

ROADMAP

Title of the initiative: **Review of the Financial Conglomerates Directive (FiCoD, Dir 2002/87)**
Lead DG/contact person: **DG MARKT, H1, Banking & Financial Conglomerates**
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Initial IA screening & planning of further work

A. Context and problem definition

What is the political context of the initiative? How does this initiative relate to past and possible future initiatives, and to other EU policies?

- (1) The FiCoD envisages a review of its provisions some years after implementation. This review started in 2008. It is guided by the objectives of the FiCoD, aimed at the supplementary supervision of regulated entities that form part of a conglomerate. The directive provides such supplementary supervision by focusing on potential risks of double gearing (multiple use of capital) and of contagion, complexity, concentration, and conflicts of interest, the so-called group risks. The review will conclude whether the current provisions are effective to that end. The Commission Services asked the Joint Committee on Financial Conglomerates for their advice which was delivered in October 2009.
- (2) In the meantime, however, these so-called group risks appear to have materialized all across the financial sector. The importance of the supplementary supervision on these inter-linkages within financial groups and among financial institutions has increased. Also the Financial Stability Board calls for supplementary supervision on complex groups. This is why the Commission decided to start a proposal for a revised FiCoD.
- (3) The initiative relates 1:1 to the two most important sectoral directives, the Capital Requirements Directive (CRD) and Solvency II (S2), regarding the prudential supervision of banks and insurers respectively. The FiCoD provides for supplementary supervision on top of those two directives, as well as solutions for regulatory loopholes between the two directives. Both the substance and the planning of the revised FiCoD will therefore be related to the conclusions of these two current legislative initiatives.

What are the main problems identified?

- (1) The FiCoD provides for the identification of financial conglomerates which should be subject to supplementary supervision on group risks, based on quantitative criteria. The implementation of the FiCoD has shown, however, that groups which are evidently exposed to group risks, the so called large complex financial institutions (LCFIs), can be excluded from the application of the directive following the current provisions, while small, simple groups consisting of two, perfectly controllable licenses, are included in the directive's scope. The artificial, quantitative thresholds that resulted from a political process back in 2002 need to be accompanied by criteria which allow identification based on the nature, scale and complexity of the financial group in question, using the quantitative criteria in the current provisions as a materiality threshold.
- (2) Supervision at the level of the holding company is affected by the combination of the current provisions of FiCoD, CRD and insurance directives, referring to 'mixed financial holding companies' (MFHC), 'financial holding companies' (FHC) and 'insurance holding companies' (IHC). The supervisory tools that can be applied at the top level change when the top level becomes a MFHC and can no longer be a FHC or IHC. This interaction of definitions and of provisions for supervision on holding companies hampers the use of supervisory tools at top level, or even lead to a loss of tools to effectively supervise the top level of a conglomerate. Since it is the top level where important decisions about capital attraction, capital allocation,

and group wide risk management are taken, this distortion needs to be restored.

- (3) The definitions of 'participation', 'close links' and 'group' have consequences for the scope of the supplementary supervision. For sector-specific reasons, the definitions of these concepts can be slightly different in sector-specific directives and allow for flexibility, which complicates the application in the case of conglomerates. This relates to a long-lasting debate regarding the possible interpretations of the 'durable link' concept as introduced in the definition of 'participating interest' in the Fourth Council Directive 78/660/EEC, and calls for more clarity.
- (4) The FiCoD provides for the inclusion of participations in other firms into the supervisory scope, regardless whether they are regulated or non-regulated firms. This is justified from a group risks point of view. However, in order to be able to control the risks coming from the participations (for the LCFI In question) or to supervise the potential contagion (for the supervisor), information is needed from that firm's risk management systems. Company law prohibits the access to information by minority owners if the information is not provided to majority owners either. Additional consideration is needed with respect to the access to necessary risk management information for supervisors, and to the way supervisors treat the participations in case they cannot access the necessary information.
- (5) The FiCoD provides for a double check of the capital adequacy of the group as a whole, aimed at the prevention of multiple use of capital (so called double gearing). However, the capital adequacy calculation methods provided for in the FiCoD appear to give different results. The calculation methods for capital adequacy of the conglomerate as a whole need to be simplified and streamlined.
- (6) Other legislative changes or alternative policy options which are foreseen after reviewing the implementation of the FiCoD relate to a.o. (i) the inclusion of re-insurers in the scope, (ii) the way asset management companies are included in the scope.

Is EU action justified on grounds of subsidiarity?

In an increasingly integrated EU financial marketplace, cross border groups of financial services providers, either insurers or banks or investment firms, or other, have become a dominating force in the sector. The EU-passport allows financial firms to operate across the EU. The group risks referred to above, are academically shown to rise with group size, and they materialize especially in this larger, more complex, environment. Importantly, gravity and implications of these risks for the financial stability has been underscored by the recent financial crisis. While supplementary supervision on a confined, national basis may help in containing them, actions taken by individual Member States will not be sufficient to facilitate effective and coordinated supplementary supervision in a cross border context that is crucial for the stability of these groups and, in turn, the stability of the financial system they operate in.

B. Objectives of EU initiative

What are the main policy objectives?

The main policy objective of the revision is to simplify and clarify the FiCoD with respect to the issues mentioned above, and to harmonize its application, when dealing with LCFIs. Questions to deal with would be: At what level should supervision be applied? What kind of groups should be scoped in, and which should be scoped out? How should the supervisory scope be streamlined across the relevant directives? How should participations be treated if the necessary information to assess the risks of intra group transactions and risk concentrations cannot be obtained? What kind of firms should be in the supervisory scope? How could the most effective supervision on contagion and risk concentration be achieved? How should capital adequacy be calculated for the group as a whole? How can convergence between member states with respect to the application of supplementary supervision on LCFIs be achieved? How should national supervisors coordinate to get a grip on cross border LCFIs?

Does the objective imply developing EU policy in new areas or in areas of strategic importance?

This initiative will be a clarification and a simplification of existing regulation, but it also contributes to the package of measures taken by the Commission in response to the financial crisis, insofar as it provides a framework for the supplementary supervision on LCFIs.

C. Options

What are the policy options? What legislative or 'soft law' instruments could be considered? Would any legislative initiatives go beyond routine up-date of existing legislation?

The initiative may result in a proposal for a legislative revision of the current directive 2002/87, addressing the issues mentioned above. In addition, the Commission could ask the Joint Committee on Financial Conglomerates (the Lamfalussy level 3 subcommittee dealing with this directive) to establish supervisory guidance and/or deliver convergence reports to the European institutions on the implementation of Directive 2002/87, or its revised version. Also, the Commission may ask the Joint Committee of the newly established European Supervisory Authorities to develop technical standards with respect to the application of specific provisions of this Directive.

Does the action proposed in the options cut across several policy areas or impact on action taken/planned by other Commission departments?

(1) As explained above, the FiCoD provides for supplementary supervision on top of the sectoral directives, the revised CRD and S2, both adopted in 2009. This initiative cannot be seen separate from these two initiatives and can only be carried out after their conclusions. This requires cooperation with other Commission services.

(2) Also, the review showed that a lot of confusion is caused by definitions in directives that came after the Fourth and Seventh Council Directive. For example, the 7th Dir had provided a clear definition of "unity of control", but more recent definitions were adapted in political processes that not necessarily added to the clarity of these definitions. This also affected the FiCoD. DG MARKT is looking into the consistency of definitions across directives in the financial sector. This initiative will also concern definitions in the FiCoD and may need to be included in a possible legislative revision. This requires close cooperation with other Commission services.

Explain how the options respect the proportionality principle

As explained above, the supplementary supervision provided by the FiCoD, is only justified when groups are potentially exposed to group risks, and/or when management complexity could cover up the potential double use of capital. The sectoral directives, CRD and S2, sufficiently deal with the required assessment of sector-specific risks, the management of these risks given the business which is allowed under the granted licenses, and the appropriate capital adequacy thereto. The FiCoD is supplementary to these sectoral directives and not meant to replace them. The purported simplification would increase the effectiveness of the supplementary supervision on the top level of the conglomerate, where the decisions are taken about the attraction of capital, the allocation of capital across their businesses and about group wide risk management, steering all sectors in the conglomerate's business model.

D. Initial assessment of impacts

What are the significant impacts likely to result from each policy option (cf. list of impacts in the impact assessment guidelines), even if these impacts would materialise only after subsequent Commission initiatives?

The current directive covers about 80 groups in Europe, which are identified as a financial conglomerate. Many of them (about 45) are small and operate domestically with a few licenses. The revision specifically deals with the supervision of the approximately 35 biggest financial groups in Europe, engaged in both the banking and insurance business, and most of the time also the asset management business. The 35 groups add up to over 25.960 billion euro in total assets (end 2007

annual public accounts figures). A typical large conglomerate has over 400 licenses in several jurisdictions and several sectors (banking, insurance life and/or non-life, asset management); the biggest groups have more than 950 licenses, and about 2,000 legal entities in total.

The clarity and simplification will make supplementary supervision more effective and focused, especially with respect to these largest LCFs. The revision may scope out the smallest, purely domestic, groups whose group risks are assessed as negligible.

First, this will remove unduly administrative burden, which was caused by a burdensome identification process and reporting requirements based on quantitative thresholds only. Second, it will contribute to financial stability on a cross border basis, by steering supervisory resources more focused to supplementary checks on the LCFs' group risks.

Could the options have impacts on the EU-Budget (above 5 Mio €) and/or should the IA also serve as the ex-ante evaluation, required by the Financial Regulation?

No.

Could the options have significant impacts on simplification/administrative burden or on relations with third countries?

The direct administrative burden stemming from implementing the FiCoD 's requirements appear to be very small (cf FSAP cost of compliance study; Europe Economics March 2009). The FiCoD has more an impact on the design of risk management systems, for which the incremental costs are hard to estimate. Both industry and supervisors, however, mention the burdensome identification process of applying quantitative thresholds. Given that conglomerates are dynamic bundles of activities and licenses, this exercise is a challenge every year.

The most important impact of the FiCoD, however, should be found in the financial stability resulting from capital management and risk management on a group wide basis, both for the conglomerate in question and for their supervisors' assessments. While current combinations of directives require checks and balances on both top and subtop levels as a fragmented aggregation of rules, the effectiveness of supplementary supervision, aligning with the purported group wide decision process on capital and risk management, could be significantly increased.

For the assessment of the applicable group supervision on parents of European financial firms in third countries, the FiCoD provides for a check of supervisory equivalence. Although the text of this principle based provision will not change, the revision of the substance in other provisions might change the substance of this equivalence check. Therefore, the Services will keep the relevant third country authorities informed throughout the process of the revision.

Who is affected?

Supplementary supervision is aimed at protecting all those who may be affected by the risks of inter-linkages within LCFs and among LCFs, which are endangering financial stability; today that's almost everyone. This review focuses on the technical issues in the legal text which have hampered supervisors from achieving that aim. The revision will mainly affect supervisors and the conglomerates under supervision.

E. Planning of further impact assessment work

What information and data is already available? What further information needs to be gathered? How will this be done (e.g. internally or by an external contractor) and by when? What type and level of analysis will be carried out (cf. principle of proportionate analysis)?

A mixed technical group (MTG) chaired by the Services gathered difficulties during the implementation of the FiCoD in 2005; their findings are available. A Call for Advice regarding specific elements of the review was sent out to the JCFC in April 2008, for a final Advice in October 2009; the draft advice was published for consultation in May 2009 and the final advice was delivered in October 2009. The cross sectoral consistency check among the definitions of the financial sector

directives was delivered by DG MARKT's unit G1. The revised Capital Requirements Directive and the Solvency II Directive were adopted in April and May 2009.

Which stakeholders & experts have been/will be consulted, how and at what stage?

The member states were informed and involved at the start of the review in April 2008, and they're being informed about the progress of the review frequently. The supervisory community was informed and involved immediately after the member states at level 2 had supported the review plan by means of a Call for Advice dated April 2008. The industry was informed and involved in May 2008, and invited to establish an industry mirror group consisting of the major financial conglomerates among the EU. The European Banking Federation, the CEA, representing insurers and reinsurers in Europe, and some of the other European associations like the European Association of Co-operative Banks (EACB), the European Association of Savings Banks (EASB) and the European Association of Public Banks (EAPB). The three groups of stakeholders (member states, supervisors, industry) gathered at a roundtable on 8 September 2008 to discuss the main issues (see chapter A). The industry reflects upon the supervisors' findings, which are included in the review advice, and responded to their draft Advice in summer 2009. On 16 December 2008 a public hearing took place, where initial findings were discussed among supervisors and industry; a second public hearing took place on 8 July 2009 about the draft Advice. On 22 January 2009 the member states in the European Financial Conglomerates Committee (EFCC) were presented interim findings by both supervisors and industry; on 9 July 2009 about the draft Advice. The JCFC published their findings for consultation in May 2009. The Commission Services conducted a public consultation in November 2009 – January 2010.