

# Financial conglomerates: supplementary supervision of financial entities

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This commission Staff Working Document accompanies the proposal for a Directive of the European Parliament and of the Council amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC as regards the supplementary supervision of financial entities in a financial conglomerate.

[Directive 2002/87/EC](#) ('FICOD') introduced group-wide supplementary supervision. The objective of this supplementary supervision was to control potential risks arising from double gearing (i.e. multiple use of capital) and group risks, that is, the risks of contagion, management complexity, concentration, and conflicts of interest, which could arise when several licenses for different financial services are combined.

Since 2002, markets have further developed in a direction where the distinction between banking business and insurance business is not always easily discernable and where the largest groups are active in many countries. As of the end of 2009, the directive covered 69 European groups and 6 third country groups.

Both the revision of the 1988 Basel Accord in 2004, implemented in the EU by the [Capital Requirements Directive](#) (CRD) in 2006, and the introduction of a comprehensive set of regulations for insurance companies in [Solvency II](#) (S2) developed the regulatory framework but, as regards conglomerates, only in so far as legal entities of a group are active in the same sector - banking or insurance. The supplementary regulatory framework under FICOD dealing with the additional complexity and risks stemming from combinations of licenses has not been evaluated yet.

Although the revision is also intended to simplify the supervision of small conglomerates, it specifically deals with the supervision of the 30 or so biggest financial groups in Europe. Total assets of these at the end 2009 exceeded €25 trillion, representing a substantial share of the EU banking market of roughly €42 trillion assets and the EU insurance market of roughly €10 trillion assets.

The over-arching objective of this initiative is to ensure that the effectiveness of the supplementary supervision of large and complex groups in the EU under the FICOD is enhanced, while maintaining the competitive position of these groups

**Problem definition:** altogether, **17 policy options** have been designed, impact-assessed and compared with a view to addressing the issues identified in the analysis:

**Supervision at the holding company level:** this is governed by the combination of the current provisions of the FICOD, the CRD and the Insurance Groups Directive (IGD). These directives refer to 'mixed financial holding companies' (MFHC), 'financial holding companies' (FHC) and 'insurance holding companies' (IHC), respectively. The supervisory tools that can be applied at the top level change when the top level becomes an MFHC and ceases to be a FHC or an IHC. The paper discusses how the **identification of a financial conglomerate can affect the application of sectoral group supervision differently, depending on the structure of the group**. As a result, certain tools of sectoral group supervision that can be applied at the level of a FHC or an IHC can not be applied to the whole group when the holding company is a MFHC. This leads to the anomalous result that a group which has acquired a license in the other sector, so that the holding company becomes a MFHC, is subject to a regulatory regime which may not be as comprehensive as that which applied before the acquisition, even though the group has increased in size and complexity and may therefore represent a higher risk to the financial system. As a consequence, the use by supervisors of a waiver in determining whether a group is a

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

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

**Identification:** provisions governing the identification of financial conglomerate also give rise to three problems:

1. the directive does not require the inclusion of asset management companies (AMCs) in the threshold tests, because UCITS were excluded from sectoral prudential supervision in 2002, although it does require that AMCs be included in the scope of supplementary supervision;
2. the threshold tests can be based on different parameters with respect to assets and capital requirements but the provisions are ambiguous as to how calculate the tests arising from, for example, different accounting treatments of assets;
3. most importantly, the threshold conditions, given their fixed amounts, are not risk-based, and the notion of expected group risks is not addressed by the threshold test. This implies that very small groups with a few licenses in each sector are subject to supplementary supervision, while the largest most complex groups can technically be identified as not being a conglomerate. As a result, the current provisions on identification may undermine the effective achievement of the underlying objectives of the directive.

**Participations:** the consistent treatment of participations in day-to-day supplementary supervision is hampered by the lack of relevant information to assess group risks, which is not so straightforward when participations are held in listed firms.

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

end the exclusion of top level holding companies of a banking or an insurance group that are classified as a MFHC, so that provisions that applied to the former FHC or IHC do not disappear when the classification of a group and its holding company changes as a result of an acquisition in the other sector;

narrow the definition of RCA to include only supervisors of ultimate parent entities within individual sectors and any other competent authorities that the supervisors of the ultimate parent entities consider are relevant.

**Identification of financial conglomerates:** to address the problem regarding the inclusion of AMCs in supplementary supervision, the inclusion of AMCs at all times, complemented with guidance on indicators for inclusion, will be proposed. In order to tackle the ambiguity regarding parameters and the lack of a risk-based identification of conglomerates, technical standards on the application of the "waiver option"

for larger groups of the FICOD will be proposed, and an option will be introduced to waive supplementary supervision for groups where the assets held by the smallest sector are below the absolute threshold of EUR 6 billion.

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

**Impact of preferred policy options:** the proposed policy changes are expected to lead to more effective risk management incentives and practices which, in turn, should also help to enhance the international competitiveness position of EU financial groups. At the level of individual stakeholder groups and systemic concerns, expected impacts of the proposals are as follows:

- **certain smaller EU financial groups with a simple structure** and not more than a few licenses in both sectors may be excluded from supplementary supervision and would therefore benefit from savings in compliance costs. This may be available to some ten smaller financial groups with combined assets of approximately EUR 69 billion. Compliance costs for **several large bank-led conglomerates that have hundreds of licenses and are active in both sectors, on the other hand, should increase** as several such groups, representing up to EUR 9 trillion assets in the financial sector, may be included in the scope of the supplementary supervision. Increased compliance costs would also be incurred by those **financial groups whose structure includes asset management business** and that will be identified as financial conglomerates following proposed changes to the conglomerate identification process. Compliance costs for financial groups that are newly included in the scope of the supplementary supervision should, given their overall size, be immaterial in relative terms. Furthermore, they should be offset with benefits arising from more effective risk management practices, induced by incentives implicit in this legislative proposal. There will also be greater trust in the markets resulting from identification as a conglomerate. These benefits should enhance the international competitiveness of large EU groups, given initiatives in the area of supplementary supervision that are being pursued in other major international jurisdictions;
- the changes to the conglomerate identification process will make the scope of the supplementary supervision more appropriate and should therefore enhance the effectiveness of supervisors' monitoring of the risks to which financial groups are exposed. Combined with a more streamlined supervision at the top level of conglomerates and an improved supervisory toolkit for detection of contagion, concentration, complexity issues and conflicts of interests in firms connected to a conglomerate through participations, this should make a positive contribution to the financial stability;
- the enhanced clarity of provisions governing the inclusion of asset management companies in the identification and supplementary supervision should provide a more level playing field in this area;
- lastly, as regards **clients of the affected financial groups**, the impact is expected to be negligible given the overall level of materiality of the net incremental effect of this proposal on those groups. Moreover, clients might not be aware of differences between the regulatory treatment of banks, insurers and conglomerates: they simply trust that the supervisory framework is comprehensive and prudent, and this revision is especially aimed at reinforcing that framework and so justifying that trust.