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Banking and financial conglomerates

General guidance from the European Financial Conglomerates Committee to EU supervisors: the extent to which the supervisory regime in the United States of America is likely to meet the objectives of supplementary supervision in Directive 2002/87/EC

General guidance from the European Banking Committee to EU supervisors: the extent to which the supervisory regime in the United States of America is likely to meet the objectives of consolidated supervision in Directive 2006/48/EC

1. INTRODUCTION

Article 143 of Directive 2006/48/EC states that "the Commission may request the European Banking Committee to give general guidance as to whether the consolidated supervision arrangements of competent authorities in third countries are likely to achieve the objectives of consolidated supervision as defined in this Chapter, in relation to credit institutions, the parent undertaking of which has its head office in a third country. The Committee shall keep any such guidance under review and take into account any changes to the consolidated supervision arrangements applied by such competent authorities." Article 143 requires that this guidance is taken into account by the competent authority which would be responsible for exercising consolidated supervision when verifying whether a credit institution, with its parent headquartered outside the Community, is subject to equivalent supervision in its home country.

Article 21(5) of the Financial Conglomerates Directive (2002/87/EC) states that the European Financial Conglomerates Committee ("EFCC") "may give general guidance as to whether the supplementary supervision arrangements of competent authorities in third countries are likely to achieve the objectives of the supplementary supervision as defined in this Directive [...]. The Committee shall keep any such guidance under review and take into account any changes to the supplementary supervision carried out by such competent authorities." Article 18(1) requires that this guidance is taken into account by the competent authority (the 'coordinator') which would be responsible for exercising supplementary (i.e., group-level) prudential supervision when verifying whether a group, with its parent headquartered outside the Community, is subject to equivalent supervision in its home country.

Recital 13 of Directive 2002/87/EC describes equivalent supervision in terms of the objectives and results achieved from it. The recital states that regulated entities should be subject to "equivalent and appropriate supplementary supervisory arrangements which achieve objectives and results similar to those pursued by the provisions of this

Directive." Recital 14 makes it clear that such equivalent supervision can, however, only exist where "third-country supervisory authorities have agreed to co-operate with the competent authorities concerned on the means and objectives of exercising supplementary supervision of the regulated entities of a financial conglomerate."

The EFCC and EBC have decided to give general guidance on the supervisory arrangements in Switzerland and in the USA, given the economic importance of Swiss and US financial groups to the European Union. In 2004, they published their first guidance on third countries' equivalence. The following guidance is updating the assessments of 2004.

The following guidance relates to the supervision of financial conglomerates and banking groups in the United States of America (USA). It is based on technical advice prepared by the Committee of European Banking Supervisors (CEBS) and the Interim Working Committee on Financial Conglomerates (IWCFC) and approved by the Committee of European Insurance and Pension Funds Supervisors (CEIOPS) and the Committee of European Banking Supervisors (CEBS). It was published on 22 February 2008. In our view the objectives of supplementary supervision under Directive 2002/87/EC and the objectives of consolidated supervision in Title V chapter 4 under Directive 2006/48/EC are sufficiently close that this guidance addresses both topics.

The EBC is giving guidance as to whether the arrangements of the American supervisory authorities concerned are likely to achieve the objectives of consolidated supervision in Chapter 4 of Directive 2006/48/EC, identifying individual authorities where appropriate. This guidance is intended to facilitate the making of equivalence decisions, as required by Article 143 of Directive 2006/48/EC, by EU supervisors.

The EFCC is giving guidance as to whether the arrangements of the American supervisory authorities concerned are likely to achieve the objectives of supplementary supervision in Directive 2002/87/EC, identifying individual authorities where appropriate. This guidance is intended to facilitate the making of equivalence decisions, as required by Article 18 of Directive 2002/87/EC, by EU supervisors.

This guidance was based on the publication of by CEBS and the IWCFC on www.ceiops.org and www.c-ebc.org and approved by the EBC and the EFCC on April 11, 2008.

2. OVERVIEW OF THE AMERICAN REGULATORY SYSTEM

As explained in the 2004 Guidance, the US regulatory system is based around a number of functional supervisors (i.e. different supervisors for banking, securities and insurance firms). The main supervisory agencies are those covered by this advice and the distribution of responsibilities between these regulators has not changed significantly since 2004.

In respect of the banking sector, the US operates a "dual banking system." A bank may choose to be chartered by a state or by the federal government, and consequently supervision may be undertaken at the state as well as the federal level. In the case of insurance firms, all supervision is undertaken by state insurance commissioners. In the case of securities firms, supervision is undertaken at the federal level. There can also be multiple regulators for a given sector; this is most notable in banking, where there are five federal agencies responsible for commercial banks, savings banks and credit unions.

This multiplicity of regulators means that diversified financial groups may be subject to the oversight of several regulators, albeit with a clear lead in most cases (see below). There are mechanisms that provide for co-ordination, such as the Federal Financial Institutions Examination Council (FFIEC) which prescribes uniform principles, standards and report forms for federal examination of depository institutions and makes recommendations to promote uniformity in the supervision of depository institutions. For some time now, state banking supervisors have been represented in the council, and a representative of the state banking supervisors has been given full voting rights on the council, leading to a further strengthening of cooperation between state and federal banking supervisors.

The NAIC, which is not itself a supervisory authority, provides a common framework for analysing insurance groups which contributes to the promotion of cooperation and coordination between supervisory authorities. In recent years initiatives have also been taken to provide for lead supervision for diversified groups.

Under the Gramm-Leach-Bliley Act 1999, the Federal Reserve has powers to act as umbrella supervisor for all bank holding companies, including financial holding companies. The OTS has similar authority to provide consolidated supervision to thrift holding company enterprises. The SEC has established a programme to provide consolidated supervision to certain holding companies predominately engaged in broker-dealer activities, and the NYSBD exercises supervision over Article XII banking companies, which are typically holding companies for foreign banking entities.

2.1. US Supervisory arrangements as at end 2007

The IWCFC and CEBS have been asked to prepare their advice ahead of implementation of Basel II in the US. The assessment provided therefore reflects the current supervisory regimes of US regulators and, where appropriate, takes into account, their Basel II implementation plans current as at the publication in November 2007 of the final rule on the Risk-based Capital Standards (Advanced Capital Adequacy Framework - Basel II). It should be noted however that due to the timing of the conclusion of this exercise it was not possible to undertake any detailed analysis of the final rule and so the following conclusions re the impact of Basel II must be considered as preliminary only.

Phased implementation of Basel II would not in itself be a bar to US supervisory authorities being considered 'equivalent' but the lack of experience as to what Basel II will eventually involve in practical terms does create some uncertainty in terms of the conclusions and recommendations contained in this advice. As such, when taking group-specific equivalence decisions as regards US supervisory authorities, each Competent Authority will need to make its assessment taking into account any changes to the particular regulatory regime which may have occurred since end 2007.

Specifically:

- The introduction of Basel II impacts most obviously on the quantitative aspects of any equivalence decision, principally in respect of the approaches to Pillar 1 risks (credit, market and operational risk). Provided that supervisory techniques are aligned in terms of qualitative approach, enforcement, communication, cooperation, disclosure etc, the capital requirements arising even from less risk-sensitive approaches may, in determining minimum regulatory capital on a group-by-group basis, achieve an equivalent outcome.

- Under the CRD, Pillar 2 does not necessarily result in a change to capital requirements, rather, requires that supervisors consider the extent to which Pillar 1 risks and the additional risks which exist within the group have been covered. Competent authorities charged with the verification of equivalence should consider the extent to which the supervisor of the group is implicitly considering Pillar 2 risks within their approach.
- This assessment also considers Pillar 3 disclosure requirements, albeit on a high-level only. Institutions' disclosure of key financial information is an important instrument for encouraging sound risk management practices and fostering financial stability. Although some disclosure requirements will be newly introduced via Basel II, a significant amount of the proposed disclosure requirements are already required by or consistent with existing GAAP, SEC disclosure requirements, or regulatory reporting requirements.

It should be noted that in designing the CSE regime (concurrently with the development of Basel II), the SEC took the opportunity to factor a number of the key features of Basel II and therefore our observations on US Basel II implementation do not apply in the same way to the SEC .

3. CONCLUSIONS AND RECOMMENDATIONS

In 2004 it was concluded that, on balance, there was broad equivalence in the US approaches to consolidated and supplementary supervision of banks and financial conglomerates respectively, notwithstanding some caveats in the area of practical cooperation, the supervisory structure, the actual implementation of the reform in the securities and investment banking supervision, and new supervisory approaches by some US supervisors in relation to group supervision.

The key observations and conclusions of the 2007 exercise in respect of each of the US supervisory authorities are set out below.

3.1. Fed/OCC

It is the IWCFC's and CEBS' opinion that the supervisory arrangements of the FED/OCC would achieve the objectives and deliver similar outcomes to those provided for by the CRD and FCD. There were no caveats in 2004 and there are no new caveats to note. EEA States' authorities should however follow-up the implementation process of Basel II, and in particular in the second transitional period.

When taking individual equivalence decisions supervisors may wish have regard to the following:

3.1.1. Supervisory cooperation and information sharing

The Fed/OCC have the authority to conclude cooperation and coordination agreements with other supervisors of group entities, and have continued to demonstrate their willingness to strengthen cooperation and foster exchange of information with US and EEA supervisors.

Supervisory information provided to the Fed/OCC is subject to adequate professional secrecy rules, which have been further enhanced recently.

3.1.2. Qualitative group assessment

The Fed/OCC perform consolidated supervision of banking groups, and group-wide supervision of financial conglomerates, and assess the fitness and property of management and the suitability of shareholdership, in line with international (i.e. Basel) standards.

The Fed/OCC take a risk based approach to qualitative supervision, relying on on-site exams and off-site reviews. This approach has not changed materially since 2004 and continues to present no concerns.

3.1.3. Quantitative group assessment

The approach regarding quantitative group assessment by the Fed/OCC has not changed materially since 2004 and as such continues to present no concerns. The Basel II Risk-Based Capital Standards will be applied to the major international banking groups in a phased way from 2008 on.

The Fed/OCC monitors significant risk concentrations at group level as well as intra-group transactions/exposures. Banks are subject to quantitative limits on risk concentration, and certain intra-group transactions are restricted.

Large and complex organisations are expected to have in place internal capital management processes, which are subject to Fed/OCC review (the objective of which is close to Pillar 2 of the Basel II capital adequacy framework.

Although Basel II has not been implemented in the US yet, the approach currently taken by the Fed/OCC in respect of the review of internal capital management processes appears to be sufficiently comprehensive to capture the objective envisaged under the CRD in this respect, in particular when taken into account the planned changes as a result of the implementation of Basel II.

3.1.4. Disclosure

The information currently disclosed by the Fed/OCC is mainly financial in nature although, to some extent, prudential information is provided, too, as envisaged under the CRD. Furthermore, when assessing the Fed's/OCC's approach, one should take into account the planned changes as a result of the implementation of Basel II.

3.1.5. Enforcement

The Fed/OCC have a broad range of enforcement powers available. The scope and type of action has not changed materially since the previous assessment and continues to present no concerns.

3.2. OTS

It is the IWCFC and CEBS' opinion that the supervisory arrangements of the OTS would meet the objectives and deliver similar outcomes to those provided for by the CRD and FCD. The caveat of 2004 (non-standardised application of quantitative supervision) remains although, as in 2004, this is not considered sufficiently material to change the overall conclusion. EEA competent authorities charged with the verification of

equivalence should assess the requirements in place for the specific group before reaching a view on equivalence.

When taking individual equivalence decisions supervisors may wish have regard to the following:

3.2.1. Supervisory cooperation and information sharing

The OTS has demonstrated willingness to strengthen cooperation and foster exchange of information with US and EEA supervisors.

Supervisory information provided to the OTS is subject to adequate professional secrecy rules, which have been further enhanced recently.

3.2.2. Qualitative group assessment

The OTS has implemented the approach to qualitative supervision proposed in 2004. It has adopted a flexible, risk focused examination programme, employing continuous on-site supervision for its largest, most complex institutions.

The OTS performs a risk focused examination program in order to assess group structure, organisation, strategy, risk management and internal control (called “CORE”). From 2008 on the OTS will place greater emphasis on the review of risk management and organisational structure.

The OTS supervisory review includes the assessment of a thrift holding company’s management, as well as the assessment of the major shareholders.

3.2.3. Quantitative group assessment

The OTS continues to assess capital adequacy at the thrift holding company level on a case-by-case basis, taking into account the overall risk profile of the institution. Competent Authorities will therefore need to understand the specific requirements for the group in question when considering equivalence for the OTS and ensure that international standards are met.

The OTS primarily monitors significant risk concentrations and intra-group transactions through its continuous onsite examination process. The OTS approach to risk concentration and intra-group transactions is also based on a case-by-case basis, but generally has the necessary tools available to adequately address the risks involved.

Large and complex organisations are expected to have in place board approved capital adequacy processes, which are subject to OTS review (the objective of which is close to Pillar 2 of the Basel II capital adequacy framework). The Basel II Risk-Based Capital Standards will be applied to the major international banking groups in a phased way from 2008 on.

3.2.4. Disclosure

The information currently disclosed at the holding company level is mainly financial in nature, although some prudential information is provided, too, as envisaged under the CRD. The OTS perceives disclosure as key component of the proposed US Basel II framework and expects that it will be in line with international standards.

3.2.5. Enforcement

The OTS has extensive enforcement powers. The approach taken in this respect has not changed in general since the previous exercise and continues to present no concerns.

3.3. NYSBD

It is the IWCFC and CEBS' opinion that the supervisory arrangements of the NYSBD would achieve the objectives and deliver similar outcomes to those provided for by the CRD and FCD. The caveat of 2004 (non-standardised application of quantitative supervision) remains although, as in 2004, this is not considered sufficiently material to change the overall conclusion. However since the technical analysis can only relate to the general framework Competent authorities charged with verification of equivalence should assess the specific requirements in place for each group. It should also be noted that the NYSBD does not currently supervise a conglomerate at the ultimate parent level.

When taking individual equivalence decisions supervisors may wish have regard to the following:

3.3.1. Supervisory cooperation and information sharing

The NYSBD has the authority to conclude cooperation and coordination arrangements with other supervisors of group entities and to share information with other supervisors. The NYSBD has shown willingness to further strengthen cooperation and foster exchange of information with US and EEA supervisors.

The NYSBD is subject to professional secrecy rules, although in some cases it can be forced to release supervisory information.

3.3.2. Qualitative group assessment

The NYSBD uses a risk-based approach to qualitative supervision, relying on continuous / on-site supervision for its largest, internationally active institutions. This includes group-wide supervisory oversight of group structure, organisation, strategy, risk management and internal control systems. The approach has not changed materially since 2004 and continues to present no concerns.

The NYSBD reviews the suitability of the holding company's management, as well as the suitability of major shareholders.

3.3.3. Quantitative group assessment

The NYSBD's approach to assessing capital adequacy had not changed since materially since 2004. Capital requirements continue to be defined on the basis of an individual, written agreement for an each group. Competent Authorities will therefore need to understand the specific requirements and their practical application for the group in question when considering equivalence for the OTS and ensure that international standards are met.

The standards for risk concentrations and intra-group transactions are set out in the supervisory agreements. Limits may be imposed. Internal reports are reviewed.

The NYSBD requires groups to have in place strategies and processes for the assessment of risks and internal capital. The arrangements are subject to review by the NYSBD.

Although Basel II has not been implemented in the US yet, the approach currently taken by the NYSBD might be sufficiently comprehensive to generally capture the objective envisaged under the CRD in this respect, in particular when taken into account the planned changes as a result of the implementation of Basel II.

3.3.4. Disclosure

Disclosure at the top entity level supervised by the NYSBD is currently not envisaged, although in practice SEC disclosure requirements apply. EU / EEA supervisors do therefore have to understand the scope and depth of information disclosed at the ultimate top-top tier level.

3.3.5. Enforcement

The NYSBD has the authority to apply appropriate enforcement measures. They have not changed in a meaningful sense compared to 2004 and continue to present no concerns.

3.4. SEC

It is the IWCFC and CEBS' opinion that the supervisory arrangements of the SEC would meet the objectives and deliver similar outcomes to those provided for by the CRD and FCD. The caveats of 2004 no longer apply as the SEC has been undertaking consolidated supervision for over two years now and experience of this has been positive overall. The transitional arrangements for the use of unsecured debt as capital will also expire at the end of 2008. There are no new caveats to note.

When taking individual equivalence decisions supervisors may wish have regard to the following:

3.4.1. Supervisory cooperation and information sharing

There is now two years' experience of the SEC's approach to supervisory co-operation and information sharing and this has generally been found to be positive. There had been no experience at the time of the 2004 exercise. The SEC has the authority to cooperate and share information with other supervisory authorities (including the conclusion of co-operation arrangements), and has demonstrated its willingness to do so.

Supervisory information that has been provided to the SEC is, generally, protected by professional secrecy rules.

3.4.2. Qualitative group assessment

The SEC's approach taken in respect of qualitative group assessments is as was proposed in 2004 and, based on experiences since then, presents no concerns as regards the CSE regime.

The SEC approach to group-wide supervision includes a group-wide supervisory oversight (including the top tier holding company), the assessment of the holding company's management, as well as the assessment of the major shareholders.

3.4.3. Quantitative group assessment

As proposed in 2004 the SEC has introduced quantitative group capital adequacy requirements to ensure that group capital is prudently measured and monitored, taking

into account the full range of the group's financial activities. The transitional arrangement on the use of long term unsubordinated debt as capital is being phased out.

The SEC monitors significant risk concentrations at a group level adequately. Although there is no systematic supervisory approach to the risk management of intra-group exposures, this is not felt to be of a material concern.

The SEC approach taken in respect of assessment of risks and internal capital is in line with Basel standards.

3.4.4. Disclosure

Disclosure is expected to start in 2008. The current proposal is as under Basel II and consequently should not present concerns.

3.4.5. Enforcement

The SEC has appropriate enforcement powers. In particular, it can withdraw CSE status.

3.5. NAIC

The NAIC is one of the entities that was also involved in the 2003/2004 equivalence exercise and has been invited to participate in the update under the current review. The main reason for this is to understand US insurance supervisors' approaches in general where EU regulated entities are part of a financial conglomerate for which a US state insurance supervisor would be the group-wide supervisor (although currently no financial conglomerate is supervised at the top level by an insurance state supervisor).

The conclusion of the 2004 exercise was that a general statement of equivalence for the NAIC was, in effect, not possible. While the NAIC undertakes valuable work in setting out model arrangements which state supervisors may wish to follow in their supervision of insurance groups, it is not itself a supervisor and the question of whether it can be deemed to undertake consolidated or supplementary supervision to an equivalent standard does not arise.

Firstly, although the NAIC has set out a model framework that may be implemented by the US insurance state supervisors, the NAIC is not a supervisor in itself. Secondly, there has been no assessment of the practical implementation of the framework across the 50 US states. Thirdly, taking into account the developments in the European Union of the recent years in both the banking and insurance sector towards a more consolidated approach of supervision, it cannot be concluded that implementation by states of the model framework of the NAIC would result in their being fully equivalent to the approach set out in the Financial Conglomerates Directive. In particular, the quantitative requirements of the model framework of the NAIC do not extend to consolidated supervision, notwithstanding the fact that individual state supervisors may have implemented a more consolidated approach than the NAIC model sets out.

In 2006, in the field of information exchange between EEA and US supervisors, a model MoU was agreed between the NAIC and CEIOPS which may be used as a basis for information exchange between US state authorities and EEA supervisory authorities. 4 MoUs have been concluded which allow for the exchange of confidential information under secrecy rules.

The conclusion of the 2004 exercise that a general statement of equivalence for the NAIC and the US insurance state supervisors cannot be given still holds. EEA supervisory authorities must therefore conduct all equivalence assessments on a State by State and firm by firm basis.