Winterthur Insurance),” Shihon Shijo Quarterly (Capital Markets Quarterly), Fall 1997, Nomura Research Institute, pp. 144–152.
Annual Reports and Other Materials

Figure 1 Examle of a Typical Financial Conglomerate

Notes:
The figure is created by the Bank of Japan based on HSBC Holding PLC Annual Report of 2003 (not all intermediate holding companies and subsidiaries are shown).

A percentage figure in parentheses indicates the percentage owned of that company within the HSBC Group or otherwise wholly owned.
**Figure 2 Organizational Structure of Financial Conglomerates**

<table>
<thead>
<tr>
<th>Type</th>
<th>Universal banking</th>
<th>Parent-subsidiary relationship</th>
<th>Holding company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conceptual models</strong></td>
<td><img src="image" alt="Diagram" /></td>
<td><img src="image" alt="Diagram" /></td>
<td><img src="image" alt="Diagram" /></td>
</tr>
<tr>
<td>Governance of the topmost company by shareholders</td>
<td>Bank shareholders govern all businesses (banking, securities, and insurance).</td>
<td>Bank shareholders (1) directly govern banks and (2) indirectly govern securities and insurance companies.</td>
<td>Holding company shareholders indirectly govern all subsidiaries in the banking, securities, and insurance sectors.</td>
</tr>
<tr>
<td>Execution of business by executives of the topmost company</td>
<td>Bank executives directly execute operations in each business.</td>
<td>Bank executives (1) directly execute the bank’s business and (2) exercise rights for shares held in securities and insurance companies.</td>
<td>Holding company executives exercise rights for shares held in all subsidiaries.</td>
</tr>
<tr>
<td>Capital relationship between businesses/sectors</td>
<td>No legal separation of capital in different businesses (allocation of capital to each business for internal management purposes is possible).</td>
<td>Banks and securities and insurance companies hold their own capital. Potential exists for problems between parent companies and subsidiaries such as double gearing of capital.</td>
<td>Banks and securities and insurance companies hold their own capital. Potential exists for problems between parent companies and subsidiaries such as double gearing of capital.</td>
</tr>
<tr>
<td>Risk insulation between businesses/sectors</td>
<td>It is difficult to insulate risks between businesses. Safety net effects on one business extend directly to others.</td>
<td>It is possible to insulate risks to some extent. Safety net effects on parent banks may extend to subsidiaries.</td>
<td>It is relatively easy to insulate risks. Safety net effects on one sector do not extend directly to other sectors.</td>
</tr>
<tr>
<td>Examples</td>
<td>In Europe, banks can engage in securities business, but none of the major industrial countries permits a single company to conduct all three businesses (banking, securities, and insurance).</td>
<td>In the U.S., this structure is permitted when national banks enter securities or insurance business. This structure is also permitted in Japan (sector-specific subsidiaries).</td>
<td>This structure is seen in many international conglomerates. This structure is common in the U.S. It is also allowed in Japan and employed primarily by large banks.</td>
</tr>
</tbody>
</table>

Note: 1. Includes cases where parent companies are securities or insurance companies.
Figure 3  Investments by U.S. and Japanese Banks in Information Technology

<table>
<thead>
<tr>
<th>Period</th>
<th>U.S. banks (US$ billions)</th>
<th>Japanese banks (trillions of yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-1994</td>
<td>19.2</td>
<td>1.3</td>
</tr>
<tr>
<td>1995-1999</td>
<td>25.1</td>
<td>1.1</td>
</tr>
<tr>
<td>2000-2001</td>
<td>30.8</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Note: All figures represent annual averages of each period.
### Figure 4  Entries by Foreign Banks into Emerging Economies

(Share of total domestic banking assets, %)

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th></th>
<th>2002</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Regional banks</td>
<td>Foreign banks</td>
<td>Regional banks</td>
<td>Foreign banks</td>
</tr>
<tr>
<td></td>
<td>Private</td>
<td>Government</td>
<td></td>
<td>Private</td>
</tr>
<tr>
<td>Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>0</td>
<td>100</td>
<td>0</td>
<td>98</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>11</td>
<td>0</td>
<td>89</td>
<td>28</td>
</tr>
<tr>
<td>Indonesia</td>
<td>—</td>
<td>—</td>
<td>4</td>
<td>37</td>
</tr>
<tr>
<td>India</td>
<td>4</td>
<td>91</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
<td>Korea</td>
<td>75</td>
<td>21</td>
<td>4</td>
<td>62</td>
</tr>
<tr>
<td>Malaysia</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>72</td>
</tr>
<tr>
<td>Philippines</td>
<td>84</td>
<td>7</td>
<td>9</td>
<td>70</td>
</tr>
<tr>
<td>Singapore</td>
<td>11</td>
<td>0</td>
<td>89</td>
<td>24</td>
</tr>
<tr>
<td>Thailand</td>
<td>82</td>
<td>13</td>
<td>5</td>
<td>51</td>
</tr>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>—</td>
<td>36</td>
<td>10</td>
<td>19</td>
</tr>
<tr>
<td>Brazil</td>
<td>30</td>
<td>64</td>
<td>6</td>
<td>27</td>
</tr>
<tr>
<td>Chile</td>
<td>62</td>
<td>19</td>
<td>19</td>
<td>46</td>
</tr>
<tr>
<td>Mexico</td>
<td>1</td>
<td>97</td>
<td>2</td>
<td>18</td>
</tr>
<tr>
<td>Peru</td>
<td>41</td>
<td>55</td>
<td>4</td>
<td>43</td>
</tr>
<tr>
<td>Venezuela</td>
<td>93</td>
<td>6</td>
<td>1</td>
<td>39</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bulgaria</td>
<td>—</td>
<td>—</td>
<td>0</td>
<td>20</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>12</td>
<td>78</td>
<td>10</td>
<td>14</td>
</tr>
<tr>
<td>Estonia</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>1</td>
</tr>
<tr>
<td>Hungary</td>
<td>9</td>
<td>81</td>
<td>10</td>
<td>11</td>
</tr>
<tr>
<td>Poland</td>
<td>17</td>
<td>80</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>Russia</td>
<td>—</td>
<td>—</td>
<td>6</td>
<td>23</td>
</tr>
<tr>
<td>Slovakia</td>
<td>—</td>
<td>—</td>
<td>0</td>
<td>9</td>
</tr>
</tbody>
</table>

Notes:
1. Years may differ in some cases.
2. Data for some countries may not add up to 100 due to rounding.

Sources:
Hishikawa and Uchida (2004).
The original document was created by the Bank for International Settlements (BIS) based on data furnished by central banks, etc.
### Figure 5 Deregulation in the U.S., EU, and Japan

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S. and EU</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>[U.S.] Ban on cross-sector entry between banking and securities via subsidiaries was lifted.</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>[U.S.] The GLB Act was passed, relaxing restrictions on cross-sector entry into banking, securities, and insurance through financial holding companies.</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>[U.S.] Ban on insurance companies participating in banking via subsidiaries was lifted.</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>• Ban on cross-sector entry between life and casualty insurance via subsidiaries was lifted.</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>• Ban on pure holding companies was lifted.</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>• Bans on the following were lifted: 1. Financial holding companies 2. Cross-sector entry between securities and insurance via subsidiaries 3. Over-the-counter sales of investment trust products by banks and insurance companies 4. Licensing system for securities companies was switched to registration system 5. Restrictions on the scope of business activities for securities companies were eliminated and ban on over-the-counter sales of insurance products was also lifted.</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>• Ban on insurance companies participating in banking via subsidiaries was lifted.</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>• Ban on banks participating in insurance via subsidiaries was lifted.</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>• Ban on cross-sector entry into the third sector by life and casualty insurance companies was lifted.</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>[EU] Ban on establishment of joint branches by banks and securities companies was lifted, allowing them to conduct business on the same premises.</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>• Ban on securities brokerage business was lifted.</td>
<td></td>
</tr>
</tbody>
</table>

Other legal background information:

1. The U.S.:
   - There are no laws or regulations on holding companies other than those provided for banking and public services. In 1832, the Baltimore & Ohio Railroad became the world’s first holding company.
   - There are no provisions regarding the division of companies.
   - Share exchange was introduced in 1976 in the Model Business Corporation Act.

2. EU:
   - There are no laws or provisions regarding holding companies.
   - France codified division of companies in its Company Law of 1966. In the EU, the Sixth Company Law Directive (1982) contains provisions for divisions of public limited liability companies (however, the intent is to provide minimum standards of protection for shareholders and creditors in member states that allow division of companies).
### Figure 6  Balance Sheets of Bank Holding Companies in the U.S.

1. J.P. Morgan Chase (Holding Company)

<table>
<thead>
<tr>
<th></th>
<th>1994</th>
<th>1999</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in subsidiaries (banking)</td>
<td>49.6</td>
<td>40.2</td>
<td>37.3</td>
</tr>
<tr>
<td>Investments in subsidiaries (non-banking)</td>
<td>6.1</td>
<td>2.1</td>
<td>8.8</td>
</tr>
<tr>
<td>Other assets</td>
<td>44.3</td>
<td>57.7</td>
<td>53.9</td>
</tr>
<tr>
<td><strong>Liabilities/ capital</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>48.4</td>
<td>64.3</td>
<td>60.8</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>51.6</td>
<td>35.7</td>
<td>39.2</td>
</tr>
</tbody>
</table>

Notes:
1. J.P. Morgan merged with Chase Manhattan in 2000. Figures up to 1999 represent totals for the two banks.

2. Bank One (Holding Company)

<table>
<thead>
<tr>
<th></th>
<th>1994</th>
<th>1999</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in subsidiaries (banking)</td>
<td>75.1</td>
<td>45.8</td>
<td>51.5</td>
</tr>
<tr>
<td>Investments in subsidiaries (non-banking)</td>
<td>4.1</td>
<td>9.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Other assets</td>
<td>20.8</td>
<td>44.5</td>
<td>42.4</td>
</tr>
<tr>
<td><strong>Liabilities/ capital</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>22.6</td>
<td>54.3</td>
<td>50.9</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>77.4</td>
<td>45.7</td>
<td>49.1</td>
</tr>
</tbody>
</table>

Source: Created by the Bank of Japan based on annual reports from the holding companies of each group.
Figure 7  Financial Services Providers before and after the Formation of Financial Conglomerates

Before the formation of financial conglomerates

<table>
<thead>
<tr>
<th>Banks</th>
<th>Securities companies</th>
<th>Insurance companies</th>
<th>Asset management companies</th>
<th>Consumer finance companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits, lending, and payments</td>
<td>Securities underwriting and securities sales</td>
<td>Life and casualty insurance</td>
<td>Investment advice and asset management</td>
<td>Lending and credit cards</td>
</tr>
</tbody>
</table>

Customers
(Individuals, small businesses, large firms, and wealthy individuals)

After the formation of financial conglomerates

Financial conglomerate

<table>
<thead>
<tr>
<th>Banks</th>
<th>Securities companies</th>
<th>Insurance companies</th>
<th>Asset management companies</th>
<th>Consumer finance companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits, lending, and payments</td>
<td>Securities underwriting and securities sales</td>
<td>Life and casualty insurance</td>
<td>Investment advice and asset management</td>
<td>Lending and credit cards</td>
</tr>
</tbody>
</table>

Retail banking
(Individuals and small businesses)

Wholesale banking
(Large firms)

Private banking
(Wealthy individuals)
Figure 8 Major Financial Conglomerates by Area of Operations and Its Change

Notes:
1. The position of each financial conglomerate on the horizontal axis indicates the share of its domestic/international operations within the conglomerate in terms of revenue.
2. The position of each financial conglomerate on the vertical axis indicates the share of its retail/wholesale businesses within the conglomerate in terms of revenue (excluding asset management services).

Source: Compiled by the Bank of Japan based on annual reports.
## Figure 9 Major M&A Bank-Insurance Deals Involving EU Institutions: Top 10 Acquisitions by Price, 1990–2003

<table>
<thead>
<tr>
<th>Acquirer</th>
<th>Country</th>
<th>Target</th>
<th>Country</th>
<th>Year</th>
<th>Deal value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allianz (insurance)</td>
<td>Germany</td>
<td>Dresdner Bank (bank)</td>
<td>Germany</td>
<td>2001</td>
<td>22.3</td>
</tr>
<tr>
<td>Lloyds TSB Group (bank)</td>
<td>United Kingdom</td>
<td>Scottish Widows Fund &amp; Life (insurance)</td>
<td>United Kingdom</td>
<td>2000</td>
<td>12.0</td>
</tr>
<tr>
<td>Fortis (insurance)</td>
<td>Belgium</td>
<td>Générale de Banque (bank)</td>
<td>Belgium</td>
<td>1998</td>
<td>10.5</td>
</tr>
<tr>
<td>Nationale Nederlanden (insurance)</td>
<td>Netherlands</td>
<td>NMB Posbank Groep (bank)</td>
<td>Netherlands</td>
<td>1991</td>
<td>5.6</td>
</tr>
<tr>
<td>ING Groep (insurance)</td>
<td>Netherlands</td>
<td>BBL (bank)</td>
<td>Belgium</td>
<td>1997</td>
<td>4.1</td>
</tr>
<tr>
<td>Abbey National (bank)</td>
<td>United Kingdom</td>
<td>Scottish Provident Institution (insurance)</td>
<td>United Kingdom</td>
<td>2001</td>
<td>2.9</td>
</tr>
<tr>
<td>Dexia Belgium (bank)</td>
<td>Belgium</td>
<td>Financial Security Assurance (insurance)</td>
<td>United States</td>
<td>2000</td>
<td>2.7</td>
</tr>
<tr>
<td>Irish Permanent (bank)</td>
<td>Ireland</td>
<td>Irish Life (insurance)</td>
<td>Ireland</td>
<td>1999</td>
<td>2.7</td>
</tr>
<tr>
<td>ING Groep (insurance)</td>
<td>Netherlands</td>
<td>BHF Bank (bank)</td>
<td>Germany</td>
<td>1999</td>
<td>2.3</td>
</tr>
<tr>
<td>Lloyds TSB Group (bank)</td>
<td>United Kingdom</td>
<td>Lloyds Abbey Life (insurance)</td>
<td>United Kingdom</td>
<td>1996</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Note: 1. In 2004, ING sold its BHF shares to Sal Oppenheim.

### Figure 10 Major Bancassurance Groups in the EU:
**Top 10 by Consolidated Assets at the End of 2001**

<table>
<thead>
<tr>
<th>Group</th>
<th>Country</th>
<th>Consolidated assets (Billions of euros)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deutsche Bank</td>
<td>Germany</td>
<td>917.7</td>
</tr>
<tr>
<td>Allianz</td>
<td>Germany</td>
<td>911.9</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>France</td>
<td>825.3</td>
</tr>
<tr>
<td>HSBC Holdings</td>
<td>United Kingdom</td>
<td>778.6</td>
</tr>
<tr>
<td>ING Group</td>
<td>Netherlands</td>
<td>705.1</td>
</tr>
<tr>
<td>ABN Amro Holding</td>
<td>Netherlands</td>
<td>597.4</td>
</tr>
<tr>
<td>The Royal Bank of Scotland Group</td>
<td>United Kingdom</td>
<td>590.0</td>
</tr>
<tr>
<td>Barclays</td>
<td>United Kingdom</td>
<td>573.5</td>
</tr>
<tr>
<td>Crédit Agricole</td>
<td>France</td>
<td>563.3</td>
</tr>
<tr>
<td>Société Générale</td>
<td>France</td>
<td>512.5</td>
</tr>
</tbody>
</table>

## Figure 11: Major Risks by Business Sector

<table>
<thead>
<tr>
<th></th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit risk</strong></td>
<td>• Risk of incurring losses from inability to collect loans/funds from customers • The most significant risk for a bank</td>
<td>• Risk of incurring losses from inability to collect loans/funds from trade counterparties</td>
<td>• Risk arising from asset investments</td>
</tr>
<tr>
<td><strong>Market risk</strong></td>
<td>• Risk of incurring losses from fluctuations in prices of investment securities, etc.</td>
<td>• Risk of incurring losses from fluctuations in prices of inventory securities, etc.</td>
<td></td>
</tr>
<tr>
<td><strong>Liquidity risk</strong></td>
<td>• Risk of having funding difficulty arising from a mismatch between the maturity of assets and liabilities • The risk inherent in banks’ transactions because they take funds short term to invest in long term</td>
<td>• The same as at left</td>
<td>• Risk of having a large outflow of funds resulting from increases in policyholders’ withdrawals or large disasters, which eventually leads to funding difficulty and forces the institution to sell off assets at fire-sale prices</td>
</tr>
<tr>
<td><strong>Insurance risk</strong></td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Operational risk and reputational risk</strong></td>
<td>Risks common among all sectors, arising from operational errors or improprieties of the institution and the subsequent decline in reputation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Figure 12 Conceptual Diagram of Integrated Risk Management

- Business planning and performance assessment based on risk-adjusted return
- Capital adequacy review based on the above business planning and performance assessment, and review and improvement of profitability and efficiency
### Figure 13 Supervision of the Banking, Securities, and Insurance Sectors: Joint Forum Comparisons of Core Principles

<table>
<thead>
<tr>
<th>Supervisory objectives and background</th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depositor protection and financial system stability with an emphasis on financial system stability. —The sector has the strongest linkage with the macro economy.</td>
<td>Emphasizes fairness, transparency, and efficiency of markets in addition to investor protection and financial system stability.</td>
<td>Policyholder protection and financial system stability, with an emphasis on policyholder protection. —Problems in this sector usually do not become a source of financial instability.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Supervisory emphasis</th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emphasizes the valuation of assets of banks. —Encourages banks to have policies in place to identify, control, and manage different kinds of risks (credit, concentration, market, liquidity, operational, etc.) and describes specific requirements for individual risk categories.</td>
<td>Covers a broad range of matters including not only the soundness of securities companies, but also markets, exchanges, collective investment schemes, and information disclosure by issuers. —Licensing requirements differ according to the area of supervision (securities companies, markets, exchanges, collective investment schemes, etc.).</td>
<td>Emphasizes the valuation of liabilities of insurance companies. —The valuation of liabilities (technical provisions) is particularly emphasized as they are estimations of the cost of futures liabilities.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Supervisory techniques</th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>The only sector of the three with a uniform, risk-based capital standard that applies to all internationally active banks. —Banks are supervised on a consolidated basis, recognizing the possibility of contagion risk within a banking group.</td>
<td>Features self-regulatory organizations that can be a valuable complement to the supervisor and also the broad scope of supervisors’ enforcement powers. —Securities supervisors generally have the authority to initiate legal proceedings either administratively or in court for violation of securities laws.</td>
<td>Emphasizes evaluating the long-term solvency of insurance companies. —Evaluations are based on actuarial and statistical assumptions and information used to establish technical provisions and product prices.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Relationship between home- and host-country supervisors</th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>For internationally active banks, host-country supervisors are expected to share relevant information necessary for consolidated supervision with home-country supervisors.</td>
<td>Globalization of securities markets has increased the need for close coordination among securities supervisors at the international level.</td>
<td>No emphasis on cross-border consolidated supervision.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Market disciplines</th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supervisors promote disclosure of information by banks, from the viewpoint that market discipline serves as an adjunct to supervision.</td>
<td>Full and fair disclosure of financial information and information on securities issuers is essential. —Many jurisdictions take an approach whereby investors, rather than supervisors, are responsible for making investment decisions based on sufficient disclosure.</td>
<td>Market disciplines have played a relatively small role as a supervisory tool. —It is not common to provide market participants with information on the actuarial and statistical assumptions used to establish prices and technical provisions.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Summarized from Joint Forum (2001a).
**Figure 14 Capital Adequacy Regulations Imposed on Banks and Securities and Insurance Companies**

<table>
<thead>
<tr>
<th>Common concepts that underlie regulations (Summary by the Joint Forum)</th>
<th>Banks</th>
<th>Securities companies</th>
<th>Insurance companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time horizon of operations</td>
<td>• Long: most assets have low liquidity and cannot be valued by the markets.</td>
<td>• Short: most assets are highly liquid.</td>
<td>• Variable: both long and short insurance terms. Some cases of extremely long-term products.</td>
</tr>
<tr>
<td>Relationship between capital and reserves</td>
<td>• In most cases, banks hold more capital than reserves against default.</td>
<td>• Capital is held as a buffer against market risk, while very few reserves are held.</td>
<td>• Technical provisions for future insurance payments are usually larger than capital.</td>
</tr>
<tr>
<td>Concepts of capital adequacy (minimum capital required under regulations)</td>
<td>• Capital is considered important as an indicator of the bank’s overall financial condition, and regulators/ supervisors take measures according to capital adequacy levels.</td>
<td>• Highly liquid assets must be held against liabilities to customers and market counterparties, together with capital as a buffer against market risk, etc.</td>
<td>• It is most important to set aside actuarially sound reserves. Having done that, reserves are required for insurance risk, etc.</td>
</tr>
<tr>
<td>Uniform international standards</td>
<td>• Basel Accord (1) Credit risk regulations introduced in 1988: Bank capital/risk assets ≥ 8 percent. (2) Market risk regulations introduced in 1996: Market risk equivalent ≤ capital. • Basel II to be applied at the end of 2006 or later, revised in three pillars: (1) Minimum capital requirement. (2) Supervisory review process. (3) Market discipline.</td>
<td>• None.</td>
<td>• None. • However, the IAIS sets guidelines on capital and solvency requirements.</td>
</tr>
<tr>
<td>U.S.</td>
<td>• Risk-based capital adequacy regulations conforming to uniform international standards and regulations on leverage ratio are imposed on all banks, on a consolidated basis.</td>
<td>• Imposes “net capital requirement” on broker-dealers to provide for specific levels of liquidity. • Applied on a non-consolidated basis, but since August 2004, brokers/dealers of a certain size or larger have been allowed to use internal risk measurement models. In those cases, requirements are both applied on a non-consolidated and consolidated basis.¹</td>
<td>• National Association of Insurance Commissioners (NAIC) formulates risk-based capital (RBC) requirements that have been applied since 1993. • Insurance companies quantify their risk exposure for price fluctuation risk, insurance risk, interest rate fluctuation risk, and management risk.</td>
</tr>
<tr>
<td>EU</td>
<td>• Directive relating to the taking up and pursuit of the business of credit institutions (2000/12/EC). • Banks are required to hold capital equivalent to 8 percent or more of risk-weighted assets on a consolidated basis, pursuant to the Basel Accord credit risk regulations.</td>
<td>• Directive on capital adequacy of investment firms and credit institutions (CAD [93/6/EEC]). (1) Applied to trading book operations of banks and investment services providers. (2) Requires institutions to hold capital equivalent to the capital requirement for risks arising from trading book operations. (3) Applied on a consolidated basis.</td>
<td>• First Directive on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance (73/239/EEC); solvency requirements are defined as a percentage of insurance premiums or insurance payments (no concept of risk quantity). • Directive concerning life assurance (2002/83/EC); (1) Solvency requirements are defined as the sum of set percentages of technical provisions and risk insurance</td>
</tr>
</tbody>
</table>

¹Note: The net capital requirement is a measure used by broker-dealers to ensure that they have sufficient capital to cover their risks. It is calculated as the sum of their regulatory capital requirements, adjusted for certain factors such as their risk profile and the riskiness of their assets.
| Japan | • Defines calculation methods for:  
  (1) Uniform international standards based on the Basel Accord of at least 8 percent of their risk-weighted assets are applied to banks with foreign offices.  
  (2) Domestic standards of at least 4 percent are applied to banks without foreign offices.  
  • Uniform international standards and domestic standards are applied on both non-consolidated and consolidated bases. | • Required to hold sufficient liquid capital to withstand losses in the event of risk emergence.  
(1) Ratio of “own capital that has not been fixed” to “total value of risk that could be generated by price fluctuations, etc., for securities holdings.”  
(2) Minimum capital adequacy ratio of 120 percent.  
(3) Applied on a non-consolidated basis. | • Introduced solvency margin standards in 1996.  
(1) Calculates the risks that could emerge beyond the normal expectations of insurance companies (insurance risk, assumed interest rate risk, asset investment risk, and management risk).  
(2) Minimum solvency margin ratio of 200 percent. |

Note: 1. The SEC introduced new consolidated-based regulations due to (1) the need to identify risk for the entire securities group, and (2) the need to respond to new regulations in the EU. Regarding the latter, the EU Financial Conglomerates Directive that took effect in 2005 requires financial groups operating in the EU and headquartered in a non-EU country to comply with consolidated regulations equivalent to the EU’s in their home country.
Figure 15 Sectoral Safety Nets

<table>
<thead>
<tr>
<th>Basic concepts common to all three countries</th>
<th>Banks</th>
<th>Securities companies</th>
<th>Insurance companies</th>
</tr>
</thead>
</table>
| Objectives                                  | • Protection of small depositors  
• Prevention of the emergence of systemic risk | Protection of investors | Protection of policyholders |
| Scope of protection                          | Deposits (small depositors) | Claims for return of physical securities, etc. | Insurance policies (maintaining existing policies by the use of fixed rate protection) |
| Basic nature of products                    | • Bank liabilities  
• Principal guarantees  
• Serves as means of payment | • Debt issued by third parties  
• Does not serve as means of payment | • Insurance company liabilities  
• Does not serve as means of payment |
| U.S. Ceiling                                | 100,000 U.S. dollars  
(Interest included. For individuals, there is separate insurance coverage up to 100,000 U.S. dollars for each designated-purpose account) | 500,000 U.S. dollars  
(100,000 U.S. dollars for cash credits) | Life insurance  
Between 100,000 U.S. dollars and 500,000 U.S. dollars in death benefits, cash surrender withdrawal, and hospitalization benefits depending on the type of insurance (NAIC model) |
| U.K. Ceiling                                | 31,700 pounds  
(Principal only, 100 percent coverage up to 2,000 pounds and 90 percent up to the next 33,000 pounds) | 48,000 pounds  
(100 percent coverage up to 30,000 pounds and 90 percent up to the next 20,000 pounds) | Life insurance  
• 100 percent coverage up to 2,000 pounds and 90 percent for the remainder |
| U.K. Foreign companies                      | Not covered in principle | Covered | Covered |
| Japan Ceiling                               | 10 million yen for the principal and its interest  
(The payment and settlement deposits are protected in full) | 10 million yen | Life insurance  
90 percent of liability reserves |
| Japan Foreign companies                     | Not covered | Covered | Covered |

Note: In 2001, the U.K. established the Financial Services Compensation Scheme (FSCS) to integrate existing safety nets as stipulated in the Financial Services and Markets Act 2000 (FSMA).
Attachment 1 Examples of Financial Groups Led by Nonfinancial Companies

(1) General Electric Group

<table>
<thead>
<tr>
<th>Business unit</th>
<th>Commercial finance</th>
<th>Consumer finance</th>
<th>Insurance</th>
<th>Other financial services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specific businesses</td>
<td>• Loans and financing leases for equipment and facilities</td>
<td>• Credit cards</td>
<td>• Insurance and investment products, etc.</td>
<td>Unknown</td>
</tr>
<tr>
<td></td>
<td>• Real estate loans</td>
<td>• Personal loans, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Real estate investment, etc.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Name of representative company</td>
<td>• GE Commercial Finance</td>
<td>• GE Consumer Finance</td>
<td>• GE Insurance Solutions</td>
<td>• GE Capital Services</td>
</tr>
<tr>
<td>Number of countries in operation</td>
<td>35</td>
<td>40</td>
<td>28</td>
<td>Unknown</td>
</tr>
<tr>
<td>Revenues (US$ millions)</td>
<td>18,869</td>
<td>12,845</td>
<td>26,194</td>
<td>1,664</td>
</tr>
<tr>
<td>Group total: 138,105¹</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: 1. Excludes corporate items and eliminations, etc.

(2) American Express Group

<table>
<thead>
<tr>
<th>Business unit</th>
<th>Travel-related services</th>
<th>Financial advisory services²</th>
<th>Banking and other financial services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specific businesses</td>
<td>• Credit cards</td>
<td>• Financial planning</td>
<td>• Banking</td>
</tr>
<tr>
<td></td>
<td>• Travelers checks (Reference) Nonfinancial services</td>
<td>• Sales of mutual funds, insurance and other investment products</td>
<td>• Other financial services (insurance, trusts)</td>
</tr>
<tr>
<td></td>
<td>• Travel</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Commercial/networking services</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Travel-related consulting services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Names of representative company</td>
<td>• American Express Travel Related Services Company, Inc.</td>
<td>• American Express Financial Corporation</td>
<td>• American Express Bank</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• American Express Financial Advisors Inc.</td>
<td></td>
</tr>
<tr>
<td>Revenues (US$ millions)</td>
<td>19,189</td>
<td>6,172</td>
<td>801</td>
</tr>
<tr>
<td>Group total: 26,262¹</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. Excludes head office accounts, etc.
2. It was announced on February 1, 2005 that the financial advisory segment (American Express Financial Advisors) would be taken independent in the third quarter of 2005.
Attachment 2 “Economies of Scale” and “Economies of Scope”

1. “Economies of scale”

Generally, pursuing economies of scale is a major impetus to mergers, normally within the same sector, among financial services providers, particularly banks, because they bear enormous costs in building networks and other infrastructure. This is clear from the results of the Group of Ten survey introduced in the text. However, empirical studies in Japan and other countries do not indicate whether bank mergers actually achieve economies of scale.

For example, mergers between small banks with assets less than 100 million U.S. dollars (and the resulting expansion in size) generally result in improving profitability and efficiency by reducing average costs (Walter [2003]).

In contrast, there are various views as to whether mergers of medium-sized or large banks actually lead to improved profitability and efficiency (Spindt and Tarhan [1993] argues that it does, while Shaffer [1993] argues that it does not). Some argue that expansion in size can actually be a factor in “diseconomies of scale” by making management more complex, increasing administrative overhead costs, and encouraging organizational compartmentalization (Walter [2003]). Yet others point out the potential for enjoying greater economies of scale in the future due to factors such as advances in information technology (Fuchita [2004]).

2. “Economies of scope”

Diversification of businesses and expansion in geographical areas of operation are generally considered as two factors that can increase economies of scope through boosting profits and allocating (thereby reducing) risks.

Economies of scope that are achieved in financial services include (1) spreading of fixed costs, (2) reuse of customer information for various purposes, (3) reduction of risk, and (4) economies of customer costs, in other words, higher fee income for improved convenience for the consumer (Berger, Hanweck, and Humphrey [1987]).

Empirical studies into economies of scope, like those into economies of scale, do not provide any clear confirmation that the above two factors actually achieve economies of scope. There are some negative views, for example, Saunders [1994], but there are also views that, while the diversification of businesses can lead to the creation of value, its contributions are not always clear depending on the overall condition in the industry or other reasons (Besanko et al. [2002]).
Attachment 3 Reduction in Telecommunications Charges

<table>
<thead>
<tr>
<th>Year</th>
<th>Tokyo¹</th>
<th>New York²</th>
<th>London²</th>
<th>Paris²,³</th>
<th>Düsseldorf²,³</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(100,000 yen/month)</td>
<td>(US$1,000/month)</td>
<td>(1,000 pounds/month)</td>
<td>(1,000 euros/month)</td>
<td>(1,000 euros/month)</td>
</tr>
<tr>
<td>1997</td>
<td>677</td>
<td>177</td>
<td>154</td>
<td>320</td>
<td>305</td>
</tr>
<tr>
<td></td>
<td>(193)</td>
<td>(261)</td>
<td>(446)</td>
<td></td>
<td>(431)</td>
</tr>
<tr>
<td>1998</td>
<td>690</td>
<td>178</td>
<td>150</td>
<td>232</td>
<td>243</td>
</tr>
<tr>
<td></td>
<td>(215)</td>
<td>(298)</td>
<td>(315)</td>
<td></td>
<td>(331)</td>
</tr>
<tr>
<td>1999</td>
<td>387</td>
<td>186</td>
<td>150</td>
<td>207</td>
<td>221</td>
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<tr>
<td></td>
<td>(243)</td>
<td>(326)</td>
<td>(301)</td>
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<td>(322)</td>
</tr>
<tr>
<td>2000</td>
<td>387</td>
<td>188</td>
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<td>207⁴⁺</td>
<td>219</td>
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<td></td>
<td>(208)</td>
<td>(252)</td>
<td>(213)</td>
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<td>(226)</td>
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<tr>
<td>2001</td>
<td>387</td>
<td>188</td>
<td>150</td>
<td>207</td>
<td>219</td>
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<td></td>
<td>(237)</td>
<td>(274)</td>
<td>(230)</td>
<td></td>
<td>(243)</td>
</tr>
<tr>
<td>2002</td>
<td>339</td>
<td>189</td>
<td>144</td>
<td>168</td>
<td>161</td>
</tr>
<tr>
<td></td>
<td>(226)</td>
<td>(271)</td>
<td>(198)</td>
<td></td>
<td>(190)</td>
</tr>
<tr>
<td>2003</td>
<td>339</td>
<td>189</td>
<td>144</td>
<td>198</td>
<td>161</td>
</tr>
<tr>
<td></td>
<td>(222)</td>
<td>(271)</td>
<td>(256)</td>
<td></td>
<td>(209)</td>
</tr>
<tr>
<td>2004</td>
<td>339</td>
<td>188</td>
<td>144</td>
<td>197</td>
<td>161</td>
</tr>
<tr>
<td></td>
<td>(209)</td>
<td>(296)</td>
<td>(267)</td>
<td></td>
<td>(218)</td>
</tr>
</tbody>
</table>

Notes:
1. Figures from 1999 are calculated assuming that Digital Access 1500 (short-distance dedicated line service with limited maintenance and servicing; 1.5 Mbps) is used.
2. Figures in parentheses for New York, London, Paris, and Düsseldorf are yen conversions (100,000 yen/month).
3. Figures from 1997 to 2001 are calculated using the euro/franc and euro/mark conversion rates for January 1, 1999.

Source: Ministry of Internal Affairs and Communications (Ministry of Posts and Telecommunications prior to 2000), “Results of Survey on Price Variances Between Domestic and Overseas Telecommunications Services.”
Attachment 4 Outline of the Gramm-Leach-Bliley Act (GLB Act)

1. History

In 1933, the Glass-Steagall Act (GS Act) took effect in the U.S. This Act prohibited banks’ engagement in securities activities and securities companies’ engagement in banking activities either directly or indirectly through subsidiaries.

In 1956, the Bank Holding Company Act (BHC Act) limited the scope of activities permissible to bank holding companies to banking and non-banking activities which are closely related to banking. The BHC Act also prohibited bank holding companies from underwriting, selling, or broking insurance, in principle.

In the late 1970s, however, progress in securitization and concern for declining bank competitiveness led banks to consider entering into securities and insurance businesses, and banking regulators supported this move by interpreting legislation more flexibly to allow banks to gradually enter into these businesses (this was later ratified by a court).

Advances in IT and financial engineering further lowered the walls between financial products, and during the period from the late 1980s through the 1990s, a number of bills to expand the scope of activities open to banks were submitted to the Congress. As a result, the Gramm-Leach-Bliley Act (GLB Act) was passed in 1999.

The law paved the way for full-fledged competition between banks, securities companies, and insurance companies. It also gave regulators discretion over the scope of activities of financial holding companies, allowing them to adapt flexibly to changes in the financial environment.

2. Outline of the GLB Act

1) Partial repeal of the GS Act

The GLB Act repeals the prohibitions in the GS Act on affiliation of banks and securities companies, allowing bank affiliates and subsidiaries to engage in the full range of securities activities, and vice versa. However, it continues to prohibit banks from engaging directly in securities activities, except for treasury bonds and the like, and bar securities companies from taking deposits.
(2) Formulation of financial holding companies

Bank holding companies that meet the following requirements are allowed to engage directly or indirectly in a broader range of activities as “financial holding companies”:

1) All of a bank holding company’s subsidiary depository institutions must be “well capitalized”\(^1\) and “well managed.”
2) All of a bank holding company’s subsidiary depository institutions must have a rating of “satisfactory” or better under the Community Reinvestment Act (CR Act) in the most recent inspection.
3) Prior filing of certification to become a financial holding company with the FRB must be completed.

Financial holding companies and subsidiaries are allowed to engage directly or indirectly in activities described below.

(a) Activities defined as “financial in nature” in the GLB Act

- Specifically, activities already permissible for bank holding companies (banking and other activities closely related to banking), securities activities, insurance activities, financial advisory services, mutual fund activities, etc.

(b) Other activities that are “financial in nature or incidental to such financial activity”

- Activities approved by the FRB, with approval of the Secretary of the Treasury.

- In doing this, the FRB considers the purposes of the GLB Act (expanding the scope of services open to banks and maintaining the separation between banking and commerce), as well as changes in the marketplace in which bank holding companies compete, changes in the technology for delivering financial services, and whether such activity is necessary for bank holding companies and their affiliates to compete effectively.

- Once approved by the FRB, a financial holding company can commence the activity. A financial holding company must give the FRB a written notice after commencing the activity.

- Such activities include “finder activities.”\(^2\)

---

1 Capital adequacy ratio of at least 10 percent, Tier I ratio of at least 6 percent, and leverage ratio (Tier I/total assets) of at least 5 percent.
2 Activities bringing together buyers and sellers of any products or services for transactions so that they can negotiate and consummate, by providing electronic commerce services on a web site or
(c) Activities that are “complementary” to financial activities

- Activities which are permitted by the FRB to individual financial holding companies. Financial holding companies are required to provide the FRB with notice at least 60 days prior to the commencement of the proposed activity (prior approval requirement).

- In the course of its evaluation, the FRB considers whether the activity poses a substantial risk to the safety or soundness of the depository institutions or the U.S. financial system generally, and whether the activity could be expected to produce benefits (greater convenience, increased competition, or gains in efficiency) to the public that outweigh possible adverse effects (concentration of resources, decreased or unfair competition, conflicts of interest, unsound banking practices, etc.).

- As a specific example, the FRB has allowed Barclays Bank PLC, UBS AG, and Citigroup Inc. to handle spot transactions of goods on a limited basis.

(3) Activities permissible to national banks

National banks that meet the following two conditions are allowed to engage in the activities described in (2)(a) and (b)\(^3\) through subsidiaries without establishing a financial holding company.

1) The national bank and all of its subsidiary depository institutions must be “well capitalized” and “well managed.”

2) The national bank must be one of the 100 largest insured banks on a consolidated basis in the U.S. and have a rating of at least “single-A” or the equivalent.

Note that the aggregate consolidated total assets of all subsidiaries of any national bank cannot exceed the lesser of 45 percent of the consolidated total assets of the parent bank or 50 billion U.S. dollars.

\(^3\) Excluding insurance underwriting, insurance portfolio investments, and real estate development/investment.
(4) Supervision of financial holding companies

The FRB is the “umbrella” supervisor of all financial holding companies, but sectoral, federal, and state regulators have primary regulatory authority over subsidiaries of these financial holding companies.

For details, see Attachment 11, “Supervision and Regulation of Financial Conglomerates in the U.S.”
Attachment 5 Examples of Financial Conglomerates Expanding Overseas

1. HSBC Group

<table>
<thead>
<tr>
<th>Total</th>
<th>The U.S.</th>
<th>Asia-Pacific</th>
<th>Europe</th>
<th>Middle East/Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td>10,004 offices</td>
<td>5,874 offices</td>
<td>688 offices</td>
<td>3,276 offices</td>
<td>166 offices</td>
</tr>
<tr>
<td>76 countries and regions</td>
<td>13 countries and regions</td>
<td>22 countries and regions</td>
<td>23 countries and regions</td>
<td>18 countries and regions</td>
</tr>
</tbody>
</table>

2. Citigroup

<table>
<thead>
<tr>
<th>Total</th>
<th>The U.S.</th>
<th>Asia-Pacific</th>
<th>Europe</th>
<th>Middle East/Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td>96 countries and regions</td>
<td>26 countries and regions</td>
<td>20 countries and regions</td>
<td>27 countries and regions</td>
<td>23 countries and regions</td>
</tr>
</tbody>
</table>

3. UBS

<table>
<thead>
<tr>
<th>Total</th>
<th>The U.S.</th>
<th>Asia-Pacific</th>
<th>Europe</th>
<th>Middle East/Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td>53 countries and regions</td>
<td>14 countries and regions</td>
<td>13 countries and regions</td>
<td>20 countries and regions</td>
<td>6 countries and regions</td>
</tr>
</tbody>
</table>

Note: Numbers of countries, regions, and offices, etc., as per the definitions used by individual groups (data as found on the web sites of each group).
Attachment 6 Major Financial Conglomerates' Areas of Operations: Breakdown by Region and Business

**Citigroup**

**By region**

- Latin America: 12%
- Japan: 10%
- Asia (excluding Japan): 6%
- Europe, Middle East, and Africa: 6%
- The U.S. and Canada: 64%

**By business**

- Wholesale: 51%
- Retail: 61%

**JP Morgan Chase**

**By region**

- Latin America: 3%
- Europe, Middle East, and Africa: 19%
- The U.S.: 72%
- Asia: 6%
- Europe, Middle East, and Africa: 19%

**By business**

- Wholesale: 51%
- Retail: 41%

**Bank of America**

**By region**

- Asia: 3%
- Europe, Middle East, and Africa: 19%
- The U.S. and Canada: 96%

**By business**

- Wholesale: 23%
- Retail: 70%

**Credit Suisse Group**

**By region**

- Asia and Africa: 3%
- Switzerland: 30%
- Europe (excluding Switzerland): 43%
- North and South America: 22%

**By business**

- Wholesale: 46%
- Retail: 28%
- Asset management: 6%
Source: Calculated on a revenue basis from information in bank annual reports (2003).
There are several empirical studies of the effects of market power on prices in the banking sector. However, there seem to be several different conclusions, particularly by the type of banks analyzed.

One study finds that concentration of market power in the U.S. banking sector to some regions that were caused by M&A among regional banks exerted unfavorable price effects (Prager and Hannan [1998] as quoted in Berger et al. [2004]). On the other hand, a study on medium-sized and large U.S. banks finds that M&A among these banks has mixed or small effects on prices (Akhavein, Berger, and Humphrey [1997]). A study on the Italian banking industry concludes that the effects of bank mergers on prices depend largely upon whether the increase in market power from the integration is greater than the increase in efficiency (Sapienza [2002]). For example, in the Italian banking industry, effects of M&A on prices are unfavorable to customers in the short run, but are favorable in the long run because efficiency dominates the concentration of market power (Panetta and Focarelli [2003]). Other studies find that the relationship between concentration and interest margins is mixed (Demirguc-Kunt, Laeven, and Levine [2003]).

Some point out that the relaxation of regulations to limit entries into financial services is an effective way to avoid restrictions on competition. Many studies focusing on banking find that stringent entry regulations may reduce customer convenience. They argue that excessive concentration of market power can temporarily restrict competition and can result in excess profits for the industry, but such excess profits (in other words, a decline in customer convenience) will be resolved as long as the restrictions on entry are relaxed and domestic and foreign capital quickly enters the market (through, for example, acquisition of existing banks).

Another study draws on two conclusions that competitive banking systems with fewer entry/exit regulations and financial systems with high bank concentration are both stable and less likely to experience systemic crises (Beck, Demirguc-Kunt, and Levine [2003]).
Attachment 8 Findings of the Joint Forum Survey on Integrated Risk Management at Financial Institutions

In 2002, the Joint Forum conducted a survey on integrated risk management (Joint Forum [2003]), to which 31 financial institutions in 12 jurisdictions responded.

Integrated risk management is an area of rapid advancement and the situation is likely to have progressed since 2002, but the survey is still useful in identifying major points to be considered in integrated risk management and we therefore provide an outline of the findings below.

- Financial institutions measure their risk exposure by type of risk inherent in financial transactions, such as credit risk, market risk, operational risk, and insurance risk. To measure risk, institutions use “Value at Risk” (VaR) methods, stress testing, and scenario analysis depending upon the type of risk.\(^1\) For example, it is common to use VaR to measure market risk, although some institutions incorporate stress testing into their calculations.

- The ultimate method for expressing the aggregated risk exposure is “economic capital” methodologies that measure various types of risks and aggregate them into a single metric.

- Integrated risk management using economic capital is clearly still in the early stages of evolution.\(^3\) Some institutions remain skeptical about the possibility of expressing exposures of different types of risks in a single figure. Institutions whose risks tend to be concentrated in a single type of activity seem to be more reluctant to adopt integrated risk management. By contrast, institutions that bear risk exposures of various types of risks are more willing to advance integrated risk management techniques which would allow them to make detailed comparisons.

- In the insurance sector, there has also been a strong tradition of risk quantification, but not all of it has been consistent with integrated risk management using economic

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\(^1\) VaR is a method of measuring risk based on a probability of loss and a specific time horizon in which the loss can be expected to occur through fluctuations in market values, such as prices and interest rates.

\(^2\) Scenario analysis is a test that measures expected losses and liquidity shortages under certain risk scenarios, for example, changes in prices of assets held.

\(^3\) In the Joint Forum survey, this was referred to as the “economic capital method.” In Japan, the more common term is “integrated risk management,” which is used in this paper.
capital methods.

- Many institutions that adopt integrated risk management still measure economic capital for each legal entity separately and aggregate them on a group-wide basis on a certain assumption instead of measuring integrated risk exposure of the group.

- The handling of risk correlations, which is the basis for calculating risk diversification benefit, is important in integrated risk management. However, there is little consistency across conglomerates regarding techniques to measure correlation values and apportionment of risk diversification benefit.

- There are also differences in views on how integrated risk management should be used. Indeed, there is a wide variety in the way it is used: profitability assessment of individual business units; assessment of the return on economic capital of particular units, important inputs into decisions about which business activities to expand and which to reduce; judgment on capital adequacy on a group-wide basis; and a measure of risk control. Some survey participants strongly supported integrated risk management as necessary to bring about the potential benefits, although no institution had introduced a full-fledged integrated risk management system before the survey.
## Attachment 9 Separation of Banking and Commerce in the U.S., EU, and Japan

<table>
<thead>
<tr>
<th>Parent companies and holding companies</th>
<th>U.S.</th>
<th>EU</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Any company which directly or indirectly owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank meets the requirements for bank holding companies (BHCs).</td>
<td>• There are no restrictions on the scope of operations for major shareholders of a bank or their subsidiaries.</td>
<td>• The scope of operations for a BHC as defined in the Anti-Monopoly Act that owns a bank as a subsidiary is limited to the management and operation of subsidiaries, etc., and incidental business (Article 52-21 of the Law).</td>
<td></td>
</tr>
<tr>
<td>— Prior approval of the FRB is required to become a BHC (Section 2 of the Act).</td>
<td>• Prior screening is required to determine suitability as a major shareholder of a bank that owes 10 percent or more of the voting shares.</td>
<td>— Prior approval of the Commissioner of the FSA is required to become a BHC (Article 52-17 of the Law).</td>
<td></td>
</tr>
<tr>
<td>• BHCs are in principle prohibited from engaging in activities other than banking or retaining direct or indirect ownership of 25 percent or more of the voting shares of any company which is not a bank or a BHC (Section 4 of the Act).</td>
<td>— Any natural or legal person who proposes to hold equity holding in credit institutions must first inform the authorities in the event that (1) voting rights or capital stake reach or exceed 10 percent as a result of the acquisition, or (2) voting rights or capital stake reach or exceed 20, 33, or 50 percent after additional equity acquisition, or the credit institution becomes its subsidiary (Directive Article 16 [1]).</td>
<td>• BHCs are not allowed to have any subsidiaries other than banks, securities companies, insurance companies, companies engaging in businesses related to the operations of these companies, companies engaged solely in finance-related operations, and holding companies etc., that have these companies as subsidiaries (Article 52-23 of the Law).</td>
<td></td>
</tr>
<tr>
<td>— BHCs are allowed to own shares of any company engaging in the following non-banking activities:</td>
<td>— The authorities should have a maximum of three months from the date of notification to oppose such plan if, in view of the need to ensure sound and prudent management of the credit institution, they are not satisfied as to the suitability of the person. (Directive Article 16 [1] Paragraph 2).</td>
<td>— Prior approval of the Commissioner of the FSA is required to hold these companies as subsidiaries (Paragraph 3 of the article cited above).</td>
<td></td>
</tr>
<tr>
<td>(1) Holding or operating properties used wholly or substantially by any banking subsidiary.</td>
<td>(2) Conducting a safe deposit business.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Furnishing services to or performing services for such BHC or its banking subsidiaries.</td>
<td>(4) Liquidating assets acquired from the BHC or its banking subsidiaries.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(5) Shares acquired by a BHC or any of its subsidiaries in satisfaction of a debt previously contracted in good faith (disposed of within two years, not to exceed ten years).</td>
<td>(6) Shares acquired by a bank in good faith in a fiduciary capacity.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(7) Shares of any company which do not include more than 5 percent of the voting shares of such company.</td>
<td>(7) Shares of any company which do not include more than 5 percent of the voting shares of such company.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Prior to the passage of the GLB Act in 1999, there were examples of nonfinancial companies engaged in banking via “unitary savings and loan holding companies.” This is now regulated under the GLB Act.*
| Major shareholders | • Prior approval of the FRB is required for ownership of 5 percent or more of bank equity (Section 3 of the Act). | • There are no restrictions on the scope of operations for major shareholders which own 20 percent or more of the voting shares of a bank or their subsidiaries.  
— However, prior approval of the Commissioner of the FSA is required to become a major shareholder (Article 52-9 of the Law).  
— Criteria for approval are (1) no potential to impair the sound and proper operation of business of the bank in light of the matters concerning funds to obtain and the purpose of retention of the voting shares by the applicant; (2) no potential to impair the sound and proper operation of business of the bank in light of matters concerning the properties and the income and expenditure of the applicant; and (3) in view of the applicant’s personal composition, etc., the applicant has full understanding on the public character of banks and sufficient social credit, etc. (Article 52-10 of the Law).  
— The Commissioner of the FSA may cancel the approval in the event that a major shareholder violates the law, is subject to administrative actions, or takes actions that injure public order (Article 52-15 of the Law). |
| Bank ownership of nonfinancial companies | • BHCs are in principle prohibited from retaining direct or indirect ownership of 25 percent or more of the voting shares of any company which is not a bank or a BHC (Section 4 of the Act).  
• National banks are only allowed to own financial subsidiaries. | • There are restrictions on the ratio of bank investments in nonfinancial sectors to the bank capital (investments in insurance companies are excluded).  
— No credit institution is allowed to have equity holding which exceeds 15 percent of its capital in an institution that is neither a credit institution nor a financial institution (Directive Article 51 [1]).  
— The total amount of a credit institution’s equity holding in institutions other than credit institutions and financial institutions is not allowed to exceed 60 percent of their capital (Directive Article 51 [2]).  
• Banks are not allowed to have any subsidiaries other than banks, securities companies, insurance companies, companies engaged in businesses related to banking, companies engaged solely in finance-related operations, and holding companies, etc., that have these companies as subsidiaries (Article 16-2 of the Law).  
— Prior approval of the Commissioner of the FSA is required to hold these companies as subsidiaries (Paragraph 4 of the article cited above).  
• For companies other than the above, the total of the voting shares owned, including all of those voting shares owned by subsidiaries, are not allowed to exceed 5 percent (Article 16-3 of the Law).  
— There are similar provisions in Article 9 of the Anti-Monopoly Act. |

Notes: 1. The “Act” refers to the “Bank Holding Company Act (BHC Act).”
3. A BHC is defined as company for which the total acquisition value of the stock of any subsidiary constitutes more than 50 percent of the value of the total assets of the company (Anti-Monopoly Act, Article 9).
4. The “Law” refers to the “Banking Law.”
## Attachment 10 Similarities between Traditional and New Financial Products and Services

<table>
<thead>
<tr>
<th>Traditional financial products and services</th>
<th>New products and services with similar functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Providers</td>
<td>Products</td>
</tr>
<tr>
<td>Banks</td>
<td>Checking accounts</td>
</tr>
<tr>
<td>Banks</td>
<td>Time deposits</td>
</tr>
<tr>
<td>Banks and insurance companies</td>
<td>Corporate loans and syndicated loans</td>
</tr>
<tr>
<td>Securities companies</td>
<td>Structured bond products</td>
</tr>
<tr>
<td>Banks</td>
<td>Credit guarantees</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>Credit insurance</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>Earthquake insurance and weather insurance</td>
</tr>
</tbody>
</table>

Note: 1. Securities accounts that provide access to bank accounts for settlement.
Attachment 11 Supervision and Regulation of Financial Conglomerates in the U.S.

1. Decentralized Supervisory Framework

In the U.S., different supervisors and regulators assume responsibility for supervising and regulating financial sectors at the federal and state levels. In the supervision of financial conglomerates, these supervisors and regulators have a primary responsibility for subsidiary institutions of financial holding companies, and may impose regulations, require reports, conduct inspections, and take corrective measures.

Banks are supervised and regulated by the FRB, the FDIC, the OCC, and state regulators. Securities companies are supervised and regulated by the SEC and insurance companies by state insurance regulators.

The FRB serves as the “umbrella supervisor” of financial holding companies, but is expected to make maximum use of the information gathered by functional supervisors and regulators described above through inspections and supervision when dealing with subsidiary institutions. The FRB can request submission of reports directly from individual financial institutions or conduct inspections on them, but only in limited cases.

<table>
<thead>
<tr>
<th></th>
<th>Federal supervisors and regulators</th>
<th>State supervisors and regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FRB</td>
<td>FDIC</td>
</tr>
<tr>
<td>Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>National banks (mandatory membership in FRS and FDIC)</td>
<td>○</td>
<td>●</td>
</tr>
<tr>
<td>State banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FRS members (mandatory membership in FDIC)</td>
<td>+</td>
<td>○</td>
</tr>
<tr>
<td>Membership in FDIC only</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Non-FRS, non-FDIC members</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities holding companies/securities companies</td>
<td>●</td>
<td></td>
</tr>
<tr>
<td>Insurance companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial holding companies</td>
<td>●</td>
<td></td>
</tr>
<tr>
<td>Bank holding companies</td>
<td>●</td>
<td></td>
</tr>
</tbody>
</table>
●: Licensing authority (registration authority for securities) and primary supervisors and regulators.

+: Federal level supervisors and regulators.

○: Inspection authority as federal deposit insurance provider.

□: Optional for financial holding companies.

Source: Based on Nonoguchi and Takeda (2000) with some revisions.

2. Regulations on Subsidiary Depository Institutions of Financial Holding Companies

In the U.S., financial holding companies are allowed to engage in a wide range of activities, but their subsidiary depository institutions are subject to restrictions, in order to prevent the increased complexity of risks associated with the expansion of activities from undermining the deposit insurance fund and the payment system. The restrictions include the following:

(1) Capital adequacy and management requirements
All subsidiary depository institutions of a financial holding company must be “well capitalized” and “well managed.”

a. They are required to have capital adequacy ratios of at least 10 percent (normally at least 8 percent), and must achieve a CAMEL composite rating of 1 or 2 and at least a satisfactory rating for management (top two ranks in the five-step grading system) given by appropriate regulators based on their inspections, etc.

b. If a subsidiary is deemed not to meet these requirements, the financial holding company, within 45 days of receiving notice from the FRB, signs an agreement with the FRB to comply with the requirements. If the financial holding company is unable to correct the conditions within 180 days of receiving the notice, the Board may order the company to divest ownership or control of any depository institution owned or controlled by the company, or may order the company to cease activities that are permitted only to financial holding companies.

c. Financial holding companies are required to meet the same consolidated minimum capital adequacy ratios as bank holding companies of at least 8 percent. When determining the adequacy of its overall capital position as a group, the FRB also reviews the financial holding company’s internal risk assessment and related capital analysis process.

(2) Restrictions on intra-group transactions
In the U.S., a bank and its subsidiaries are allowed to engage in transactions with their
affiliates only (1) on terms that are substantially the same, or at least as favorable to, such bank or its subsidiary, as those prevailing at the time for comparable transactions with other nonaffiliated companies (“arm’s length rule”); (2) when secured by collateral for credit extension; and (3) if the aggregate amount of such transactions with any single affiliate does not exceed 10 percent of the total capital and surpluses of the bank and its subsidiaries while the aggregate amount of such transactions with all affiliates does not exceed 20 percent of the total capital and surpluses of the bank and its subsidiaries. Subsidiary banks of financial holding companies have wider scopes of transactions and affiliates subject to these rules.

a. Regulated transactions are (1) loans or extension of credit to affiliates; (2) purchase of or investment in securities issued by affiliates; (3) purchase of assets from affiliates; (4) acceptance of securities issued by affiliates as collateral for loans or extension of credit, etc., and; (5) issuance of guarantees on behalf of affiliates. As for subsidiary banks of financial holding companies, derivatives transactions between and intra-day credit extensions to affiliates are subject to the regulation. However, collateral requirements are exempted for these two transactions.

b. The scope of affiliates is normally deemed to be bank holding companies and subsidiaries of bank holding companies belonging to the bank. For subsidiary banks of financial holding companies, the scope is broadened to any company in which the financial holding company owns 15 percent or more of equity.

In addition to monitoring at the level of each individual bank, the FRB monitors intra-group exposures and risk concentrations of financial holding companies at the group level. In doing this, the FRB focuses on understanding and monitoring related-party exposures at the group level, including areas such as servicing agreement and payments system exposures. The FRB also focuses on management effectiveness of the financial holding company in monitoring and controlling risks and considers how the risk management processes measure and manage group-wide risk concentrations.
Attachment 12 Supervision and Regulation of Financial Conglomerates in the EU

1. Regulatory Framework for Financial Institutions

The EU has different sets of uniform regulations (EU directives) covering banks, securities companies, and insurance companies that do and do not belong to financial groups.  

The EU directives stipulate the following.

- **Single licensing system within the EU:** Entities that have obtained licenses in their home countries can operate in other EU member states through branch offices, etc., without obtaining separate licenses for those countries.

- **Emphasis on home-country supervision:** In principle, supervision of financial institutions is conducted by home-country supervisors.

- **Prudential regulations:** Regulations on capital adequacy, large exposures, the eligibility of managers (fit and proper) and major shareholders, etc.

Note that, in EU member states, banks are allowed to directly engage in securities services (“universal banking”).

In 2002, the European Commission issued a directive on the supplementary supervision of credit institutions, insurance undertakings, and investment firms in a financial conglomerate (2002/87/EC) (“Financial Conglomerates Directive” hereafter), which sets out rules concerning regulation of financial groups engaging in banking, securities, and insurance (effective from the accounting year beginning on or after January 1, 2005).

2. Supervision and Regulation in Accordance with the Financial Conglomerates Directive

(1) Supervisory framework

Among national and sectoral supervisors responsible for individual financial

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1 The EU directive is binding on the EU member states in terms of the results of supervision to be achieved, but leaves to the national authorities the choice of form and methods.

2 On the other hand, the EU directives do not, as a uniform rule within the region, include insurance among the activities that banks are allowed to directly engage in. Likewise, institutions other than banks are prohibited from accepting deposits in the EU, thus insurance companies are not allowed to provide banking services. Banks, securities companies, and insurance companies are permitted to engage in banking, securities, and insurance activities only indirectly, through subsidiaries, etc.
institutions in conglomerates, one supervisor is appointed as a “coordinator” for each conglomerate according to certain criteria.\(^3\)

The tasks of the coordinator include (1) coordination of the gathering and dissemination of relevant or essential information during both ordinary and emergency situations, (2) supervisory overview and assessment of the financial situation of a conglomerate, (3) assessment of compliance with the rules on capital adequacy and of risk concentration and intra-group transactions, (4) assessment of the financial conglomerate’s structure, organization, and internal control system, and (5) planning and coordination of supervisory activities in ordinary and emergency situations.

All reporting concerning the financial conglomerate is made to the coordinator. The authorities responsible for supervision of individual financial institutions within the conglomerate are required to exchange information and closely cooperate with each other.

(2) Capital adequacy on a group-wide basis

Financial conglomerates must comply with capital adequacy regulations on a group-wide basis in addition to those at the sectoral level imposed on each of their subsidiary institutions.

Formulas for the calculation of capital adequacy requirements for financial conglomerates (EU member states may choose from the following)\(^4\)

(a) Accounting consolidation method:

Consolidated capital — the sum of required capital for each sector \(\geq 0\).

(b) Deduction and aggregation method:

The sum of capital of individual companies — the sum of required capital of individual companies — capital participation in other group companies \(\geq 0\).

(c) Book value/requirement deduction method:

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\(^3\) The criteria for appointment of a coordinator are as follows.
(1) If a financial conglomerate is headed by a regulated financial institution, the supervisory authority which has authorized that financial institution is appointed as a coordinator.
(2) In cases other than (1), the authority supervising the most important financial institution in the group is appointed as the coordinator.
  - The supervisory authority which has authorized the regulated subsidiary financial institution in the country in which the parent financial holding company (the topmost company in the financial conglomerate) has its head office.
  - The supervisory authority which has authorized the regulated financial institution with the largest balance-sheet total in the most important financial sector of the conglomerate.

\(^4\) All of the formulas are designed to eliminate cross-holdings of capital within the group (double gearing and multi-gearing) in order to appropriately assess the capital on a group-wide basis.
Parent company’s capital — required capital of the parent company — (the larger of capital participation of the parent company in subsidiaries or required capital of subsidiaries) ≥ 0.

(d) Any combination of the above three methods.

(3) Risk concentration and intra-group transactions

Financial conglomerates are required to report to their coordinator on a regular basis about any significant risk concentration and intra-group transactions.

The coordinator, after consultation with other relevant authorities, identifies the type of transactions and risks that financial institutions within a particular financial conglomerate need to report. In doing so, the coordinator needs to take into account the specific group and risk management structure of the financial conglomerate. To identify significant intra-group transactions and significant risk concentration to be reported, the coordinator, after consultation with other relevant authorities and the financial conglomerate itself, defines appropriate thresholds based on the capital, etc., of the conglomerate.

The coordinator monitors risk concentration and intra-group activities, paying special attention to the following: the possible risk of contagion in the financial conglomerate; the risk of conflict of interests; the risk of circumvention of sectoral rules, and the level or volume of risks.

(4) Internal control and risk management processes

Financial conglomerates are required to have adequate risk management processes and internal control mechanisms such as those described in the table below, and are subject to supervisory overview of the coordinator.

| Risk management processes                      | • Sound governance and management systems at the financial conglomerate level  
|                                               | • Adequate capital adequacy policies  
|                                               | • Adequate procedures to ensure that risk monitoring systems are well integrated into organizations  
| Internal control mechanisms                   | • Adequate mechanisms as regards capital adequacy to identify and measure risks incurred and to appropriately relate capital to risks  
|                                               | • Sound reporting and accounting procedures to control intra-group transactions and risk concentration  

## Attachment 13 Capital Adequacy Regulations Applied to Investments Made by Holding Companies/Banks in Financial Affiliates

<table>
<thead>
<tr>
<th></th>
<th>Securities affiliates</th>
<th>Insurance affiliates</th>
<th>Other financial affiliates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basel Accord</strong>¹</td>
<td>Controlled by holding companies</td>
<td>Controlled by holding companies</td>
<td>Controlled by holding companies</td>
</tr>
<tr>
<td></td>
<td>• No provisions.</td>
<td>• No provisions.</td>
<td>• No provisions.</td>
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<tr>
<td></td>
<td>Controlled by banks</td>
<td>Controlled by banks</td>
<td>Controlled by banks</td>
</tr>
<tr>
<td></td>
<td>• No specific provisions, but subject to consolidation when they are subject to similar regulation as banks.</td>
<td>• No specific provisions, but interpreted to be out of the scope of consolidation.</td>
<td>• No specific provisions, but subject to consolidation when they are subject to similar regulation as banks.</td>
</tr>
<tr>
<td></td>
<td>• In the case above, investments in affiliates which are not consolidated are deducted from the bank capital.</td>
<td></td>
<td>• In the case above, investments in affiliates which are not consolidated are deducted from the bank capital.</td>
</tr>
<tr>
<td><strong>Agreements in Basel II</strong></td>
<td>• Consolidated for majority holdings where they are subject to similar regulation as banks.</td>
<td>• Not consolidated.</td>
<td>• Consolidated for majority holdings.</td>
</tr>
<tr>
<td></td>
<td>• Significant minority investments in affiliates which are not consolidated are deducted from the capital of the holding company/bank (consolidation on a pro rata basis is permitted).</td>
<td>• Majority equity and significant minority investments in insurance companies are deducted from the capital of the holding company/bank². However, investments may be treated as risk assets if domestic rules do not require insurance companies to deduct investments in banks.</td>
<td>• Significant minority investments in affiliates which are not consolidated are deducted from the capital of the holding company/bank (consolidation on a pro rata basis is permitted).²</td>
</tr>
<tr>
<td><strong>EU³ (Proposed revisions to capital adequacy rules based on Basel II)</strong></td>
<td>• Consolidated for majority holdings.</td>
<td>• Not consolidated.</td>
<td>• Consolidated for majority holdings.</td>
</tr>
<tr>
<td></td>
<td>• Holdings amounting to more than 10 percent or holdings of up to 10 percent but exceeding 10 percent of the capital of the holding company/bank are deducted from the capital of the holding company/bank.</td>
<td>• Holdings of 20 percent or more are deducted from the capital of the holding company/bank.</td>
<td>• Holdings amounting to more than 10 percent or holdings of up to 10 percent but exceeding 10 percent of the capital of the holding company/bank are deducted from the capital of the holding company/bank.</td>
</tr>
<tr>
<td><strong>U.S.⁴,⁵</strong></td>
<td>• Consolidated for majority holdings. Not consolidated if supervisory authorities deem non-consolidation to be more suitable in order to achieve supervisory purposes.</td>
<td>• Consolidated for majority holdings. Not consolidated if supervisory authorities deem non-consolidation to be more suitable in order to achieve supervisory purposes.</td>
<td>• Consolidated for majority holdings in principle. (Investments in unconsolidated subsidiaries are deducted from the capital of the holding company/bank.)</td>
</tr>
<tr>
<td></td>
<td>Investments in subsidiaries and joint ventures in which the banking organization owns 20 to 50 percent of the voting stock are deducted from the capital of the holding company/bank and proportionally consolidated or consolidated.</td>
<td></td>
<td>Investments in subsidiaries and joint ventures in which the banking organization owns 20 to 50 percent of the voting stock are deducted from the capital of the holding company/bank and proportionally consolidated or consolidated.</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>• Consolidated for majority holdings. Not consolidated in specific circumstances, with investments deducted from the capital of the holding company/bank.</td>
<td>• Not consolidated.</td>
<td>• Consolidated for majority holdings.</td>
</tr>
<tr>
<td></td>
<td>• Investments of 20 percent or more are deducted from the capital of the holding company/bank.⁶</td>
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</tr>
</tbody>
</table>
more are deducted from the capital of the holding company/bank. In some cases, they are proportionally consolidated.

Notes:

1. The Basel Accord does not specify criteria that are used to determine whether accounts are subject to consolidation (e.g., investment ratios).
2. The definition of “significant minority investment” is not clear, but the EU standards of 20–50 percent are noted.
3. The EU applies the same capital adequacy regulations to banks and securities companies.
4. For financial holding companies with consolidated assets of 150 million U.S. dollars or more.
5. The U.S. permits bank holding companies to offer a full lineup of securities and insurance services or to own subsidiaries providing these services conditional upon meeting certain requirements and registering as a financial holding company with the FRB. In these cases, companies engaged in securities and insurance services must comply with the capital adequacy regulations imposed by their respective authorities. The regulator responsible for the financial holding company verifies the capital adequacy of the group as a whole.
6. Criteria for determining consolidation or deduction are based on ownership of voting rights. Contributions to the funds of mutual insurance companies are therefore not subject to deduction.