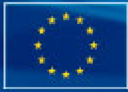
European Commission
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Info-letter: Financial Conglomerates

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# Call for Evidence for Fundamental Review

In view of the consultative paper of the Joint Forum, and given the commitment of the Commission Services to follow up on Basel agreements, any stakeholder interested in the supervision of large complex financial groups in Europe is invited to contribute to the European fundamental review in the first half of 2012. This review must answer many questions. **The Commission Services invite stakeholders to respond to the issues and questions in cursive in the second, third and fourth subset below before 19 April 2012.**

**Firstly**, note that draft replies to Call for Advice no. 4 will be consulted before the summer by the JCFC itself, and stakeholders are invited to contribute to that consultation then, regarding the draft replies of the JCFC to the following questions:

- What should be the perimeter of supplementary supervision, when a financial conglomerate is supervised on a group-wide basis?
- Which legal entity in a conglomerate should be responsible and qualify for compliance with group wide requirements, i.e. which legal entity should be the responsible parent entity?
- Which requirements should be imposed on this qualified parent entity in the context of group wide supervision?
- Which incentives would make the enforcement of the group-wide requirements more credible?
- When reflecting upon the necessary requirements and incentives, would supervisors in Europe need other or additional empowerment in their jurisdictions?

**Secondly**, FICOD1's review clause invites a reflection upon the following issues:

- The scope of the Directive for supplementary supervision, including:
    - the identification process and the use of waivers;
    - the application of supplementary supervision to non-regulated entities, in particular special purpose vehicles;
    - the identification criteria of financial conglomerates owned by wider non-financial groups, whose total activities in the banking sector, insurance sector and investment

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services sector are materially relevant in the internal market for financial services, and whether the ESAs should, through the Joint Committee, issue guidelines for the assessment of this material relevance.

- The supplementary supervision of systemically relevant financial conglomerates, whose size, inter-connectedness or complexity make them particularly vulnerable, and which are to be identified by analogy with the evolving standards of the Financial Stability Board, respectively for banking groups and for insurance groups, and of the Basel Committee on Banking Supervision.
- Mandatory stress tests for financial conglomerates, given the current stress tests for the banks and insurers separately, when they are part of the same group.

Stakeholders are invited to give their views on the general concept of supplementary supervision on groups that meet certain thresholds:

*In the light of the objective of this kind of supervision, the detection and correction of group risks in groups with many different licenses (i.e. contagion, concentration of risks, conflicts of interest, management complexity, multiple use of capital), is the concept of supplementing group risk related supervision to the sector-specific supervision of individually authorized entities in a financial conglomerate still effective?*

*Is the application of this supplementary supervision only to groups that meet the cross-sector thresholds effective in the light of the objective of this kind of supervision, or should it be applied to a differently defined set of groups active in the financial sector?*

*In view of the objective of this framework, is stress testing at sector-specific level only sufficient to take account of unexpected scenarios in financial conglomerates?*

**Thirdly**, the Joint Forum suggests, following up the DNSR report as endorsed by the FSB, revised or new principles in the following 5 areas. Please refer to the full document of the Joint Forum for background. Stakeholders are invited to provide their European specific perspective to these 5 areas:

## 1. Supervisory powers (Joint Forum principles 1-4)

Observing that the facilitating role of the coordinating supervisor in the 1999 framework appeared to have played quite a small role in times of high stress, the Joint Forum suggests that it may be

worthwhile exploring whether supervisors should be empowered to approach the head of a financial conglomerate and impose corrective measures on this head if deemed necessary.

In European legislation, supervisory provisions are applied to the authorized entities, and supervision of the holding company as a stand-alone entity is not implied, even though this holding company may have a crucial role as a head of a group of authorized entities, being responsible for group-wide policies. As a consequence of the lack of coordinated European legislation in this area, the head of a financial conglomerate may not systematically be supervised, if the head is not a regulated entity itself.

*The question is, whether, in the context of group wide supervision, supervisors in Europe should at all times be empowered to access this head of the financial conglomerate in its leading role and impose corrective measures on this entity, if it is not an authorized entity itself.*

## 2. Supervisory responsibilities (Joint Forum principles 5-9)

The Joint Forum observes that the regulatory framework up until now assumed that the resources, skills and systems of supervisory authorities would be sufficient to implement the agreed rules, e.g. the Basel agreements. The IMF's FSAPs, however, revealed that countries could be aware of necessary supervisory programmes, but were sometimes simply not able to implement them because the basic preconditions were not fulfilled. For example, a ready- to-use set of prudential standards against which to assess firms' behaviour (other than the capital ratio), including standards for group risks and triggers for corrective actions. This could be addressed by adding the same set of basic preconditions to the three sets of Core Principles of the Basel bodies BCBS, IOSCO and IAIS, but the notion is also included in this consultative paper of revised principles of financial conglomerates supervision.

In Europe, the implementation of the legal provisions is left to member states and supervisory authorities. The authorities themselves develop supervisory programmes that specify the application of the provisions and triggers for action. They can share these approaches and programmes within their ESA-networks and colleges, but legally, the way they do that is left to their discretion.

*The question is, whether the discretion to apply the rules in the supervisory approach as chosen by the respective authorities is effective in the context of cross-border and cross-sector groups, or*

*whether other enforceable provisions (such as transparency, or obligatory cooperation, see the Joint Forum document for more provisions) are necessary.*

## 3. Governance (Joint Forum principles 10-14)

Broadly, corporate governance describes the processes, policies and laws that govern how a company or group is directed, administered or controlled. It defines the set of relationships between a company's management, its board, its shareholders, clients, employees, etcetera. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.

Financial conglomerates are often complex groups with multiple regulated and unregulated financial and other entities. Given this inherent complexity, corporate governance must carefully consider and balance the combination of interests of recognized stakeholders of the ultimate parent, and the regulated financial and other entities of the group. Ensuring that a common strategy supports the desired balance and that regulated entities comply, on an individual and on an aggregate basis, should be a goal of the governance system. This governance system is the fiduciary responsibility of the board of directors.

In Europe, both Solvency II and CRD4 added specific governance provisions to the set of rules for authorized entities. The scope of Solvency II's group supervision and its governance requirements include non-insurance entities in the group. Like Solvency II applies to authorized insurers, the CRD also applies to authorized banking entities only, but CRD doesn't define "group" in the way Solvency II does. The FICOD's governance provisions were recently beefed up with living wills and group structure transparency requirements, but the question is, whether this set of prudential provisions is sufficient for imposing effective governance systems on financial conglomerates as a whole. For example, the Joint Forum suggests that a supervisor should be able to require a legal and organisational group structure that is consistent with the group's overall strategy and risk profile and is well-understood by the board and senior management of the head company. Also,

the Joint Forum suggests imposing an explicit responsibility on the head of the conglomerate with respect to defining and implementing a group-wide strategy. Finally, the Joint Forum suggests to no longer limit the remuneration requirements to regulated entities only, but to apply them to any employee of the financial conglomerate.

*The question is whether explicit new or amended legal provisions are necessary to achieve sound group-wide governance systems in Europe, or whether sufficient legally clear provisions already exist to implement the suggested principles.*

## 4. Capital adequacy and liquidity (Joint Forum principles 15-20)

Although the level of required capital buffers against sector-specific risks is dealt with within the sector-specific frameworks, the supplementary framework should ensure that the allocation of capital across the legal entities of the group as a whole is such, that at all times the required capital buffer is indeed available when an unexpected loss hits a regulated entity. In addition to the care for the capital of regulated entities, the supplementary framework should ensure sufficient capital buffers against group risks and risks of unregulated entities that are part of the same group.

In Europe, capital management provisions are not yet included in the set of authorization requirements; it is left to the discretion of the groups to ensure they can meet the minimum capital standards at all times in each supervised sector. The crisis revealed however, that asset transferability was thus hampered under stress, that intra-group transfers did not always result in the purported buffers at the right times at the right places. Although the FICOD allows supervisors to monitor intra-group transactions, this constrained asset transferability could not be addressed during the crisis.

Also, liquidity provisions were not yet part of the prudential frameworks. CRD4 introduces liquidity provisions, but no tools are available yet to deal with the liquidity swaps currently observed in the financial conglomerates across Europe. Although the character of liquidity swaps is known, there's no tool yet to prevent that the beneficial intra-group liquidity swaps can transform into contagion channels under stress.

*The question is, whether the European prudential framework should remain confined to enforceable capital- and liquidity-ratio's, and leave discretion to firms to ensure they always meet*

*those minimum ratios, or that additional provisions are necessary, as suggested by the Joint Forum, to ensure that a conglomerate's internal capital and liquidity policy is sufficient to meet the required standards at all times in all of its authorized entities.*

## 5. Risk management (Joint Forum principles 21-29)

The 1999 Joint Forum framework, as well as the 2002 FICOD, included several provisions meant to deal with group risks, especially risk concentration and intra-group contagion. The Joint Forum published many additional analyses and guidelines to illustrate, clarify and strengthen the application of these provisions.

Again, like was the case for liquidity and capital management policies and for governance systems, the discretion left to firms with respect to the way they would ensure group-wide compliance, appeared a handicap for supervisors in correcting excessive risk situations. The Joint Forum suggests introducing more detailed policy-requirements to deal with contagion and risk concentration. The issue is the inclusion of non-regulated entities in the scope of supervision. As was observed in the DNSR report already, this problem is more a question of imposing sound policies onto the unregulated head of a group than a question of lacking tools at the level of authorized bank and insurance entities. *Experts are invited to give their views on the European implementation of more specific regulation of group risks of this kind and introducing relevant requirements at the level of the head of a financial conglomerate.*

**Finally**, in order to finish a full review, which was only partly finalized with FICOD1, the Services intend to review the following essential elements of the Directive and invites experts to provide their views.

The structure of the Directive and its legal relations to the banking and insurance frameworks that it should support may be confusing in the sense that it may not be clear at first sight which legal entity is responsible for which obligations, and which supervisor is in charge of enforcement.
*The question is whether the structure of the Directive, of this set of provisions that must supplement sector-specific provisions, is clear and whether legal certainty is optimal. If not, how could legal clarity and certainty be improved?*

The FICOD defines the groups that are subject to supplementary supervision in article 2(14), which refers to the thresholds in article 3. On top of that, article 5 restricts the application to certain legal entities within the groups found by combining articles 2(14) and 3. The provisions in articles 6-9 then regard the group as a whole. It's not immediately clear which entity is responsible for which provision and which supervisor is in charge of enforcing the obligations onto the group of entities. It's neither clear what should happen to contagion and concentration coming from non-regulated entities in the group. *How could the definition of the relevant "group" and the determination of responsible entities be improved?*

Omnibus 1 added obligations in the area of governance and internal control to article 9. FICOD1 added more internal governance related provisions. These living wills and group structure transparency related provisions could be regarded as governance obligations for groups as also recently considered by the Commission's Reflection Group on the Future of EU Company Law. *The question is whether the framework for prudential supervision of financial groups could benefit from this "legal tandem" with company law, or whether the financial supervision framework should be complete and clear in and of itself.*

**All interested stakeholders are invited to contribute to the fundamental review by sending comments and suggestions regarding the issues above before 19 April 2012 to the EFCC secretariat at MARKT-FCD-CONSULTATION@ec.europa.eu**

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