Financial Conglomerates Law –
Going beyond traditional supervision

Jorge Castaño Gutiérrez,
Financial Superintendent

I. Background

Until the beginning of the 90s, the Colombian financial system was primarily composed by specialized financial institutions. Nevertheless, in order to promote further liberalization of the market, in 1990 Law 45 was issued by Congress. Such regulation established two types of financial institutions: credit entities and financial services companies (i.e. trust companies, general deposit companies, pension and severance funds and stock brokerage firms). Furthermore, Law 1735 of 2014 established a new type of regulated institution, the so-called specialized companies in electronic deposits and payments - SEDPE's (under its Spanish acronym). These regulations promoted a "multibanca" scheme under a parent and subsidiaries model[1].

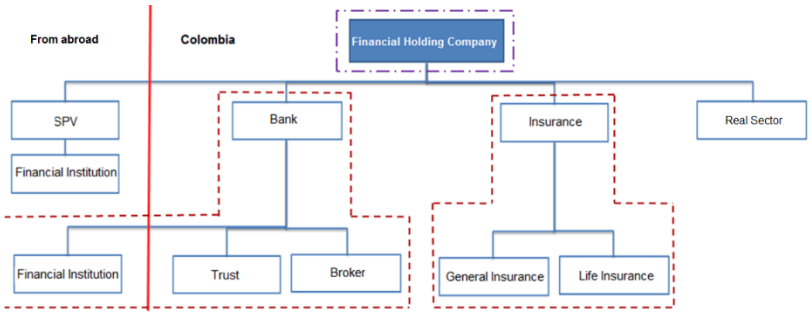
Even though the main purpose of such model was to allow the supply of financial services through subsidiaries while promoting economies of scale[2], it resulted in a greater concentration of the financial system since it required financial institutions to hold a minimum participation of 51% in the capital of financial services companies. This led to financial institutions becoming the parent company of such companies.

II. Regulatory and supervisory framework of financial conglomerates

Former regulatory framework in Colombia incorporated a definition of conglomerate that excluded non-financial holding companies and its financial subordinates abroad. In other words, under the aforementioned scheme, the supervision scope only included the financial

[1] See explanatory memorandum of Law 1328 of 2009.
[2] See explanatory memorandum and presentations for the Congress of Law 45 of 1990

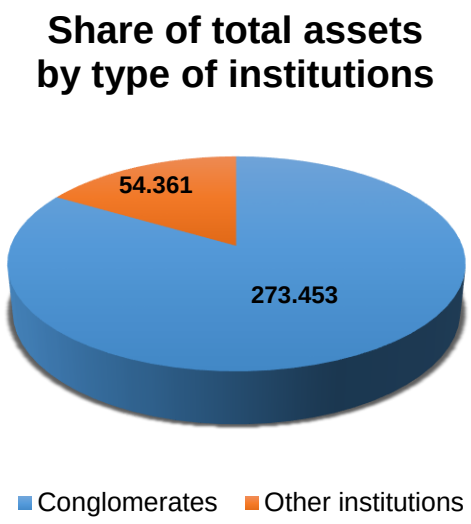
holding company supervised by the Financial Superintendency of Colombia (hereinafter the "SFC"), and its domestic and foreign subsidiaries. Graphically, the supervisory perimeter of the SFC can be explained as follows:

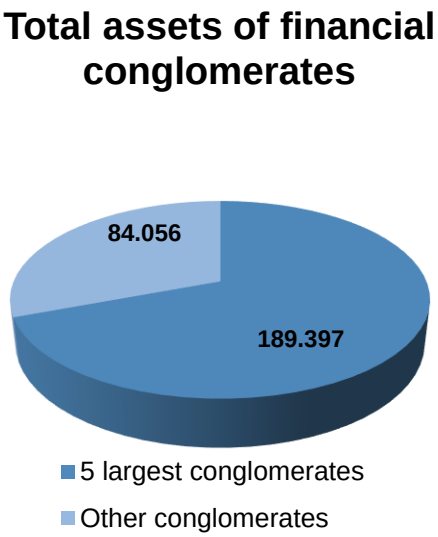


III. Expanding the supervisory and regulatory framework

3.1. Growth of financial groups

Domestic and regional expansion of financial groups highlighted the need to strengthen the regulatory and supervisory framework applicable to financial conglomerates. For instance, around 83% of the assets of the Colombian financial system are owned by conglomerates. Additionally, 58% of the system's assets are concentrated in the top five largest conglomerates.

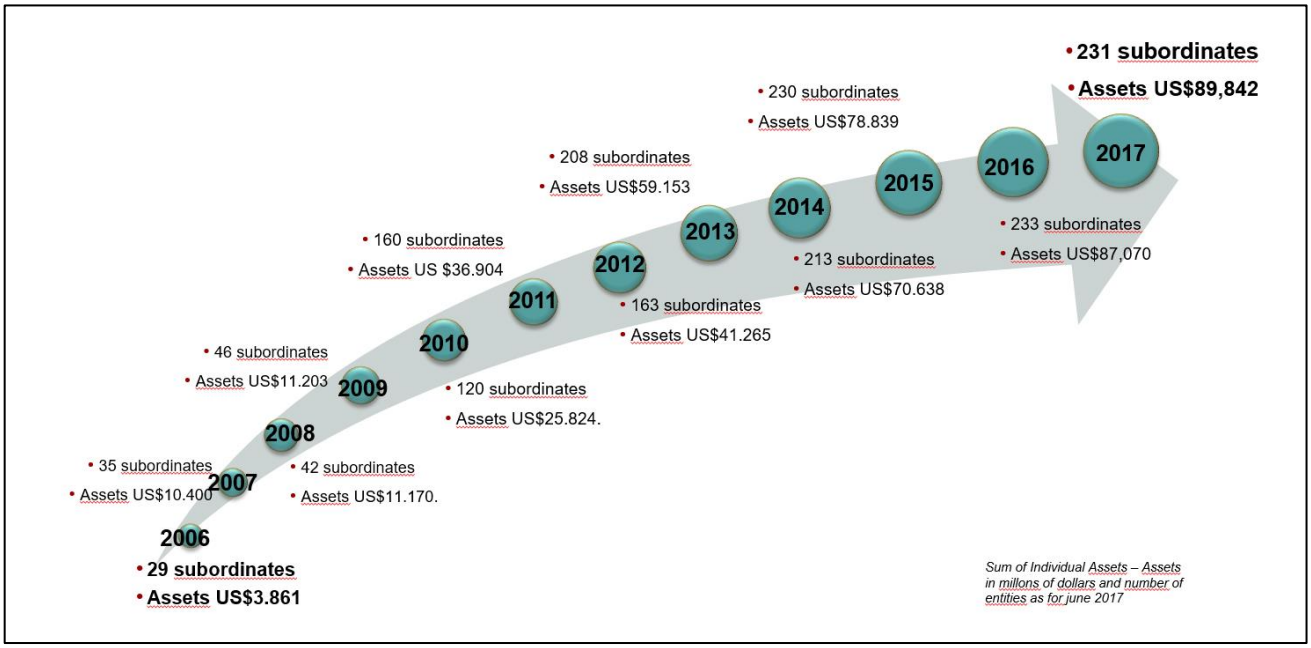




Figures in USD millions as of June the end of 2017.

Nowadays, Colombian financial conglomerates have invested nearly USD90 billion[3] abroad. Therefore, their assets in Salvador and Panama account roughly for 53% and 22% of the financial and banking assets, respectively.

Evolution of subordinates abroad of Colombian entities



3.2. International recommendations

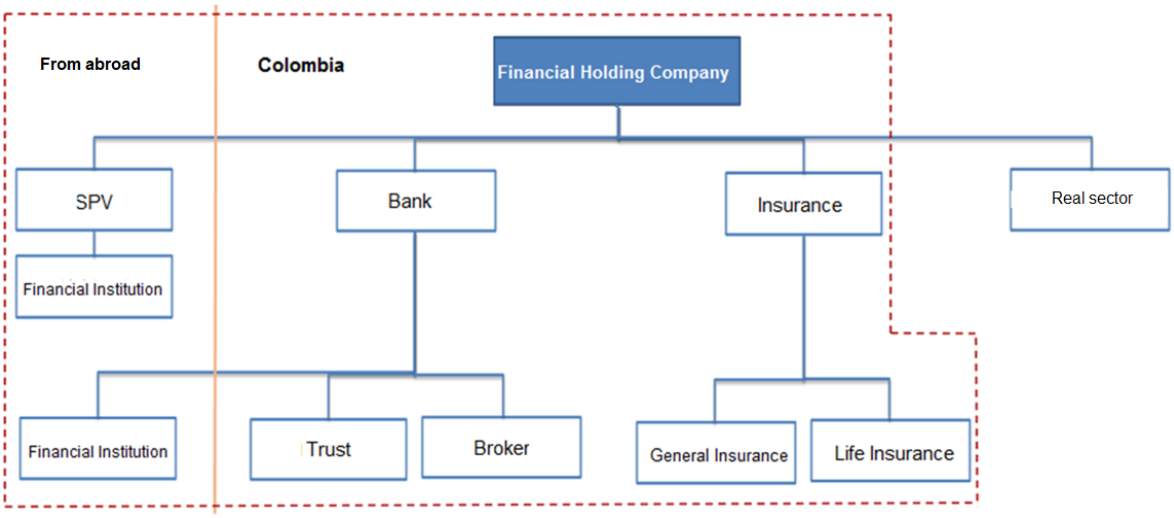
Several international organizations highlighted the need to extend the scope of supervision and regulation of conglomerates. For instance, the 2012 Financial Sector Assessment Program (FSAP) carried out by the International Monetary Fund (IMF) and the World Bank (WB) emphasized the need to extend the regulatory and supervisory powers over the financial conglomerate as a whole, including non-financial holding companies.

In the same way, the Organization for Economic Cooperation and Development (OECD) indicated that it is important to provide the SFC with supervisory powers over the holdings of financial conglomerates, when these are not supervised entities.

[3] Figures as of June 2017.

IV. Law 1870 of 2017 - Financial Conglomerates Law

On September 2017, Law 1870 of 2017 was enacted with the purpose of strengthening the regulation and supervision of financial conglomerates. Such Law granted the SFC the legal power and authority to supervise financial institutions holding companies even if it does not carry out financial activities directly. Furthermore, this Law gives the SFC more efficient tools to carry out a comprehensive supervision of the relevant conglomerate, including the offshore vehicles and financial institutions that are part of it, in the terms shown below:



The Financial Conglomerates Law has 12 articles seven of which are aimed at regulating the specific issues of supervision of financial conglomerates and introduces five main definitions:

4.1. Financial conglomerate

A set of institutions falling under common control, that includes two or more domestic and/or foreign entities involved in an activity regulated by the SFC, provided that at least one of them carries out said activities in Colombia. According to Law 1870, a conglomerate is formed by (i) the common controller (financial holding company), (ii) Colombian licensed financial subsidiaries, (iii) offshore financial subsidiaries that carry out what would be

deemed financial, securities or insurance activities in Colombia, and (iv) investment vehicles used to exercise control.

4.2. Holding company

The legal person or investment vehicle that is the most proximate common controller (or that exercises significant influence, as defined below) over all the companies and/or vehicles that belong to the financial conglomerate. Therefore, under the Law a financial holding company might arise either by control or by significant influence. Such differences will be recognized by the secondary regulation.

4.3. Holding by control

Under the Colombian Corporate Law, a corporation is controlled by another person whenever its decision powers are exercised directly or indirectly by one or more third parties. The Law deems that this occurs in the following three circumstances: (i) ownership of more than 50% of the relevant corporation's voting stock, (ii) the holding of enough voting stock to give the controller a voting majority in shareholders meetings or to enable the appointment a deciding majority to the board of directors, and (iii) the exercise of dominant influence over the relevant corporation by means of an agreement between the controller or controllers and the corporation itself or its shareholders. The first, or most proximate level of control is the closest legal entity or investment vehicle that exercises actual common control over all the entities and/or corporations that are part of the financial conglomerate.

4.4. Holding by significant influence

The notion of significant influence is understood in the context of deducting from the legal presumption of share ownership *((i) above)* the stakes held by institutional investors which are barred by regulation from exercising control. However, Law 1870 does not give a comprehensive definition of this notion. Therefore, in determining the composition of the different financial conglomerates, the SFC has referred to the definition of this term set forth

in the international accounting standard IAS28 on investments in associates and joint ventures. This definition states that significant influence is the power to intervene in the decisions of an entity without having absolute control or joint control of it.

According to the standard, significant influence commonly arises in any of the following cases: (i) representation on the board of directors, (ii) participation in policy-setting processes, including decisions regarding dividend distribution and other earnings distributions, (iii) relevant transactions among entities, (iv) common membership in upper management and boards, (v) disclosure of essential technical information, among others.

Taking into account the aforementioned definitions, the SFC has identified 15 financial conglomerates on which a comprehensive consolidated supervision will take place.

V. Powers conferred to the National Government

The Law empowered the National Government to strengthen the prudential regulatory framework applicable to financial conglomerates by setting forth: (i) capital adequacy levels that are sufficient to support the risks assumed by the conglomerate while avoiding the multiple gearing; (ii) criteria to exclude from a given conglomerate certain investment vehicles and entities, in order to make conglomerate oversight more efficient; (iii) exposure risk concentration limits; (iv) criteria to ascertain the related parties to the conglomerate, and (v) the rules to manage and disclose conflict of interest and related party transactions.

VI. Powers granted to the SFC

The Law also empowers the SFC to: (i) issue regulations to be followed by the financial holding company regarding risk management, internal control, information disclosure and corporate governance; (ii) authorize the financial holding company to carry out direct/indirect capital investments in domestic or foreign financial institutions; (iii) require the financial holding company to change the conglomerate structure if it does not allow: a) adequate

information disclosure, b) a comprehensive and consolidated supervision, or (c) the identification of the conglomerate's beneficial owner; and (iv) revoke the license of a local financial institution which controller is domiciled abroad whenever the SFC considers that the information levels provided hinder the proper exercise of its supervisory functions.

Also, financial holding companies domiciled abroad, in jurisdictions having prudential regulation and supervision that is equivalent to Colombia's (as determined by the SFC), will not be bound by the provisions of Law 1870. In any event, under general provisions of local law, the SFC may make information requests for supervision purposes to any controller of local financial institutions.

To conclude, it is important to acknowledge that the supervisory scope over the holding companies will be limited to their role as business managers and shareholders.

6.1. Conglomerate prudential framework: a work in process within the SFC

Currently, the SFC is working in defining the instructions that institutions must comply in order develop an integrated and comprehensive assessment of the risks faced by the financial conglomerates. This framework, as the Basel Committee defines it, seeks to have in place management policies and procedures that are designed to help ensure an awareness of, and accountability for, the risks undertaken by the financial firms, and also to develop the tools needed to address those risks. Moreover, in order to be aligned with the latest practices in risk management, this framework will require conglomerates factors like risk culture, group-wide risk tolerance levels and a risk appetite policy and the use of a group-wide stress test for its major sources of risk and the monitoring of risk concentrations.

One important element in an integrated risk management system of a conglomerate engaged in a broad set of activities is the development of a framework in which multiple types of risks are aggregated. The most common use of this framework is to support

decisions about capital allocation which will ultimately contribute to the resilience of complex conglomerates. Nonetheless, risk aggregation has developed new roles that are equally important: (i) it supports risk identification and monitoring since it enables the financial conglomerate to gain a better understanding of the variety of risks faced by the conglomerate, and (ii) it defines more accurately the amount of capital needed to operate and absorb potential losses under different economic conditions, while determining the probability of financial distress.

In this matter, the following steps should be undertaken in order to define the capital sufficiency using aggregation risk models. First, financial conglomerates must ensure that all risk types are adequately captured and communicated along the group and that a common risk language is used across the group. The second step is to make sure that institutions belonging to a conglomerate understand each other's businesses. Third, define the model that will be used for each risk. Finally, model each risk to a certain confidence limit, aggregate them and determine how much capital is required to cover them.

As part of the modeling process, the risk aggregation should take into account probability distribution, which quantifies potential outcomes and their associated relative likelihoods of occurrence. These methodologies should reflect tail events. Therefore, this requires that the model assigned appropriate probabilities to potential severe events and perform robust scenario analysis and stress testing. This takes relevance to the extent that: (i) correlations among risk exposures are usually lower during stress periods than in normal times, and (ii) scenario analysis allows institutions to identify risk drivers and the potential interactions in risk measurement in different economic conditions.

Another important aspect to bear in mind in the risk management process and in the capital assessment is the quantification and integration of the specific risk associated to conglomerates. This is, according to OECD and the Joint Forum, transaction risk, moral

hazard risk, regulatory arbitrage, double gearing risk, contagion risk, reputational risk, conflict of interest and concentration risk.

The assessment of these risks should consider the following features: the size and structure of the financial conglomerate, the types of institutions that belong to the group and the degree of integration along the value chain. These factors might determine the cross-sector and cross-border inter-linkages that a conglomerate may possess, the inter-dependencies and systemic consequences of failures, and therefore, the measures that conglomerate must implement to mitigate, manage or prevent such risks.

Another element included in the SFC's working agenda is the need for a financial conglomerate to have adequate management information systems and reporting practices. This is that institutions must have in place effective systems and processes to identify, assess and report group-wide risk exposures. The recent financial crisis proved that risk exposure information and information technology were insufficient to support the management of financial risks and to have a prompt consolidated view of the risk exposures.

Finally, the SFC will be also working on the information needed not only to assess compliance with the prudential framework but also to have a comprehensive understanding of the operations of the financial conglomerates, their business strategy, governance arrangements and risk exposure, including a forward-looking assessment of the sources of risk faced by these groups.

To conclude, the Financial Conglomerates Law confers to Colombia's regulators and supervisors a wide range of tools in order to strengthen the conglomerate supervision in a comprehensive and consolidated manner. This implies an evolving regulation that not only aims at converging at international standards but also recognizes the current structure of the Colombian financial system.