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**COMMISSION STAFF WORKING DOCUMENT**

**Accompanying document to the**

**Proposal for a**

**DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

**amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC as regards the  
supplementary supervision of financial entities in a financial conglomerate**

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## 1. BACKGROUND

The establishment and development of large, complex groups combining several banking and insurance licenses, was recognized in the early nineties. Following recommendations by the Joint Forum, the G10 body of supervisors, the Financial Conglomerates Directive<sup>1</sup> (FICOD) was adopted in 2002. It aimed at the supplementary supervision of regulated entities that form part of a financial conglomerate, by focusing on potential risks of double gearing (multiple use of capital) and on "group risks": the risks of contagion, management complexity, risk concentration, and conflicts of interest.

Since 2002, markets have further developed in a direction where the distinction between banking business and insurance business is not always easily discernable and where the largest groups are active in many countries. Both the revision of the 1988 Basel Accord in 2004, implemented in the EU by the Capital Requirements Directive (CRD)<sup>2</sup> in 2006, and the introduction of a comprehensive set of regulations for insurance companies in Solvency II (S2)<sup>3</sup> developed the regulatory framework but, as regards conglomerates, only in so far as legal entities of a group are active in the same sector - banking *or* insurance. The supplementary regulatory framework under FICOD dealing with the additional complexity and risks stemming from combinations of licenses has not been evaluated yet.

As of the end of 2009, the directive covered 69 European groups and 6 third country groups. About 35 of them are small and operate mainly domestically with a few licenses. Although the revision is also intended to simplify the supervision of small conglomerates, it specifically deals with the supervision of the 30 or so biggest financial groups in Europe. Total assets of these at the end 2009 exceeded €25 trillion, representing a substantial share of the EU banking market of roughly €42 trillion assets and the EU insurance market of roughly €10 trillion assets. A typical large conglomerate has over 400 licenses in several jurisdictions and several sectors: banking, life and/or non-life insurance, asset management.

## 2. STAKEHOLDER CONSULTATION

The Commission discussed possible improvements to the current legislative text three times at the European Financial Conglomerates Committee (EFCC)<sup>4</sup> and three times in its FICOD working group. The FICOD review benefited from two earlier evaluation exercises with respect to financial conglomerates regulation conducted by the so-called [Mixed Technical Group](#) in 2005 and by the Interim Working Committee on Financial Conglomerates, a predecessor to the Joint Committee on Financial Conglomerates (JCFC),<sup>5</sup> in 2008 ("the [Capital Advice](#)"). In April 2008 the EFCC approved the launch of the required review of the FICOD with a [Call for Advice](#) to the JCFC.

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<sup>1</sup> Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

<sup>2</sup> Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and directive 2006/49/EC on the capital adequacy of investment firms and credit institutions

<sup>3</sup> Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), but until Solvency II is implemented, the FICOD supplements the insurance directives presently in place

<sup>4</sup> Advisory committee for financial conglomerates.

<sup>5</sup> Lamfalussy level 3 committee for financial conglomerates

The industry has been involved - by means of the EFCC first newsletter and dialogues - since May 2008, and has also expressed its views on four public occasions since then.

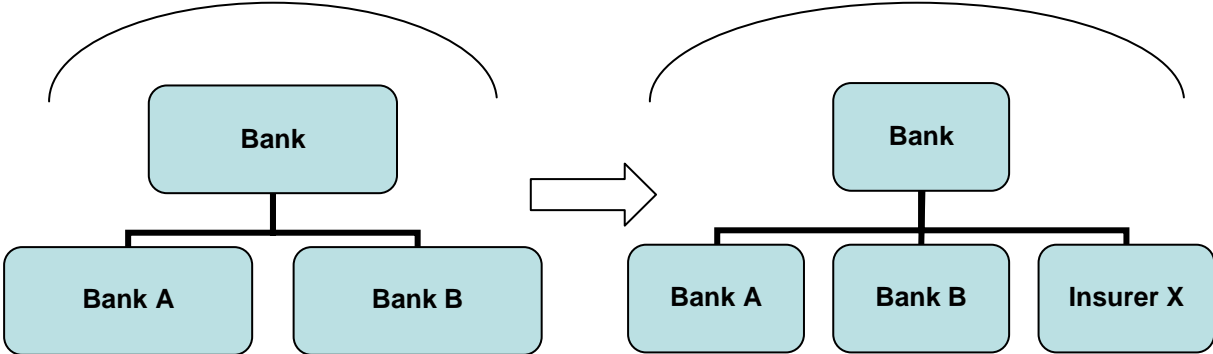
After receiving the final [JCFC Advice](#) in October 2009, a public consultation on the remaining questions and potential policy alternatives under consideration ran from 6 November 2009 until 15 January 2010. Responses to the public consultation<sup>6</sup> from a variety of both bank- and insurance-led conglomerates of a range of sizes revealed a broad support for the Commission services' suggestions.

**3. PROBLEM DEFINITION**

**3.1. Supervision at the holding company level**

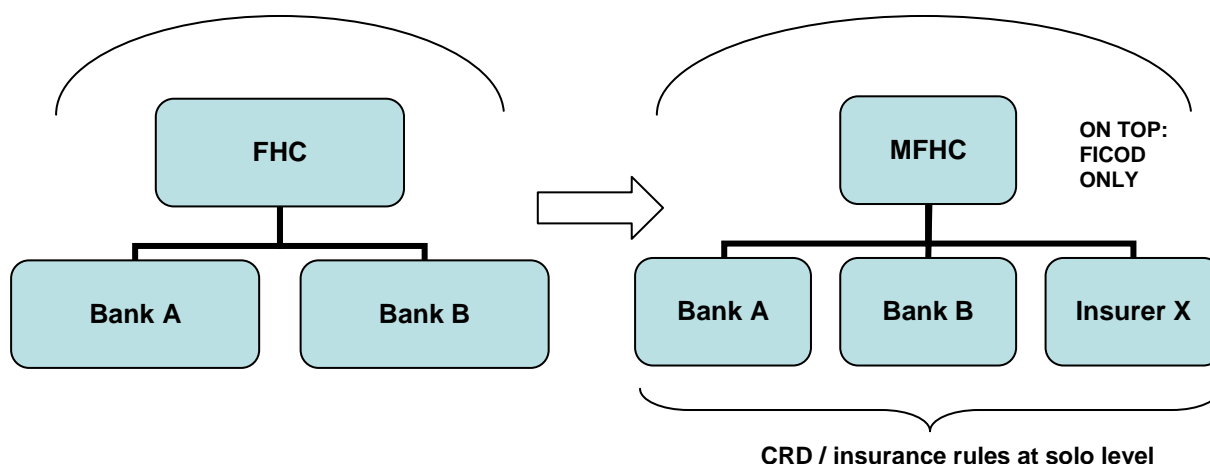
Supervision at the level of the holding company is governed by the combination of the current provisions of the FICOD, the CRD and the Insurance Groups Directive<sup>7</sup> (IGD). These directives refer to 'mixed financial holding companies' (MFHC), 'financial holding companies' (FHC) and 'insurance holding companies' (IHC), respectively. The supervisory tools that can be applied at the top level change when the top level becomes an MFHC and ceases to be a FHC or an IHC. Figures 1 and 2<sup>8</sup> below demonstrate that the identification of a financial conglomerate can affect the application of sectoral group supervision differently, depending on the structure of the group.

**Figure 1:** FICOD supplements and partly replaces sectoral supervision if a banking or insurance group becomes a conglomerate. Before acquisition by a holding company, a bank or an insurer is subject to consolidated supervision as laid out in either the CRD or the IGD. After the acquisition, consolidated supervision can only be applied to a top level banking or insurance entity. FICOD supplements that consolidated supervision.



**Figure 2:** FICOD replaces sectoral supervision at a group level. If a MFHC replaces a FHC and/or an IHC and if there is no top level banking or insurance entity (i.e., all licenses are owned directly by an MFHC), sectoral group supervision provisions can no longer be applied.

<sup>6</sup> [http://ec.europa.eu/internal\\_market/consultations/docs/2009/ficod/feedback\\_document\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2009/ficod/feedback_document_en.pdf)  
<sup>7</sup> Directive 98/78/EC on the supplementary supervision of insurance undertakings in an insurance group  
<sup>8</sup> Figures 1 and 2 use the example of a banking group for the purposes of illustration, but the same is true for insurance groups, with reference to the application of the CRD replaced by the IGD



As a result of the interaction depicted in Figure 2, certain tools of sectoral group supervision that can be applied at the level of a FHC or an IHC can not be applied to the whole group when the holding company is a MFHC. Those tools include the waiving of solo-supervision of subsidiaries, the application of provisions on disclosure (Pillar 3) and self-assessment and supervisory review (Pillar 2) on a consolidated basis. This leads to the anomalous result that a group which has acquired a license in the other sector, so that the holding company becomes a MFHC, is subject to a regulatory regime which may not be as comprehensive as that which applied before the acquisition, even though the group has increased in size and complexity and may therefore represent a higher risk to the financial system.

As a consequence, the use by supervisors of a waiver in determining whether a group is a financial conglomerate is influenced by the assessment of whether the application of the sectoral supervision may be more prudentially sound. However, the continued application of sectoral supervision may not adequately address the additional prudential risks that arise from the increased size and complexity of the group - risks which would have been addressed by the supplementary aspects of the FICOD; and may result in differences in supervisory treatment (based on the structure rather than on the risk profile) of conglomerates.

### 3.2. Supervisory coordination

FICOD supplements the CRD and insurance directives for additional supervision at the top level of a group. To that end, it also contains provisions for coordination among different supervisors of a group. FICOD defines who is a relevant competent authority (RCA), and requires the coordinator (the top level supervisor) to consult RCAs on certain supervisory questions. However, the current provisions leave room for varying interpretations of the authorities that qualify as RCAs. A broad interpretation results in a high number of RCAs that must be consulted by the coordinator at the financial conglomerate level, which may undermine the effective and efficient coordination of the work to be carried out by the "college" of a coordinator and RCAs.

### 3.3. Identification

Provisions governing the identification of financial conglomerate also give rise to three sub-problems.

First, the directive does not require the inclusion of asset management companies (AMCs) in the threshold tests, because UCITS were excluded from sectoral prudential supervision in

2002, although it does require that AMCs be included in the scope of supplementary supervision. Second, the threshold tests can be based on different parameters with respect to assets and capital requirements but the provisions are ambiguous as to how calculate the tests arising from, for example, different accounting treatments of assets, or parts of the group which do not always have a solvency requirement. Third and most importantly, the threshold conditions, given their fixed amounts, are not risk-based, and the notion of expected group risks is not addressed by the threshold test. This implies that very small groups with a few licenses in each sector are subject to supplementary supervision, while the largest most complex groups can technically be identified as not being a conglomerate. As a result, the current provisions on identification may undermine the effective achievement of the underlying objectives of the directive.

### **3.4. Participations**

The consistent treatment of participations in day-to-day supplementary supervision is hampered by the lack of relevant information to assess group risks, which is not so straightforward when participations are held in listed firms. Company law may prohibit one minority shareholder from receiving more information about that firm than its other shareholders. For example, if information about risks with respect to participations in insurance and reinsurance companies cannot be obtained by bank-led conglomerates, they cannot provide their supervisors with the evidence of a satisfactory level of integration of management and internal control with these entities that is necessary for consolidation and the right to deduct such participations from their capital that consolidation entails.

## **4. OBJECTIVES**

The over-arching objective of this initiative is to ensure that the effectiveness of the supplementary supervision of large and complex groups in the EU under the FICOD is enhanced, while maintaining the competitive position of these groups. This translates into the following three general policy objectives to:

- Enhance financial stability;
- Enhance safeguarding of creditor and policyholder interests;
- Ensure international competitiveness of EU financial groups.

In light of the problems presented above, three sets of operational objectives have been identified to address the specific problem drivers. Effective realization of such operational objectives should contribute to the achievement of the longer-term specific policy objectives aimed at enhancing the effectiveness of supplementary supervision, reinforcing the risk management of financial conglomerates, eliminating opportunities for regulatory arbitrage, reducing the burden of compliance and enhancing the level playing field, supervisory cooperation and convergence, and legal clarity.

## **5. POLICY OPTIONS AND THEIR IMPACT**

Altogether, seventeen policy options have been designed, impact-assessed and compared with a view to addressing the issues identified in the analysis. This section describes the expected impacts of preferred policy measures in each area.

### **5.1. Supplementary supervision on holding company level and supervisory coordination**

In order to align supervisory powers at the top level of a conglomerate, to prevent both the loss of powers when a group structure changes and the duplication of supervision at the conglomerate level, and to facilitate coordination by the most relevant supervisors, the following targeted amendments will be introduced:

- end the exclusion of top level holding companies of a banking or an insurance group that are classified as a MFHC, so that provisions and powers that applied to the former FHC or IHC do not disappear when the classification of a group and its holding company changes as a result of an acquisition in the other sector;
- narrow the definition of RCA to include only supervisors of ultimate parent entities within individual sectors and any other competent authorities that the supervisors of the ultimate parent entities consider are relevant.

### **5.2. Identification of financial conglomerates**

To address the problem outlined in section 3.3 regarding the inclusion of AMCs in supplementary supervision, the inclusion of AMCs at all times, complemented with guidance on indicators for inclusion, will be proposed.

In order to tackle the ambiguity regarding parameters and the lack of a risk-based identification of conglomerates, technical standards on the application of the "waiver option" for larger groups in Article 3(3) of the FICOD will be proposed, and an option will be introduced to waive supplementary supervision for groups where the assets held by the smallest sector are below the absolute threshold of €6 billion.

### **5.3. Participations**

The problem of the day-to-day treatment of participations under supplementary supervision, which is aggravated by the fact that company law may prohibit a minority owner from accessing information which is not accessible to other shareholders, will be alleviated by technical standards with respect to treatment of participations in various situations.

### **5.4. Impact of preferred policy options**

The proposed policy changes are expected to render the supplementary supervision framework more robust, leading to more effective risk management incentives and practices which, in turn, should also help to enhance the international competitiveness position of EU financial groups. The proposals should contribute positively to containing the risks to the financial stability and the concomitant costs to society. At the level of individual stakeholder groups and systemic concerns, expected impacts of the proposals are as follows:



- Certain smaller EU financial groups with a simple structure and not more than a few licenses in both sectors may be excluded from supplementary supervision and would therefore benefit from savings in compliance costs. This may be available to some ten smaller financial groups with combined assets of approximately €9 billion. Compliance costs for several large bank-led conglomerates that have hundreds of licenses and are active in both sectors, on the other hand, should increase as several such groups, representing up to € trillion assets in the financial sector, may be included in the scope of the supplementary supervision. Increased compliance costs would also be incurred by those financial groups whose structure includes asset management business and that will be identified as financial conglomerates following proposed changes to the conglomerate identification process. Compliance costs for financial groups that are newly included in the scope of the supplementary supervision should, given their overall size, be immaterial in relative terms. Furthermore, they should be offset with benefits arising from more effective risk management practices, induced by incentives implicit in this legislative proposal. Another positive impact can be expected from a greater visibility and trust in the markets that should result from identification as a conglomerate. These benefits should enhance the international competitiveness of large EU groups, given initiatives in the area of supplementary supervision that are being pursued in other major international jurisdictions.
- The aforementioned changes to the conglomerate identification process will make the scope of the supplementary supervision more appropriate and should therefore enhance the effectiveness of supervisors' monitoring of the risks to which financial groups are exposed. Combined with a more streamlined supervision at the top level of conglomerates and an improved supervisory toolkit for detection of contagion, concentration, complexity issues and conflicts of interests in firms connected to a conglomerate through participations, this should make a positive contribution to the financial stability.
- The enhanced clarity of provisions governing the inclusion of asset management companies in the identification and supplementary supervision should provide a more level playing field in this area.
- As regards clients of the affected financial groups, the impact is expected to be negligible given the overall level of materiality of the net incremental effect of this proposal on those groups. Moreover, clients might not be aware of differences between the regulatory treatment of banks, insurers and conglomerates: they simply trust that the supervisory framework is comprehensive and prudent, and this revision is especially aimed at reinforcing that framework and so justifying that trust.

## 6. MONITORING AND EVALUATION

It is expected that the proposed amendments will enter into force in 2011. The proposed amendments are closely linked with a recent proposal of the Commission for the Omnibus Directive, amending the financial services directives to take account of the introduction of the new European Supervisory Authorities. They also are likely to be followed by a more fundamental review of the FICOD that may include provisions on the quality of capital buffers and scope as regards non-regulated entities. Therefore, it might be sensible to conduct a comprehensive evaluation based on the entirely overhauled legislative framework, for which a target date should be set in line with the evaluations of these other directives.