



EUROPEAN COMMISSION  
INTERNAL MARKET DIRECTORATE GENERAL

MARKT/3021/2000

# **TOWARDS AN EU DIRECTIVE ON THE PRUDENTIAL SUPERVISION OF FINANCIAL CONGLOMERATES**

**Consultation Document**

MARKT/3021/00-EN

## ***Contents***

- I Executive Summary***
- II Introduction***
- III Present EU Regulation of Financial Conglomerates***
- IV The Definition of a Financial Conglomerate***
- V Assessing the Capital Adequacy of a Financial Conglomerate***
- VI Intra-Group Transactions and Risk Concentration within a Financial Conglomerate***
- VII Assessing Fitness and Propriety of Managers and Directors and the Suitability of Major Shareholders***
- VIII The Appointment of the Coordinator(s) for a Financial Conglomerate***
- IX The Exchange of Information between Authorities to fulfil their Tasks***
- X Convergence of Supervisory Practices***

*ANNEX I comparison of methods to prevent double gearing*

*ANNEX II: cross-sector capital elements*

## **TOWARDS AN EU DIRECTIVE ON THE PRUDENTIAL SUPERVISION OF FINANCIAL CONGLOMERATES CONSULTATION DOCUMENT**

This Consultation Document sets out the present thinking on the key elements for a Directive concerning the prudential supervision of financial conglomerates. Its purpose is to stimulate response from the financial industry and any other interested parties. The Commission's Action Plan to Implement the Framework for Financial markets indicated that it intended to come forward with a proposal for a directive at the beginning of 2001. According to the Action Plan the objective of the proposal will be to implement the recommendations of the Joint Forum on Financial Conglomerates, which were released in 1999. The Joint Forum also undertook a (global) consultation process to which the financial industry has responded. This consultation document builds on that earlier process and puts it in the perspective of an EU-directive.

Responses to this Consultative Paper should be forwarded (by 10 February 2001) to the Internal Market Directorate General at the following address:

European Commission  
Internal Market DG  
Financial Conglomerates & Cross Sector Issues Unit C/3  
Av. de Cortenberg, 107  
B 1049 Bruxelles

Responses may also be sent by e-mail to the following address :

MARKT-C3@cec.eu.int

This consultative document is available on the European Commission website. Member States competent authorities and other interested parties are invited to create hyperlinks to this site if they so wish. The website reference is as follows :

[http://europa.eu.int/comm/internal\\_market/finances/cross-sector issues](http://europa.eu.int/comm/internal_market/finances/cross-sector%20issues)

# I Executive Summary

## Introduction

The Financial Services Action Plan announces a proposal for a directive on the prudential supervision of financial conglomerates at the beginning of 2001, to implement the recommendations of the Joint Forum on Financial Conglomerates. This proposal may also meet the recommendations of the 'Brouwer group' on stability in the financial sector which were endorsed by the Ecofin Council in Lisbon.

This Consultation Document sets out the present thinking on a proposal for a Directive concerning the prudential supervision of financial conglomerates. Its purpose is to stimulate response from the financial industry and any other interested parties. The Joint Forum also undertook a (global) consultation process to which the financial industry has responded. This consultation document builds on that earlier process and puts it in the perspective of an EU-directive. Responses to this proposal will draw on the response to the Commission's Services' consultations.

## Present EU regulation

An analysis of existing EU financial sector legislation shows the prima facie need for further measures at EU-level. The present EU prudential framework shows important overlaps and underlaps in respect of the regulation of financial conglomerates.

Underlaps exist as:

- (i) certain types of financial groups are not captured by the existing directives, and
- (ii) important prudential issues that are regulated in sectoral directives aiming at the supervision of banking groups, investment firm groups and insurance groups, are not regulated at the level of 'mixed' financial conglomerate type groups.

Overlaps in the existing legislative exist because:

- (iii) inconsistencies occur in the treatment of similar prudential questions, and
- (iv) the same financial group can be covered by different sectoral directives.

## Definition of a financial conglomerate

The definition of a financial conglomerate is an important starting point for legislation to distinguish a financial conglomerate from other groups of undertakings and to determine the scope of application of the financial conglomerates directive. This paper distinguishes between *financial conglomerates* and *mixed activity conglomerates*. There is need to synchronize the sectoral regulation with the regulation on financial conglomerates, in order to come to a consistent regulatory framework for financial groups in general.

### Assessing capital adequacy

A central issue is to ensure that the objectives of separate supervisors to ensure the capital adequacy of the entities for which they have regulatory responsibility should not be impaired as a result of the existence of cross-sector financial conglomerates. This requires measures to prevent situations in which the same capital is used simultaneously as a buffer against risk in two or more entities in the same financial conglomerate ('double gearing') and situations where a parent issues debt and downstreams the proceeds as equity to its regulated subsidiaries ('excessive leveraging').

In developing capital adequacy assessment methods, the existence of capital adequacy rules in each sector is recognised, as is their effectiveness and reasons for the differences. Sectoral capital adequacy approaches are therefore taken as given as they reflect the different nature of business undertaken by each sector, differing risks to which they are exposed and different approaches to risk management and assessment by supervisors and/or firms.

### Intra-group transactions and risk concentration

The presence of *intra-group transactions and risk exposures* within a financial group is not a matter of supervisory concern per se. As the supervisory responses to both concerns are very similar, the recommendations are presented as a common supervisory policy approach.

Effective EU-legislation should be introduced to address the supervisory concerns about intra-group transactions and risk exposures in a financial conglomerate. As it is not yet feasible to introduce quantitative limits in this area, an adequate and effective regulatory approach for intra-group transactions and risk exposures should be built on the following three pillars:

- an internal management policy with effective internal control and management systems;
- reporting requirements to supervisors; and
- effective supervisory enforcement powers.

### Co-ordinator

The Commission services find that the developments demonstrate the clear need to introduce *co-ordination* (Chapter IX) arrangements between supervisors to ensure an efficient and adequate supervision of cross-border financial conglomerates. The benefits will be:

- to avoid 'underlaps' in the prudential supervision of a financial conglomerate which will enhance financial stability;
- to avoid duplication of supervision, which are burdensome and costly for supervisors and the supervised entities of a group;
- to achieve simplification of procedures and supervisory efforts.

The role and responsibilities of the co-ordinator(s) depend heavily on the specific

circumstances of a financial conglomerate, such as the legal framework and the risk profile of the institution involved. Although the appointment of the coordinator(s) should be mandatory at EU-level, any further arrangements or obligations should therefore be framed in as flexible terms.

### Exchange of information

Information sharing is a precondition for effective supervision. None of the supervisory instruments discussed in this report will function effectively in the absence of a proper flow of information from the entities within a financial conglomerate to the supervisors and between supervisors themselves.

### Convergence of supervisory practices

The convergence of supervisory practices requires attention. A number of supervisory issues have been identified for the prudential supervision of financial conglomerates, which need not be harmonised by a proposal for EU-legislation on financial conglomerates. It is important to ensure that these issues are applied in a similar and consistent manner across sectors and between Member States in the day-to-day application of the legislative principles of the directive. This will further level-playing fields between Member states and sectors and enhance certainty in the market.

## II Introduction

The Financial Services Action Plan announces a proposal for a directive on the prudential supervision of financial conglomerates at the beginning of 2001, to implement the recommendations of the Joint Forum on Financial Conglomerates<sup>1</sup>. This proposal may also meet the recommendations of the 'Brouwer group' on stability in the financial sector<sup>2</sup> which were endorsed by the Ecofin Council in Lisbon.

The present EU prudential framework shows important overlaps and underlaps in respect of the regulation of financial conglomerates. In view of the increasing cross-border dimension of financial conglomerate type groups, the need to maintain level playing fields across the EU and the need to protect the financial stability of the EU financial system, there is therefore a need to address the most pressing issues arising in such structures. This will enhance legal certainty and clarity for regulators, supervisors and the market, and will make an important contribution to the stability of the EU financial system. The Commission services are of the view that that the most appropriate way to address these issues is by introducing specific prudential legislation for (heterogeneous) financial conglomerates and by aligning the regulations for financial conglomerates and for homogeneous financial groups as much as possible (i.e. eliminating inconsistencies) in order to ensure equivalency in the treatment of these groups.

This Consultation Document sets out the present thinking on the key elements for a Directive concerning the prudential supervision of financial conglomerates. Its purpose is to stimulate response from the financial industry and any other interested parties. The Joint Forum also undertook a (global) consultation process to which the financial industry has responded. This consultation document builds on that process and puts it in the perspective of an EU-directive.

---

<sup>1</sup> Joint Forum Paper on the Supervision of Financial Conglomerates (February 1999); Risk Concentration Principles (December 1999) and Intra-Group Transactions and Exposures principles (December 1999)

<sup>2</sup> Economic and Financial Committee – Report on Financial Stability (April 2000)

### III PRESENT EU REGULATION OF FINANCIAL GROUPS

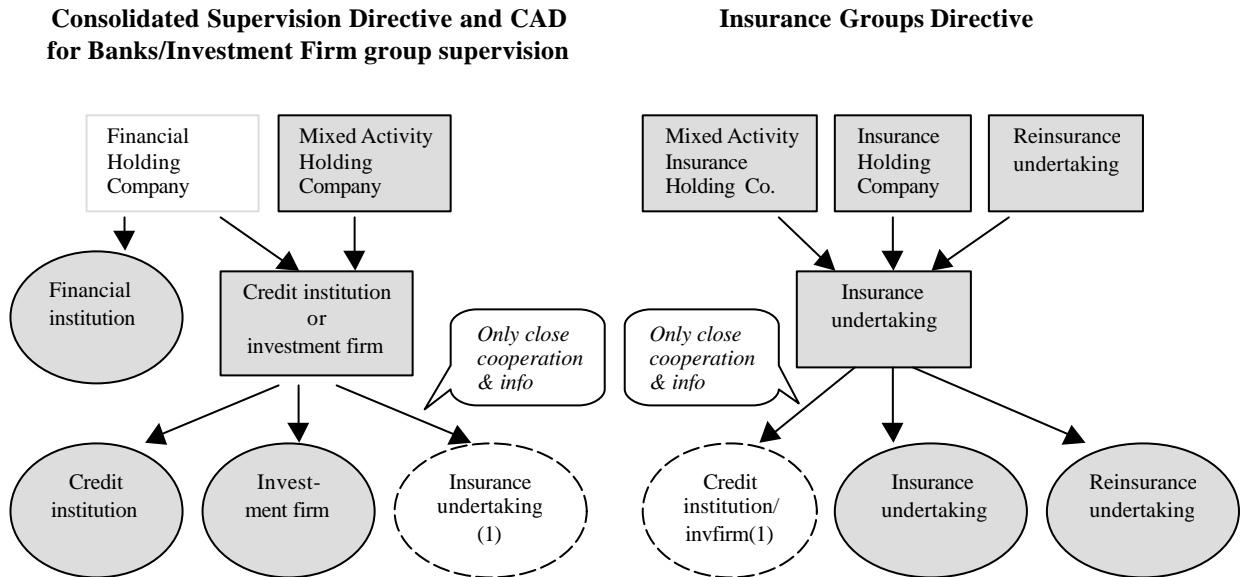
‘Homogeneous’ groups of financial institutions are already covered by EU-directives for specific prudential purposes. Directive 92/30/EEC on the supervision of credit institutions on a consolidated basis (the ‘Consolidated Supervision Directive’) and Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions (the ‘CAD’) provide for the consolidation of banking groups, investment firm groups and bank/investment firm groups, whereas Directive 98/78/EC on the supplementary supervision of insurance undertakings in insurance groups (the ‘Insurance Groups Directive’) applies additional group supervision over insurance groups.

*Homogeneous groups of financial institutions are already covered by EU-directives*

‘Heterogeneous’ financial conglomerate type groups are only covered to a limited extent. Figure 1 illustrates the present EU legislative framework for such heterogeneous groups that are not subject to groupwide supervision.

*Heterogeneous financial conglomerate type groups are only covered to a limited extent*

Figure 1: supervisory scope of sectoral directives



Squares represent parent undertakings. Circles represent subsidiaries and other entities in which a participation is held

(1) or any other related entity, active in a different financial sector than the parent company

This (simplified) overview illustrates the need for further measures at EU-level as the present EU prudential framework shows important overlaps and underlaps in respect of the regulation of financial conglomerates.

Underlaps exist as:

- certain types of financial group are not captured by the existing directives, and
- important prudential issues that are regulated in sectoral directives aiming at the supervision of banking groups, investment firm groups and insurance groups, are not regulated at the level of ‘mixed’ or ‘heterogeneous’ financial conglomerate type groups (see figure 2).

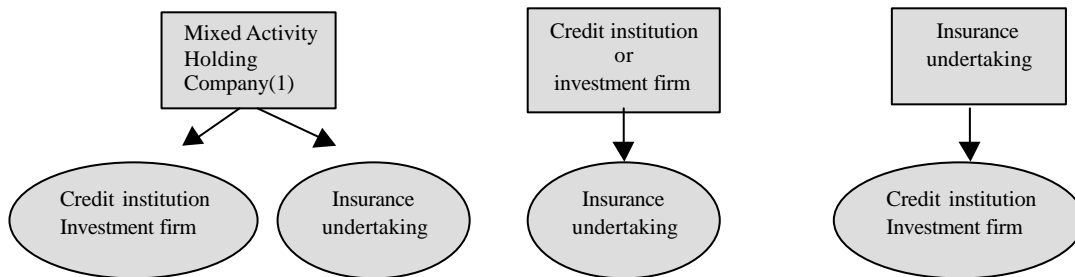
*Underlaps exist in the existing legislative*

Overlaps exist in the existing legislative because:

- inconsistencies occur in the treatment of similar prudential questions, and
- the same financial group can be covered by different sectoral directives (e.g. a mixed activity insurance holding company can also be a financial holding company in the sense of the banking/investment firm directives; a mixed activity holding company covered by the banking/investment firm directives can also be an insurance holding company).

*Overlaps exist in the existing legislative*

Figure 2 : Examples of groups escaping group-wide regulation and supervision under sectoral directives



*(Squares represent parent undertakings. Circles represent subsidiaries and other entities in which a participation is held)*

*(1) the sectoral directives only provide for some partial measures (primarily information sharing and supervisory co-operation)*

Some Member States have acknowledged the imperfection of the present EU legislative framework for financial conglomerates and have either introduced or are planning to introduce national measures on their own accord to address the supervisory concerns arising from the group structures described above. Measures that have been introduced by Member States to date vary in their scope and approach. In view of the increasing cross-border dimension of financial conglomerate type groups, the need to maintain level playing fields

across the EU and the need to protect the financial stability of the EU financial system, there is therefore a need to address the most pressing issues arising in such structures. This will enhance legal certainty and clarity for regulators, supervisors and the market, and will make an important contribution to the stability of the EU financial system. The Commission services are of the view that that the most appropriate way to address these issues is by introducing specific prudential legislation for (heterogeneous) financial conglomerates and by aligning the regulations for financial conglomerates and for homogeneous financial groups as much as possible (i.e. eliminating inconsistencies) in order to ensure equivalency in the treatment of these groups.

## IV The definition of a ‘financial conglomerate’

A clear and comprehensive definition of a ‘financial conglomerate’ is a vital starting point for legislation to distinguish a financial conglomerate from other groups of undertakings. Any EU-legislation on the prudential supervision of financial conglomerates will need to take into account the group structure and wide area of activities that a financial conglomerate may be engaged in. Regarding groups with cross-sector financial activities, the report distinguishes between *financial conglomerates* and *mixed activity conglomerates*.

The Commission services have developed the following definition of a financial conglomerate as a first step to scope its work:

*Definition of a  
‘financial  
conglomerate*

“A group of undertakings whose activities mainly consist in providing financial services in different financial sectors (banking, investment services, insurance). Such groups comprise at least one supervised undertaking according to EU definitions and at least one undertaking engaged in insurance business, active with at least one other undertaking from a different financial sector ”

This definition captures the groups that escape regulation and supervision under the present sectoral directives. It is based on four key elements which are examined in more detail below, and would include the following types of *cross-sectoral financial groups* presently falling outside the scope of group-wide prudential supervision:

- (i) groups with a credit institution as the parent
- (ii) groups with an investment firm as the parent
- (iii) groups with an insurance company as the parent
- (iv) groups with an unregulated entity as the parent, which would be called a ‘mixed financial holding company’, and horizontal groups as defined below.

The concept of ‘*mixed financial holding company*’ is not yet defined in EU legislation. It would refer to a non-regulated parent undertaking, which would be neither a mixed activity holding company or a financial holding company in the sense of the banking/investment directives, nor a mixed activity insurance holding company or insurance holding company in the sense of the Insurance Group Directive. Its subsidiaries would be exclusively or mainly financial institutions and insurance undertakings, at least one of them being a credit institution or an investment firm and another an insurance company, and its cross-sector financial activity is significant.

*‘mixed  
financial  
holding  
company’*

As the homogeneous parts of the above-mentioned groups are already subject to group-wide prudential regulation as regards their sectoral activity, there is need to synchronize the sectoral regulation with the regulation on financial conglomerates, in order to come to a consistent

regulatory framework for financial groups in general. This important issue is discussed in the following paragraphs.

An EU-definition or concept of a 'group' does not yet exist. The relevant sectoral directives (Consolidated Supervision Directive and CAD for banking/investment firm groups, and the Insurance Groups Directive for insurance groups) complicate the picture as they differ in substance and permit Member State options. A clarification of the concept of a 'group' therefore needs to be developed in order to ensure a consistent application of rules on financial conglomerates between sectors and between Member States. This will enhance legal certainty.

*i) There should be a 'group' of undertakings.*

In order to define which entities are included in the definition of a financial conglomerate, the Commission services suggest to build on and apply the definitions that already exist in the sectoral directives. Entities with the following relationships would be included:

- a parent /subsidiary relationship as defined in the 7<sup>th</sup> Consolidated Accounts Directive and any undertaking which in the opinion of the supervisor effectively exercises a dominant influence over another undertaking. The definition of a 'dominant influence' and 'control' that are part of these definitions should be further clarified using the definitions that have been introduced by the Post-BCCI directive, i.e. situations in which two or more natural or legal persons enjoy close links' by a participation or control relationship;
- a participation of at least 20% of the capital or voting rights, or of less than 20% if there is a 'durable link' (as defined in the 4<sup>th</sup> Annual Accounts Directive);
- a horizontal group relationship where there is no common parent company but the entities are managed on a unified basis as defined in 7<sup>th</sup> Consolidated Accounts Directive. In the broad sense, a horizontal group relationship may also refer to the case of a conglomerate where the parent is a non-financial undertaking

The Commission services are of the view that, if these definitions are inserted into an EU-directive on the prudential supervision of financial conglomerates, the inconsistencies between the sectoral definitions should also be removed. Therefore there is a need to ensure that all directives:

*...there is also a need to align the sectoral directives as regards the definition of a 'group'*

- include participations of less than 20% if there is a 'durable link' as defined in the 4<sup>th</sup> Annual Accounts Directive;
- clarify the meaning of 'dominant influence' and 'control' in the definitions of a parent/subsidiary relationship by using the definitions that have been introduced by the Post-BCCI directive. These include relationships between one or more natural persons acting together systematically and situations in which two or more natural or legal persons enjoy close links' by a participation or control relationship;
- include horizontal group relationships.

In particular the inconsistencies between the definitions of mixed activity holding companies requires specific attention. The following examples illustrate the considerable potential for legal overlap and confusion. At present one and the same unregulated top holding company of a ‘financial conglomerate’ (‘mixed financial holding company’) can simultaneously be covered by:

- \* the definition of a ‘mixed-activity holding company’ of the banks’ Consolidated Supervision Directive;
- \* the definition of a ‘mixed insurance holding company’ of the Insurance Groups Directive.

The accepted view is that groups that cover a wide variety of commercial or industrial pursuits alongside with financial activities are so heterogeneous that their full inclusion in group supervision would not give a meaningful picture taking into account the objectives of prudential supervision. Financial conglomerates should therefore be distinguished from industrial groups with relatively minor financial activities. In doing so, a distinction needs to be made between groups or subgroups headed by a regulated entity and those headed by an unregulated entity (this parallels the current approach under the sectoral directives).

*ii) The activity of the group should be ‘mainly financial’*

As regards groups headed by a non-regulated entity, a distinction between groups which focus mainly on financial activities and those with a wider ambit already exists in EU sectoral directives (see the Consolidated Supervision Directive and the Insurance Groups Directive). However, none of the sectoral directives provides clear guidance for a possible indicator to determine how to calculate whether the activities of a group are ‘mainly’ financial. E.g. the Consolidated Supervision Directive defines a ‘financial holding company’ as a financial institution with “exclusively or mainly” credit institution or financial institution subsidiaries, but no further guidance is provided.

*... groups headed by an unregulated entity: the need for a ‘materiality test’*

The Commission services are interested in determining possible materiality thresholds. Such thresholds have also been discussed in the context of the bank capital review to identify whether the activities of a holding company are ‘mainly financial’. According to this approach, and if applied by analogy to financial conglomerates, groups with combined banking, investment services and insurance activities below a threshold of 40% of total group activities (on- and off balance sheet items could provide a useful criterion) would be considered to be ‘non-financial groups’. Groups with combined financial activities between 40% and 50% would be left to the discretion of the relevant supervisors to determine whether they should be considered to be financial groups (and in particular financial conglomerates) or not. Groups with financial activities of more than 50% of overall activities would be considered to be financial: in particular they would be considered to be a ‘financial conglomerate’, falling under the financial conglomerate supervisory regime, and the unregulated parent would be

called a mixed ‘financial holding company’.

The Commission services are also of the view that the materiality thresholds should be subject to certain exemptions which may be applied at the discretion of supervisors. This may arise in particular in the following instances (which are also acknowledged in the sectoral directives on group supervision):

- (i) if the undertakings that are included are negligible with respect to the objectives of supervision of the financial conglomerate;
- (ii) if the inclusion of the undertakings would be inappropriate or misleading with respect to the objectives of supervision of the financial conglomerate;
- (iii) if the undertaking(s) are situated in a third country where there are legal impediments to the transfer of the necessary information (however without prejudice to Art. 2.2 of the Post-BCCI Directive);
- (iv) in the case of groups that are on the borderline of inclusions or exclusion there may be legitimate concerns to avoid sudden ‘regime shifts’ (this concern would however sufficiently be addressed by introducing a 40%-50% category that is subject to national discretion).

If these definitions are applied in an EU-directive on the prudential supervision of financial conglomerates, the present inconsistencies between the sectoral definitions should also be removed and the sectoral definitions and their relationship with the financial conglomerates directive should be clarified.

*...there is also a need to align the sectoral directives with the new definitions*

Where a credit institution, an investment firm or an insurance company is a parent company that holds participations in credit institutions, investment firms, insurance companies or other financial institutions, (presumed there is significant cross-sector financial activity as defined below) the financial conglomerate supervisory regime could apply to the regulated parent and its financial subsidiaries on a group-wide basis, whether or not there is also significant non-financial activity elsewhere in the group. The regulated parent can be the head of a financial conglomerate, of a group that holds industrial participations exceeding the materiality thresholds (as defined in this report) or of a financial subgroup of a predominantly industrial or commercial group (i.e a financial conglomerate being a sub-part of a mixed activity conglomerate).

*...groups or subgroups headed by a regulated entity*

The presence of at least one insurance undertaking in the group distinguishes a financial conglomerate from groups comprising exclusively credit institutions and/or investment firms. As the latter type of groups are already subject to harmonised capital requirements and supervision on a consolidated basis the presence of at least one insurance undertaking and an entity from different financial sector are necessary for a group to qualify as a ‘financial conglomerate’ for the purposes of the present work.

*iii) At least one insurance undertaking and/or a credit institution/investment firm in the group*

There is a need to distinguish groups in which the share of one financial sector is insignificant compared to the other. For example, a banking group with a life assurance undertaking subsidiary which accounts only for a minor proportion of the overall business of the group. The Commission services are considering to apply a threshold of [10, 15 or 20%] of the overall business activities of the group (criteria could be based on balance sheet total, income, or risk/capital requirements or a combination of these criteria) to identify a financial conglomerate. This ratio takes into account the concern that the prudential justification to include entities of groups whose financial activities in a different financial sector are below [10, 15 or 20%] of overall business will pose unnecessary burdens on supervisors as well as on the entities within those groups.

*iv) the cross-sector activity must be 'significant': the need for a threshold*

In the case of financial groups with a lower portion of cross-sector business activities (i.e. = [10, 15 or 20%] ), the group and its regulated entities would not be assessed on the basis of the capital adequacy rules, intra-group transactions and risk concentrations that will be developed for financial conglomerates. In order to address the potential of double gearing of capital which remains also in these groups, as well as the issue of appropriate risk spreading, the sectoral directives will apply. As the sectoral methods and approaches differ, a consistent cross-sector approach should be developed.

The threshold of [10, 15 or 20%] should be subject to supervisory discretion. In certain instances, the supervisor should have the flexibility to lower the threshold, or to decide not to include credit institutions, investment firms and insurance undertakings under the scope of supervision even though they are captured by the definition of a financial conglomerate. This latter may arise in particular in the following instances (which are also acknowledged in the sectoral directives on group supervision):

- (i) if the undertakings that are included are negligible with respect to the objectives of supervision of the financial conglomerate;
- (ii) if the inclusion of the undertakings would be inappropriate or misleading with respect to the objectives of supervision of the financial conglomerate;
- (iii) if the undertaking(s) are situated in a third country where there are legal impediments to the transfer of the necessary information;
- (iv) in the case of groups that are on the borderline of inclusions or exclusion there may be legitimate concerns to avoid sudden 'regime shifts'.

To trigger group supervision the sectoral directives require the presence of at least one supervised European entity in the group and either another supervised entity or an unsupervised entity that carries out financial activities that are potentially important for the financial health of the group. This approach strikes a balance between the need to address unregulated entities from a group perspective but to leave

*v) There should be at least one supervised entity according to EU definitions in the group*

such entities unsupervised at the solo-level. The Commission services would consider to continue this approach also for the regulation of financial conglomerates. A financial conglomerate shall comprise at least one legal entity to which a banking, insurance or investment firm licence has been granted in the EU.

Where credit institutions, investment firms and insurance companies are part of a group which is not a financial conglomerate - such a group could be called a 'mixed activity conglomerate' - the competent supervisors must be able to assess individually and on a group-wide basis the financial situation of these regulated entities in the context of that group. In particular they must have as complete as possible a picture of the risk profile of these entities as it emerges from the entities' relationship with the other group entities. This parallels the current approach in the sectoral directives.

*Definition of a 'mixed activity conglomerate'*

A mixed activity conglomerate could be defined as "a group of undertakings, which is not a financial conglomerate, that comprises at least one supervised undertaking according to EU definitions and at least one undertaking engaged in insurance business, active with at least one other undertaking from a different financial sector (banking activities or investment services)". The same definition of a group would apply as for the definition of a financial conglomerate.

The following minimum framework could be applicable to mixed activity conglomerates, as well as to financial conglomerates:

- access to information by supervisors concerning the group, and
- reporting requirements for intra-group transactions.

The specific modalities of this framework are explained in the relevant sections of this consultative document.

The definition of a financial conglomerate - which refers to the 10, 15 or 20% and 40% thresholds to define respectively significant cross-sector financial activities and mainly financial activities - implies that some of the financial groups that currently fall under the scope of the sectoral directives for banking, investment firm or insurance groups, will also fall under the scope of the future financial conglomerates regime. Most financial conglomerates are either predominantly banking/investment business oriented or predominantly insurance focused; none are exactly 50% banking/investment and 50% insurance oriented.

*'Exclusivity' of the financial conglomerate regime*

E.g. a group with a credit institution as a parent, the activity of which is 70% banking and 30% insurance, would according to the current legislation fall under the Consolidated Supervision Directive for the banking part of the group, and would as a whole also fall under the financial conglomerates regime. A group, headed by a holding company, with 70% insurance and 30% banking activity, would according to the current legislation fall under the Insurance Groups Directive as regards the insurance part of the group, and the holding

would qualify as an insurance holding ; however the group as a whole would also fall under the financial conglomerates directive because of its significant cross-sector activities.

This raises the issue of the ‘exclusivity’ of the new supervisory regime for financial conglomerates. In particular, the future financial conglomerates directive will need to clarify whether or not, and if so how, the scope of the existing sectoral directives on group-wide supervision will be affected by the approach for financial conglomerates. Possible solutions range from narrowing the scope or even disapplication of the sectoral directives to a cumulative application of both regimes. The Commission services are interested in developing an approach along the following lines:

- as a starting point, the introduction of a group-wide supervision for financial conglomerates should not in principle result in the disapplication of the sectoral directives, i.e. the bank/investment and insurance sub-parts of the financial conglomerate should still be subject to sectoral group-wide supervision according to the sectoral rules; neither would there be a transfer of responsibilities from the sectoral supervisor to the co-ordinator;
- if a group is headed by a holding company, the Commission is interested in developing an ‘exclusive’ approach, since the holding could not at the same time be a mixed financial holding company (subject to the financial conglomerate regime) and a financial holding company (subject to the Consolidated Supervision Directive or the CAD) or an insurance holding company ( subject to the Insurance Groups Directive);
- however, where a group falls under the financial conglomerate regime the sector directives would continue to be applied to the lower level homogeneous sub-parts of the conglomerate that are headed by a regulated entity; this latter would not prevent a supervisor from including the holding company in the sectoral group-wide supervision where he deems it necessary to assess capital adequacy at sectoral level;
- if a group is headed by a regulated entity ( a credit institution, investment firm or insurance company), the sector directives would apply to the homogeneous parts of the group (in particular as regards capital adequacy) and the financial conglomerate regime would apply to the group as a whole; as in principle the supervisor of the parent regulated entity will be the co-ordinator for the whole group, the supervision of the whole group will complement the supervision of the sectoral sub-part;

It could be argued however that this approach creates too much supervisory overlap; in particular the sectoral group-wide capital adequacy test could be replaced (not combined) with the conglomerate’s group-wide capital test, and the application of the sectoral requirements could be limited to the lower levels of the conglomerate. This would mirror the approach that applies to conglomerates headed by a non regulated holding company.

Figure 6: supervision of a financial conglomerate headed by an unregulated holding company

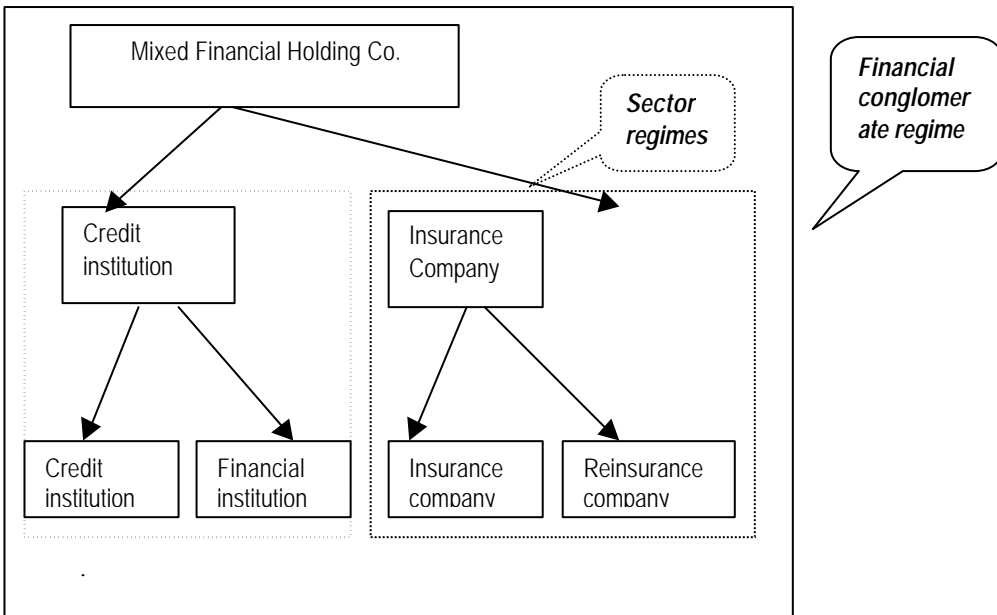
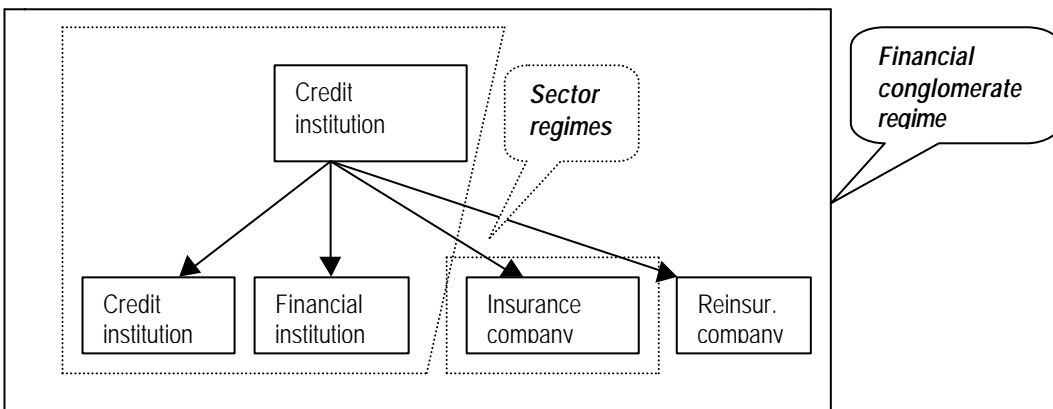


Figure 7: supervision of a financial conglomerate headed by a regulated entity (cross-sector activity above threshold)



**The Commission services seek views with respect to the proposed scope and definition of a financial conglomerate. Responses are particularly sought with respect to the thresholds that have been identified to determine whether a group is engaged in mainly financial activities and has a cross-sector nature. Comments are also invited on the possible criteria that could be applied.**

## V Assessing the Capital Adequacy of a Financial Conglomerate

There are two important starting points. First, a central issue is to ensure that the objectives of separate supervisors to ensure the capital adequacy of the entities for which they have regulatory responsibility should not be impaired as a result of the existence of cross-sector financial conglomerates. There is a need to ensure that there is sufficient capital available to the individual regulated entities to ensure their viability. This requires measures to prevent situations in which the same capital is used simultaneously as a buffer against risk in two or more entities in the same financial conglomerate ('double gearing') and situations where a parent issues debt and downstreams the proceeds as equity to its regulated subsidiaries ('excessive leveraging'). Second, in developing capital adequacy assessment methods, the existence of capital adequacy rules in each sector is recognised, as is their effectiveness and reasons for the differences. Sectoral capital adequacy approaches are therefore taken as given as they reflect the different nature of business undertaken by each sector, differing risks to which they are exposed and different approaches to risk management and assessment by supervisors and/or firms.

*A considerable amount of analysis has already been undertaken*

Given the unanimous international agreement (see the Joint Forum Recommendations) on these important principles, work must therefore focus on certain *technical* issues that need to be resolved in order to present coherent legislative solutions. In particular three issues arise:

- (a) the consistency and acceptability for supervisory purposes of a number of methods to prevent double gearing in a financial conglomerate;
- (b) the cross-sector mobility of capital to meet regulatory capital requirements
- (c) the treatment of a minority interests in subsidiaries within group entities.

The Commission services have not developed new methods to prevent double gearing or excessive leveraging. It has benefited from the valuable body of available technical analysis in examining existing approaches and methods that have been identified by the Joint Forum and set out in the Insurance Groups Directive as well as in the Consolidated Supervision Directive (the IGD and CSD apply to homogeneous groups)<sup>10</sup>. The Commission services have examined the methods described in these sets of documentation and concludes that they are essentially the same, even though there are differences in terminology (Annex I).

*Methods to prevent double gearing*

The documentation referred to offers an exhaustive description of the specific methods. This documentation also contains numerical

examples of the application of these methods. The methods are only briefly recapitulated and summarised here for the ease of discussion. The methods should also be regarded as a complement to existing sectoral approaches to capital adequacy.

The methodologies developed in all three approaches are similar, they share the same objectives, and are equivalent as they yield similar results within a range of acceptable outcomes. They could be applied to the entities covered by the definition of a financial conglomerate.

In view of the cross-sector, heterogeneous nature of financial conglomerates, the Commission services are of the view that in practice the supervisors should have the discretion and flexibility to apply a combination of the three methods to a specific group. None of the methodologies may be practicable for the financial conglomerate as a whole, even though they may be perfectly suited to assess the capital adequacy of sub-parts of the group.

*... but supervisors should be able to apply a combination of the methods*

The working assumption is that the capital adequacy of banking/investment firm activities on the one hand, and insurance activities on the other, are separately calculated before being combined to give an overall group capital adequacy assessment. Within each 'block', of course, various techniques can be used to pull together the sectoral assessment: i.e accounting consolidation, aggregation, deduction.

The methods themselves reflect and are stated as technical principles, but they do not describe the technical details for their practical application. The detailed way in which they are applied in practice will affect the results they bring. Although it would go too far to spell-out these details in a directive, there is a need for supervisors to ensure that they apply the methods in the same manner in their day-to-day supervision.

The application of the three methods is dependent on agreed definitions of regulatory capital. The three financial sectors enjoy different definitions of capital under EU prudential legislation. The Commission services are of the view that it is not feasible to aim for a cross-sector harmonisation of the definition of regulatory capital in a short to medium time-frame.

*Cross-sector capital mobility: available capital*

In order to address the question of the extent to which regulatory capital located in one sector can be used to meet capital requirements at the level of a financial conglomerate, the Commission services have identified common capital elements in the banking/investment firm and insurance sectors. This is referred to as 'cross-sector capital'. These are capital items recognised in both sectoral capital adequacy frameworks. The regulatory capital of a financial conglomerate can then be divided in three categories:

- cross-sector capital

- banking/investment firm sectoral capital
- insurance sectoral capital

The attraction of this division is that it allows for the future evolution of capital adequacy rules within the EU. Should sectoral rules on regulatory capital converge in the future, then the number of items qualifying as cross-sector capital would simply increase. The common capital items that would qualify as cross-sector capital are set out and compared in Annex II.

All other capital elements that are acceptable to meet sectoral capital adequacy requirements, but that are not common across sectors would not be eligible to meet the capital requirements at the level of a financial conglomerate.

*Sectoral capital elements would not be eligible to meet the requirements of a financial conglomerate at group-wide level*

The Commission services consider that capital requirements should only be met by capital elements allowed under that sector's regulatory framework. The application of this principle is essential if the assessment of the capital adequacy of a financial conglomerate is to be meaningful and accepted by supervisors. It is also consistent with the existing sectoral capital adequacy directives. However, this principle has two important consequences.

*Capital requirements should only be met by capital elements allowed under that sector's regulatory framework*

The first consequence is that sectoral capital will only be recognised up to the level allowable under that sector's capital requirement. (For example, in a financial conglomerate, hidden reserves will only be eligible capital to meet the insurance undertaking's requirement and up to the level allowed under the insurance rules). Any surplus in this capital element will therefore be lost to the financial conglomerate as a whole....

*..... first consequence: sectoral capital will only be recognised up to the level allowable under that sector's capital requirement*

The second consequence is that the amount of surplus cross-sector capital a financial conglomerate has, must be determined. Each 'block' will in practice have a mix of cross-sector and sectoral capital elements : the extent to which a (sub-) group uses the latter rather than the former to meet that block's requirement will determine the amount of surplus cross-sector capital available to the financial conglomerate as a whole. In supervisory practice however an accounting consolidated method will not always be able to distinguish between the origin of cross-sector capital elements. Among the available options to deal with this, in effect sectoral capital should be used first

*second consequence: how to determine the amount of surplus cross-sector capital?*

---

<sup>13</sup> Directives 98/78/EC and 92/30/EEC (see Chapter III)

to meet sectoral capital requirements, any surplus sectoral capital element will be lost to the financial conglomerate as a whole. Cross-sector capital, which has not been used to meet sectoral capital requirements, could count towards the capital requirement of the financial conglomerate as a whole.

This approach does not take into account the existence of internal restrictions on the use of certain capital in the banking/investment firm sector. There are limitations on the proportion of core and supplementary capital (tier 1, 2 and 3 capital). And there are restrictions on the type of risk that tier 3 capital can cover. This means that not all cross-sector capital that may arise in the banking /investment firm sector will be available to the financial conglomerate as a whole. These limits could be taken into account when calculating group-wide capital (e.g. cross-sector tier 2 capital instruments should also at the level of the conglomerate be limited to 100% of core capital, which limit applies in the banking/investment firm sector).

*... and dealing with sectoral limits and restrictions on the type of risks capital can cover*

Having decided how much surplus cross-sectoral capital the conglomerate has, any constraints on that surplus' effective mobility and availability across the financial conglomerate should be taken into account. For instance, even though it may be a surplus to local minimum requirements, there may nonetheless be regulatory or legal restrictions on the transfer of surplus capital. There could also be considerable tax liabilities to be set against any surplus reserves or, in some (third country) jurisdictions, capital or exchange controls. There are also likely to be legal restrictions on the use of an insurance company's hidden reserves, outside the company in which they are located.

*Dealing with constraints on the effective mobility of capital*

The proportion in which minority interests are used – relative to the group's own interests - to meet the requirement of the entity in which they are held, can significantly influence the extent of surplus capital in a less than fully owned subsidiary. They also have the potential to significantly affect the results of the methodologies to prevent double gearing. Agreement on how to handle minority interests in subsidiaries (also consistently across sectors) is therefore essential to achieve a level playing field.

*Cross-sector capital mobility: minority interests in subsidiaries*

Three options are available.

- (a) Minority interests are deducted from the group's capital. This option is not recommended; it heavily penalises the group as it disregards completely the contribution made by minority shareholders to meeting capital requirements and diverges from sectoral regulation.
- (b) Minority interests are counted up to their share of the subsidiary's capital requirement on a 'pro rata' basis. This option limits the use of any capital paid into an entity by third parties to that undertaking. This prevents a situation in which a regulated financial undertaking 'finances' its participations in other

undertakings partly by relying on minority shareholdings of third parties in its other related undertakings. The surplus capital that 'belongs' to minority shareholders is therefore deducted as minority shareholders also have a claim on their share of the surplus, which is not considered to be available to the financial conglomerate.

- (c) Minority interests are included in full in the group's capital. This option recognises all minority interests and suggests that their share of the surplus is available to the group, whereas the benefits of a surplus will be shared amongst the different shareholders. The point of departure of this option is that a parent undertaking will have control over its subsidiaries. In the event of financial difficulty, the parent will usually be required to provide financial assistance, not the minority shareholders. In addition, international accounting standards require the inclusion in full of minority shareholdings: taking full account of capital surpluses at subsidiary level to assess capital at financial conglomerate level would be consistent with these standards.

The choice for either option (b) or (c) should be consistent with the sectoral approaches to the treatment of minority interests. A consistent treatment would be desirable. Otherwise, it might lead to a different treatment of conglomerate groups on the one hand, and banking/securities or insurance groups on the other hand. Moreover, there could be an asymmetrical treatment within a conglomerate.

The Commission services suggest that minority interests should therefore be:

- included *pro rata* if there is a surplus (i.e. deduct minority shareholders' share of the surplus from the capital surplus), and
- included in full if there is a capital deficit (in this case they are not sufficient to meet their share of the capital requirement).

*This section has described the Commission services' policy approach with respect to the capital requirements for a financial conglomerate and the various issues this raises. Industry comments on the appropriateness of this approach and any particular additional issues that would have to be considered in taking forward this approach are invited*

## VI Intra-Group Transactions and Risk Concentration within a Financial Conglomerate

The presence of intra-group transactions and risk exposures within a financial group is not a matter of supervisory concern *per se*. In order to facilitate risk management, increase efficiency and synergies, and more effectively manage capital and funding, financial conglomerates frequently centralise core activities and enter into intra-group transactions and exposures. Achieving these benefits will often lie at the heart of the existence of a financial conglomerate type group structure. The presence of intra-group transactions and risk exposures can be either beneficial or harmful to the entities in a conglomerate. The challenge is ensure that these operations are not detrimental to its financial health. As will be explained there are particularly good reasons to look at these operations in the context of a financial conglomerate, as well as in the wider context of a mixed activity conglomerate.

*Intra-group transactions and risk exposures are not risk conducive per se*

Although there are many similarities between the supervisory challenges and prudential solutions to intra-group transactions and risk exposures, they are discussed separately in the following section in view of certain important differences between the two. As the supervisory responses to both concerns are very similar, the recommendations are presented as a common supervisory policy approach.

A definition of intra-group transactions could refer to “all operations by which entities of a financial conglomerate rely upon other entities within the same group for the fulfilment of a contract or a service, whether or not for payment”. The element of interdependence between the entities within the same financial conglomerate is crucial from a supervisory perspective. The pricing of a transaction may give rise to additional supervisory concerns.

*Defining intra-group transactions*

This definition of intra-group transactions is, however, too wide to evaluate the practical prudential concerns related to these operations. A ‘typology’ of intra-group transactions is of greater assistance to target specific transactions between group entities. On the basis of the typology developed by the Joint Forum, a specific list of intra-group transactions that merit specific prudential consideration has been developed.

*Figure: typology of intra-group transactions that merit specific prudential consideration*

- ❶ trading operations (one entity in the financial conglomerate deals with or on behalf of another entity within the same group)
- ❷ central management of short-term liquidity within the financial conglomerate
- ❸ the provision of management and other service arrangements
- ❹ exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees)
- ❺ purchase or sale of assets with other entities in the financial conglomerate
- ❻ exposures arising through the placing of clients' assets with other in the financial conglomerate
- ❼ guarantees, loans and commitments provided to or received from other companies within the financial conglomerate
- ❽ transfer of risk through insurance or reinsurance
- ❾ transactions to shift third-party related risk exposures between entities in the financial conglomerate

As is the case with intra-group transactions, the present sectoral legal definitions of 'risk concentration' also provide insufficient guidance to capture related risks across different financial sectors. It can be better described on the basis of the following three elements:

*Defining risk concentration in a financial conglomerate*

- i) a loss potential borne by one or several entities within a financial conglomerate
- ii) which is large enough to undermine the solvency of at least one relevant entity within the conglomerate or threaten the continuance of its core operations
- iii) and which is caused by large-scale:
  - a) credit risk exposure to a client or group of risk-connected clients,
  - b) investment in risk-related companies or real estate,
  - c) insurance of geographically or otherwise closely interrelated risk, or
  - d) other aggregation of similar or interacting risk factors by investment or by contract.

There are two key observations about risk concentration in a financial conglomerate. First, they are more likely to arise from a combination of the elements described in the previous paragraph than in the case of a purely banking or purely insurance group. A single event may therefore have a different impacts on a financial conglomerate which must be aggregated in assessing the overall risk exposure of the group. (For example, insurance claims arising from a natural catastrophe and credit losses if the activities of a group are concentrated in the same geographical region. The aggregation of apparently unrelated losses complicates the picture). At present, banking, insurance and securities supervisors look at these separately and differently.

Second, the present EU rules dealing with risk concentration (large

exposures provisions for credit institutions and investment firms) are not compatible across sectors, nor are there common cross-sector supervisory methodologies to assess the overall risk concentration within a financial conglomerate. Risks can interact in a financial conglomerate in a way that is not recognised by sectoral regulation.

Supervisory concerns about intra-group transactions and risk concentration exist in four areas: risk of contagion; risk of a conflict of interests; supervisory arbitrage; the lack of a comprehensive overview of the risk exposures within a group. The degree of concern may vary between the specific transactions at stake or the type of risk concentration.

*Supervisory concerns*

There is a potentially high risk of contagion for regulated entities in a financial conglomerate. Although intra-group transactions and exposures will seldom be the reason for solvency problems in a group, they can exacerbate solvency, liquidity or profitability problems of individual entities in a financial conglomerate and thus also affect other undertakings in the group. The resolution of problems in regulated entities within a troubled or failing financial conglomerate may therefore be complicated.

*Risk of contagion*

For **direct trading between group entities**, the volume of intra-group transactions may have a substantial detrimental effects on regulated entities and the group as a whole. **Trading on behalf of another group entity** (e.g. a specialist FX trader) and in particularly in the name of other group entities (which is not uncommon in the case of financial conglomerates) can also give rise to contagion risk. The same applies to the **intra-group placement of assets** (funds, securities or contracts) with other entities within a financial conglomerate. This may also give rise to 'reputational risk'. This relatively common practice aims to benefit from more favourable sectoral market or tax conditions, or centralised expertise within the group.

In order to ensure efficient and optimal short term liquidity within a group, **centralised liquidity management** within the parent company or a specific entity of trading or financial activities is not uncommon. Cash-pooling operations are beneficial to the group as a whole. Liquidity shortages within an entity in a conglomerate may however give rise to acute contagion risk which may lead to a liquidity crisis.

The contagion risk associated with **intra-group guarantees and loans** is also considered to be high. Particular attention needs to be given to the originator of the guarantee or loan in the group, as unregulated entities escape regulation or supervision.

**Insurance (and reinsurance) operations** within a group may also incur a contagion risk. Such operations may also include contingency funding or securitisation operations within the group. A failure to honour a claim will have a detrimental impact on the group as a whole.

A risk of a conflict of interests may also occur, i.e. the best interest served by a transaction in one part of the group may not coincide with the interest of other entities in the group. This can particularly be the case for transactions involving shareholders of the conglomerate. Although this risk is generally considered to be moderate, **trading transactions** may not be priced or conducted on terms and conditions which are at arm's length. Examples of transactions which may give rise to particular supervisory concern are: subsidising arrangements to a group entity in difficulty, transferring resources to it by underpricing ordinary deals.

*Risk of a conflict of interests*

The **placement of clients' assets** might be done in the best interests of the group, rather than in the best interest of the client. LSO, the purchase and sale of assets which are not entered into at arm's length may reveal a conflict of interest within the group.

**Intra-group guarantees and loans** also incur a high risk of conflict of interests. As the pricing of these products can be difficult to assess (in particular derivative contracts) such transactions may mask the transfer of funds within the group. Even in the event of a transaction at arm's length, an intra-group loan may create an excessive exposure or asset allocation mismatch. This does not mean that there is a conflict of interests if a transaction is not at arm's length. Under certain circumstances, it may be in the interest of a financial conglomerate if an entity lends to an affiliate below the market rate.

A key concern for supervisors in this regard is the sustained autonomy of the management of the separate entities within a financial conglomerate to take business decisions that are in the best interest of the individual entity.

Intra-group transactions and exposures can be used as a means of supervisory arbitrage to purposefully evade or opt for less strict sectoral requirements by (re-) allocating business within a financial conglomerate. The degree of seriousness of this risk will differ depending on the type of transaction or exposure involved. As will be explained later in this chapter, this risk is considered to be particularly high in the area of risk concentrations.

*Supervisory arbitrage*

Supervisory arbitrage may also induce the **purchase and sale of assets** between group entities. The investment in shares of affiliate companies or claims to customers may be sold or transferred elsewhere in the group, for example where group entities are located in jurisdictions with more favourable accounting or taxation rules.

Particularly in the case of **deals on behalf of other entities in the group**, the allocation of (significant) exposures within the group and the adequacy of risk management systems may be obscured. The lack of a comprehensive overview of the risk exposures within a group is

*Lack of a comprehensive overview of the risk exposures within a group*

therefore clearly present.

In particular in the case of **centralised management of short-term liquidity**, there is a risk if the responsible entity within the group lacks a complete view of liquidity resources and requirements within the group as a whole. The need for a comprehensive overview of the risk exposures are particularly important for insurance and reinsurance operations between entities of a financial conglomerate. In the absence of such an overview excessive risk concentration may occur.

EU-banking regulation focuses predominantly on risk concentration. The large exposures directive sets out an overall quantitative limit for exposures arising from intra-group transactions. The reporting requirements provide an opportunity for supervisors to monitor the related transactions if they cause for concern.

EU-directives regulate excessive risk concentration in all three financial sectors. The extent and methodology varies considerably however.

*Existing  
sectoral  
solutions for  
risk  
concentration  
differ*

Credit institutions and investment firms are subject to a detailed system of **large exposure rules** aimed at monitoring and limiting the exposures of solo institutions and groups of institutions to an individual client or group of connected clients. The quantitative limits are calculated as a percentage of solo supervisory capital and the group's consolidated capital in the case of a 'group'. A large exposure is any exposure that equals or exceeds 10% of the institution's own funds. A single large exposure may not exceed 25% of own funds. The aggregate of all large exposures are capped at 800% of own funds. These limits are applied on a solo basis (where solo requirements apply) and on a consolidated basis. In addition, credit institutions are subject to quantitative limits on any **qualifying holdings** in non-financial undertakings (an individual limit of 15% of own funds and a aggregate limit of 60% of own funds).

Insurance undertakings are subject to quantitative '**asset spread rules**'. Unlike credit institutions and investment firms the limits are not measured against the capital of the institution but against the insurer's technical provisions. (For example, an insurance undertaking may not invest more than 10% of its gross technical provisions in any one piece of land or buildings close enough to each other to be considered effectively as one investment). Member States are not allowed to prescribe any rules for the assets that are not used to cover technical provisions. The assessment of the asset-related risks is only made on a solo basis for insurance companies (with the exception of a participation of 50% or more in an investment fund: insurance supervisors must 'look through' to that fund and take into account its portfolio of assets). In the context of an insurance group the technical provisions and the investment of the assets backing those provisions are aggregated. Compliance with the asset spread rules at a solo level

implies compliance also at aggregate, group level. Moreover, the asset spread rules in the insurance sector only deal with the assets covering technical provisions, which account for most of the total assets of an insurance company (i.e. a multiple of the own funds).

The dissimilarities in approach between the sectors is caused by differences between the underlying philosophies of the prudential risks at stake. Although in both sectors risk concentration rules concern asset-related risks, there are no concentration rules for the liabilities underwritten by insurers as insurance business uses other techniques to diversify and limit the underwriting risk (reinsurance, co-insurance, etc.).

Having said this, this analysis of sectoral regulations addressing risk concentration emphasises the problems related to the multisectoral dimension of conglomerates which are not taken into account in the present rules. The limits set by sectoral regulations do not take account of exposures located in entities of the other sectors elsewhere in the conglomerate.

The differences between sectoral regulatory approaches gives rise to the potential for regulatory arbitrage. This potential is more significant for the banking side of a financial conglomerate than for the insurance side. A bank (or an investment firm) can relatively easily circumvent the consolidated large exposure limits established, acting through an insurance company in the group, as it will not be included in the scope of consolidation.

*... and give rise to a potential of regulatory arbitrage*

The Commission services are interested in developing an integrated approach for the regulation and supervision of intra-group transactions and risk exposures. The scope of application of these measures should differ. The recommended regulatory measures addressing the prudential concerns with regard to intra-group transactions should be covered by the definition of a financial conglomerate as well as by the wider definition of a mixed activity conglomerate. On the other hand, the recommended measures for concentrations of risk exposures should be limited to the definition of a financial conglomerate.

*Regulatory and supervisory solutions for intra-group transactions and risk exposures*

It is not feasible at this juncture to introduce quantitative limits in this area:

*Quantitative, harmonised limits are difficult to achieve in a short time-frame...*

- **Intra-group transactions** do not lend themselves easily to traditional forms of regulation as this could imply an intrusion by supervisors into the responsibility of the managers of a financial conglomerate. Moreover, the supervisory concerns may only arise for specific types of transaction when they introduce an interdependence between entities in a group.
- The absence of a common **risk concentration** measurement approach in the different sectors because of differences between the underlying philosophies of the prudential risks at stake means that, in the short-term at least, the focus should be on other options

to address the supervisory concerns. Suitable common risk measurement approaches would be valuable, but are only likely to evolve in the light of supervisory experience. In the given circumstances the imposition of quantitative limits might be counterproductive. The imposition of an imperfect limit system could introduce artificial distortions in the market and inhibit the development of good risk management systems in financial conglomerates.

The Commission services are therefore interested in an adequate and effective regulatory approach for intra-group transactions and risk exposures built on the following three pillars:

- an internal management policy with effective internal control and management systems;
- reporting requirements to supervisors; and
- effective supervisory enforcement powers.

These recommendations are in line with those presented by the Joint Forum end 1999, but go somewhat further where appropriate.

*... so the focus should be on qualitative measures.*

The competent authorities require that a financial conglomerate should have adequate risk management processes in place to measure, monitor and control intra-group transactions and to manage group-wide risk concentrations. To this end, a financial conglomerate could be required:

- a) to have **sound administrative and accounting procedures and adequate internal control mechanisms** in place to:
  - identify, measure, monitor and control all intra-group transactions (including appropriate reporting to the management committee)
  - identify and record major risk concentrations and subsequent changes to them, and to monitor, analyse, and administer them in accordance with the conglomerate's own exposure policies, and evaluate the effectiveness of those procedures and mechanisms in practice across the conglomerate.
- b) to define its **management policy** on intra-group transactions and risk concentration.

*(i) An internal management policy and effective internal control and management systems*

The requirement of sound administrative and accounting procedures and adequate internal control mechanisms is familiar to EU-prudential legislation as they already exist at sectoral level. Each regulated entity should therefore (continue to be) required to have its own internal control mechanisms in place, but extended and adapted to the broader profile of risk concentrations in a financial conglomerate. This will be of particular importance if the management of a financial conglomerate is centralised in an unregulated (holding company) entity.

The definition of a financial conglomerate's internal risk policy is the

starting point of any meaningful risk management. It is particularly important in the absence of EU-quantitative limits on intra-group transactions and risk concentration (at least until a common risk measurement approach for banking and investment business and insurance business has evolved).

Reporting to supervisors is an integral part of the risk monitoring process. The suggestion is made to require financial conglomerates (as well as mixed activity conglomerates as regards intra-group transactions) to report relevant intra-group transactions and risk concentrations to supervisors on a regular basis. ‘Soft’ quantitative reporting limits for such operations could be set as an indicator which operations and exposures should be considered as ‘relevant’. This would provide an important incentive for financial conglomerates to implement their internal risk management policy seriously. Reporting limits should neither pose serious problems nor add costs to supervisors or the industry if the limits were set too high or too low. A possible reporting threshold could be defined as a percentage of the regulatory own funds of the regulated entities involved.

*(ii) Supervisory reporting requirements*

The effectiveness of this approach depends on the existence of supervisory enforcement powers. Supervisors should therefore conduct an independent evaluation of the conglomerate’s strategies, policies, procedures and practices related to the management of risk in intra-group transactions. In addition, supervisors should also have the necessary powers to take corrective action if certain intra-group transactions or the level of risk exposures give rise to concern.

*(iii) Effective supervisory enforcement powers*

*The Commission services seek views with respect to the proposed strategy in addressing issues posed in the context of intra-group transactions and risk concentration. Responses are particularly sought with respect to the use of qualitative requirements to be met and implemented by entities within a financial conglomerate itself.*

## VII Assessing Fitness and Propriety of Managers and Directors and the Suitability of Major Shareholders

All of the sectoral directives require prior assessment by the supervisor of the suitability of shareholders (or members) which have or intend to acquire a direct or indirect qualifying holding in a credit institution, investment firm or insurance undertaking. Authorisation should be refused if the major shareholders are deemed to be unsuitable, and if plans to acquire a qualifying holding may be detrimental to the sound and prudent management of the regulated entity. In response to the BCCI-affair these powers were extended: authorisation can also be revoked if the supervisor considers that ‘close links’ between the regulated entity and other natural or legal persons prevent the effective exercise of his functions.

*Assessing the suitability of shareholders on a cross-sector basis*

In the context of a financial conglomerate the application of these powers may give rise to difficulties, particularly when the shareholders originate from another sector or jurisdiction. This can affect the powers of the supervisor to access the relevant information and make an effective assessment. The banking and investment services directives deal with this by requiring prior consultation between supervisors if the acquirer comes from another Member State and is a (parent of a) regulated entity, or other natural or legal person. The absence of a similar provision in the insurance directives gives rise to a lacuna in EU-prudential regulation as regards the supervision of a financial conglomerate, which should be addressed. Supervisors should keep each other informed and assist each other in obtaining any relevant information for the assessment of the suitability of a qualifying shareholder on an ongoing basis. These shortcomings should be addressed in forthcoming legislation on financial conglomerates.

All of the sectoral directives require the supervisor to withhold authorisation for a credit institution, investment firm or insurance undertaking unless the persons who effectively direct the business in the regulated undertaking are of sufficiently good repute and sufficiently experienced (‘fit and proper’). The Joint Forum recommendations go further and suggest that the ‘fit and proper’ requirements also apply to the managers and directors of other entities in a financial conglomerate if they exercise a material or controlling influence on the operation of regulated entities. This gives rise to two issues:

*Fitness and propriety of directors and managers*

- (i) the possible need for a harmonised application of the ‘fit and proper’ requirements across sectors and borders;
- (ii) the need to extend the scope of the ‘fit and proper’ requirements in the EU to any person who exercises a material or controlling influence over a regulated undertaking in a financial conglomerate, whether or not they are legally appointed in this regulated entity.

The Commission services are not of the view that an harmonised application of ‘fit and proper’ requirements should be pursued. The difficulties arising from differences in the application of national legal systems (in particular in the field of company law) and supervision practices prevent an easy convergence of practices. Furthermore, there are advantages to having a flexible notion of ‘fitness and propriety’ which can be adapted to different sectors and Member States’ circumstances.

*(i) harmonised ‘fit and proper’ requirements?*

In the absence of a harmonisation of the ‘fit and proper’ criteria, the a need for supervisors to co-operate in all cases involving the assessment of the fitness and propriety of managers and directors of regulated undertakings in a financial conglomerate. In particular, upon request supervisors should keep each other informed of any relevant circumstances known to them and assist each other as far as possible in obtaining any relevant information.

In line with the Joint Forum recommendations the ‘fit and proper’ requirements should also apply to the managers and directors of other entities in a financial conglomerate, or a mixed activity conglomerate if of relevance, if they exercise a ‘material or controlling influence’ on the operation of regulated undertakings in the group. The modifications to the sectoral directives introduced by the BCCI-Directive, and in particular the need to take into account any ‘close links’ between a regulated entity and other natural or legal persons, are not adequate to address this issue as they relate to the transparency of the structure of the group.

*(ii) applying ‘fit and proper’ requirements to any person who exercises a material or controlling influence*

The Commission services therefore consider that a provision should be introduced to this effect in the EU prudential framework for the supervision of financial conglomerates and, to ensure consistency, in the sectoral directives. In addition, the supervisor should be given the power to apply appropriate sanctions on the regulated undertaking and its legally appointed managers and directors. In any event, the legally appointed managers and directors of the regulated entity should be required to meet the ‘fit and proper’ test on an ongoing basis.

***The Commission services invite comment on the proposed policy approach.***

## VIII The appointment of the Co-ordinator(s) for a Financial Conglomerate

Present practice shows that the supervision of large international financial conglomerates or of large financial groups involves several supervisors, each of them responsible for one or more of the regulated institutions composing the conglomerate or the group. In these cases it is vital to ensure a mutual understanding of the risk profile of the group among all regulators involved to avoid loopholes in prudential supervision, duplication of tasks and efforts, and the imposition of contradictory measures on the (entities of a) conglomerate. This applies on a going-concern basis as well as in emergency situations. The overall prudential risk faced by a financial conglomerate also requires a different practice in supervision as risks may be underestimated if supervision is only conducted on a solo basis, or on the basis of its sub-groups.

*The co-ordination of prudential supervision must be ensured*

In recent years, international regulatory and supervisory organisations have considered how to best ensure a co-ordination of prudential supervision. The most elaborate and authoritative are the principles adopted by the Joint Forum which recommend the appointment of one or more authorities to act as co-ordinator(s).

The analysis of the present EU regulatory framework, which has also been summarised in the Brouwer Report on ‘Stability in the Financial Sector’, confirms that the Joint Forum Principles, as well as those developed in the insurance sector, requiring the appointment of one (or more) co-ordinator(s) need to be implemented in the EU regulatory context.

These developments demonstrate the clear need to introduce co-ordination arrangements between supervisors to ensure an efficient and adequate supervision of financial conglomerates. The benefits will be:

- to avoid ‘underlaps’ in the prudential supervision of a financial conglomerate which will enhance financial stability;
- to avoid duplication of supervision, which are burdensome and costly for the supervised entities of a group;
- to achieve simplification of procedures and supervisory efforts.

The role and responsibilities of the co-ordinator(s) depend heavily on the specific circumstances of financial institutions, such as the legal framework and the risk profile of the institution involved. Each conglomerate may present a specific combination of risks to be addressed and this may change over time in the event of internal restructuring, mergers and acquisitions. Proper supervision could then

*Ensuring co-ordination: the need for flexibility*

be ensured by ad-hoc agreements which take into account the structure of a financial conglomerate.

As regards financial conglomerates, although the appointment of the coordinator(s) should be mandatory at EU-level, any further arrangements should be framed in as flexible terms as possible in terms of legislative obligations imposed. Nevertheless, the choice of roles and responsibilities of the coordinator(s) are influenced by the need to balance the benefits of improved coordination against the risk of appearing to create a new level of supervision, a new institutional model for supervision within Member States, or an extension of the public safety net to unsupervised entities within a financial conglomerate.

In practice and in most cases the identification of the coordinator(s) will be obvious given the structure of the financial conglomerate. For example, if the parent of the conglomerate is a regulated entity (credit institution, investment firm or insurance undertaking), the supervisor that authorised the undertaking would normally assume the role of coordinator. If there is a dominant entity or sector in the conglomerate, the coordinator would be the supervisor of that entity and originate from that sector.

*Identifying the coordinator(s)*

Even though identifying the coordinator(s) will be relatively straightforward in most cases, a situation should be avoided in which no coordinator is appointed. The most suitable way to approach this is to lay down criteria for guidance to identify the coordinator(s). It is important that supervisors should be given the discretion to diverge from the criteria developed to identify the coordinator(s).

There are three core tasks for the coordinator(s) of a financial conglomerate:

*The three key tasks of the coordinator(s)*

- i) assessing capital adequacy;
- ii) gathering and disseminating information;
- iii) planning supervisory activities.

As financial conglomerates are comprised of entities that are subject to the supervision of two or more authorities, there is a greater need to cooperate on a cross-border and cross-sector basis. The exchange of information is the *sine qua non* of cooperation. The coordinator(s) should facilitate information sharing efforts in a timely and efficient manner.

*i)gathering and disseminating information*

Differences in organisational structures of financial conglomerates will have implications for the type, frequency and use of information by supervisors and the coordinator(s). Therefore the co-ordinator(s) should agree with the supervisors who are responsible for the supervision of other parts and entities of the conglomerate to specific arrangements for providing and receiving information, the nature of

that information and under what circumstances it will be provided.

The coordinator(s) should ensure that an assessment of the capital adequacy of the financial conglomerate is carried out. This task is important to fill the present lacuna in the EU prudential regulation for credit institutions, investment firms and insurance undertakings.

*ii) assessing capital adequacy*

This responsibility also covers the monitoring of intra-group transactions and risk concentrations at the level of the conglomerate. The coordinator would therefore periodically need to ascertain the overall risk profile of the conglomerate on the basis of the information received, including the conglomerate's risk management process with regard to intra-group transactions and risk exposures.

In the event of a shortfall in capital adequacy, problematic intra-group transactions, or important risk concentrations in the conglomerate, the coordinator(s) should be entrusted with the task of organising and agreeing with the responsible sectoral supervisors which measures will be taken as a response and which authority will execute them.

The co-ordinator(s) should play a role in co-ordinating, together with solo supervisor(s), the supervisory activities on an on-going basis. This could involve activities such as planning on-site inspections (including joint inspections) or hearings at the conglomerate level. On site-inspections are an important means for supervisors to verify the information received from supervised entities within the conglomerate. The key advantage would be, through bilateral discussions between the coordinator(s) and other supervisors, to avoid any overlap in supervisory activities and undue burdens on the supervised entities in the group.

*iii) planning supervisory activities*

The identification, appointment and tasks of a co-ordinator(s) raise the issue of responsibilities and competencies. The appointment of the co-ordinator(s) and the exercise of certain task should not (appear) to create a new level of supervision. Nor should it, of course, imply a new institutional model for supervision within Member States, or an extension of the public safety net to unsupervised entities within a financial conglomerate.

*The allocation of responsibilities to the co-ordinator(s) does not imply a transfer of responsibilities*

Consistent with the principles developed by the Joint Forum, the appointment and tasks of the co-ordinator(s) in principle should neither result in nor imply any *transfer* of responsibilities from the solo supervisor to the co-ordinator(s). Where the co-ordinator(s) do not have a specific competence or responsibility the impression should be avoided that such a responsibility exists

***The Commission services invite views on the appointment, role and tasks of the co-ordinator(s) and in particular how it could contribute to an efficient supervision of a financial conglomerate.***

## **IX The Exchange of Information between Authorities to Fulfil their Tasks**

Information sharing is a precondition for effective supervision. None of the supervisory instruments discussed will function effectively in the absence of a proper flow of information from the entities within a financial conglomerate to the supervisors and between supervisors themselves.

*Information sharing is a precondition for effective supervision*

Financial conglomerates introduce new and different information needs. A comprehensive system of information sharing arrangements between supervisors is already in place, but they are aimed at solo (regulated) undertakings and in a homogeneous group structure. The present arrangements need to be adapted to the specific circumstances presented by financial conglomerates which may pose problems for supervisors such as: the cross-sector and cross-border spread of activities; and their operational, legal and organisational complexity.

The individual supervisor's ability to access information from regulated and unregulated entities will be key to acquiring an adequate overview of the prudential risks in a conglomerate. While supervisors should be able to obtain a detailed knowledge of a financial conglomerate, gathering the information should not give rise to unnecessary accumulation of information, duplication of work or the passing on of irrelevant information, all of which will result in inefficiencies and higher compliance costs. The role of the coordinator(s) will be important in this respect.

There are three circumstances in which supervisors will need specific information about a financial conglomerate and a mixed activity conglomerate: when a conglomerate is established; when a new entity becomes part of a conglomerate; when structural changes are made within a conglomerate; and ongoing supervisory needs. Any new arrangements that might need to be introduced in forthcoming EU legislation should not change, but complement the information routing processes which are in place in existing EU directives.

*Information needs*

The possibility for supervisors to access information in the entities within a conglomerate is vital to acquire an adequate picture of the group. The issues presented by conglomerates are no different from bank/investment firm groups and insurance groups. They concern the possibility to obtain information from regulated and unregulated entities and the availability of that information: all of these issues are addressed in the sectoral directives. The main difference in the context of a financial or a mixed activity conglomerate is the cross-sector dimension.

*Access to information*

On the basis of an analysis of the existing directives in order to identify any inconsistencies or lacuna, the following two improvements can be made:

- Any legal impediments to the exchange of information between the undertakings within a conglomerate should be removed.
- In order to remove inconsistencies between the banking/investment firm and the insurance directives, the scope of the provisions for the obligation to provide information at the supervisors' request should be widened for the purposes of consolidated supervision of banks and investment firms. Those provisions should also cover (subsidiaries of) entities that participate in regulated undertakings that do not exercise a dominant influence, and entities that do not exercise a financial activity.

*The Commission services invite comment on the proposed policy approach.*

## X Convergence of supervisory practices

The Commission services have identified a number of supervisory issues arising from divergences between sectoral legislation which need not be harmonised by a proposal for EU-legislation on financial conglomerates. These issues may either be too technical to be addressed in an EU-directive, or may relate to administrative co-operation between authorities which should also be addressed in another form than a directive. It is important to ensure that these issues are applied in a similar and consistent manner across sectors and between Member States in the day-to-day application of the legislative principles of the directive. This will further level-playing fields between Member states and sectors and enhance certainty in the market. As an alternative to legislative harmonisation in technical areas, a convergence of supervisory practices should be pursued.

*Convergence of supervisory practices is needed for a consistent application of rules across sectors and borders*

The first area where there is a need to ensure that the relatively broad technical principles are applied in a similar and consistent manner in supervisory practice concerns the three methods to prevent double gearing and excessive leveraging. The technical details of the methods as they have been presented in this report have not been set out in detail. If the methods are introduced to regulate financial conglomerates there is a need to ensure that they are commonly understood and implemented by regulators, supervisors across sectors and across borders. If appropriate, further efforts could be made to clarify the technical details of the application of the methods – but not necessarily in an EU directive. This would benefit regulators, supervisors and the entities within a financial conglomerate.

► *Capital adequacy*

The described approach to address risk concentrations and intra-group transactions in a financial conglomerate is that they have in place “ sound administrative and accounting procedures and adequate internal control mechanisms” to:

► *Risk concentrations and intra-group transactions*

- identify, measure, monitor and control all intra-group transactions
- identify and record major risk concentrations and subsequent changes to them, and to monitor, analyse, and administer them in accordance with the conglomerate’s own exposure policies, and evaluate the effectiveness of those procedures and mechanisms in practice across the conglomerate.

In addition, this consultative document notes that financial conglomerates should have in place a defined management policy on intra-group transactions and risk concentration. This flexibility is necessary at this point in time, but that supervisors should be encouraged to benefit from exchanges of views and experience on how colleagues approach these requirements in practice. Entities within a financial conglomerate would also stand to benefit from such

transparency.

When co-ordinator(s) for a financial conglomerate have been identified and appointed, other EU supervisors will have an interest in becoming informed and aware of this. The co-ordinator may be useful as a first point of contact for information or as a point of contact, e.g. in the event that a conglomerate acquires a regulated entity in another Member State. This should be arranged for by through the cross-sector collaboration between authorities.

► Co-ordinator(s)

*The Commission services invite comment on the need to converge supervisory practices and in particular whether there are any other areas than those indicated above from which regulated entities within a financial conglomerate could benefit if practices converged further.*

ANNEX I comparison of methods to prevent double gearing

Joint Forum 1999	Insurance Groups Directive 1998
<p data-bbox="384 461 619 488">‘Building Block Approach’</p> <ul data-bbox="240 510 762 663" style="list-style-type: none"> <li>• Uses consolidated financial statements</li> <li>• Divides statements into individual sectors (‘blocks’)</li> <li>• Adds the solo capital requirements/proxy of each regulated entity</li> <li>• Compares aggregate capital requirement/proxy to consolidated capital</li> </ul>	<p data-bbox="783 461 1139 488">‘Accounting consolidation based method’</p> <ul data-bbox="783 510 1299 663" style="list-style-type: none"> <li>• Uses consolidated accounts</li> <li>• Compares the solvency requirements of the parent and the proportional requirements of its related insurance subsidiaries OR the consolidated solvency requirement</li> <li>• To the consolidated capital eligible to back the solvency margin</li> </ul>
<p data-bbox="384 719 619 745">‘Risk-based Aggregation’</p> <ul data-bbox="240 745 762 999" style="list-style-type: none"> <li>• Uses <u>un</u>consolidated financial statements</li> <li>• Adds the capital of each entity in the group</li> <li>• Deducts intra-group holdings of regulatory capital to adjust for double gearing</li> <li>• Adds the solo capital requirements/proxy of each regulated entity</li> <li>• To arrive at an aggregate capital requirement</li> <li>• Deducts aggregate capital requirement/proxy from the adjusted group-wide capital to calculate surplus or deficit</li> </ul>	<p data-bbox="783 719 1102 745">‘Deduction and Aggregation method’</p> <ul data-bbox="783 745 1299 972" style="list-style-type: none"> <li>• Uses <u>un</u>consolidated financial statements</li> <li>• Adds the capital of the parent and (proportionally) its subsidiaries</li> <li>• Deducts book value of participations and holdings of other supervisory capital items which the parent holds in its subsidiaries</li> <li>• Deducts capital requirements of the parent and its subsidiaries (proportionally) from the adjusted group-wide capital to calculate group-wide capital</li> </ul>
<p data-bbox="384 1023 619 1050">‘Risk-based deduction’</p> <ul data-bbox="240 1050 762 1256" style="list-style-type: none"> <li>• Uses <u>un</u>consolidated financial statements</li> <li>• Analysis performed from parent company perspective</li> <li>• Based on pro-rata consolidation of subsidiaries</li> <li>• Investment in subsidiaries deducted from parent capital</li> <li>• Capital surplus/deficit of subsidiaries deducted from parent capital</li> <li>• Parent solo requirement deducted from adjusted parent capital to determine group surplus or deficit</li> </ul>	<p data-bbox="890 1023 1177 1050">‘Requirement deduction method’</p> <ul data-bbox="783 1050 1299 1256" style="list-style-type: none"> <li>• Uses <u>un</u>consolidated financial statements</li> <li>• Based on use of equity method by parent to show its participations in related undertakings</li> <li>• Parents capital</li> <li>• Minus solo supervisory capital requirement of the parent</li> <li>• Minus (proportional) solo supervisory capital requirement of subsidiaries</li> </ul>
<p data-bbox="240 1272 1299 1377">The Consolidated Supervision Directive (1992) provides for group-wide supervision based on ‘accounting consolidation’. The Own Funds Directive provides for the deduction of participations and holding of other capital instruments in credit institutions and financial institutions on a solo basis (no obligation to deduct where the latter are included in the scope of consolidation).</p>	

ANNEX II: cross-sector capital elements

<b>Common elements</b>	<b>Credit institutions / investment firms</b> (Source: Own Funds Directive & CAD)	<b>Life and Non-Life Insurance undertakings</b> (Source: 1st Life Directive as amended by 3 <sup>rd</sup> Life Directive and 1st Non-Life Directive as amended by 3 <sup>rd</sup> Non-Life Directive)
Paid-up capital	Paid-up share capital	Paid-up share capital For mutuals: paid-up initial fund, plus members' accounts under certain conditions
	Share premium accounts	Share premium accounts (not explicitly mentioned, but included)
Reserves	Reserves (within the meaning of the 4 <sup>th</sup> Co.Law Directive)	Reserves (not corresponding to underwriting liabilities)
	Revaluation reserves	Revaluation reserves (not explicitly mentioned, but included under the Reserves)
Profits brought forward	Net profits brought forward as a result of the application of the final results	Any profits brought forward which are not earmarked for distribution
	Interim profits, under certain conditions	
	Net profits in the trading book (after deduction of losses)	
Other items which are subordinated and paid-in or earned in the undertaking	Subordinated instruments of indeterminate duration and similar instruments, under certain conditions, including undated cumulative preferred shares	Subordinated instruments of indeterminate duration and similar instruments, under certain conditions, including undated cumulative preferred shares
	Subordinated debt/loan capital, including fixed-term cumulative preferred shares, under certain conditions	Subordinated loans and cumulative preference shares, under certain conditions