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COMMISSION STAFF WORKING DOCUMENT
IMPACT ASSESSMENT

Accompanying document to 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

{COM(2010) 433 final}
{SEC(2010) 981 final}

This document commits only the Commission's services involved in its preparation and does not prejudge the final form of any decision to be taken by the Commission

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1. INTRODUCTION

The establishment and development of large, complex groups combining licenses in various sub-sectors of the financial market, and in particular combining insurance business with banking business, was recognized in the early nineties. The Joint Forum[1] - the G10 body of supervisors which monitors and discusses financial market trends affecting banking, insurance and securities markets - observed a need for additional supervision of this kind of groups and published their principles for the supervision of financial conglomerates in 1999. These principles explain that such supplementary supervision should enable supervisors to monitor, ring-fence, limit or otherwise influence activities which may spread risks from one entity of a financial conglomerate to another. The objective of this supplementary supervision was the control of potential risks of double gearing (i.e., multiple use of capital) and "group risks", i.e., the risks of contagion, management complexity, concentration, and conflicts of interest, which arise incrementally when licenses for different financial services are combined under the same roof. The typical supervisory tools for this kind of supervision would be not only monitoring tools such as reporting of intra-group transactions, but also requirements for internal governance and group-wide risk management, and, of course, supervisory cooperation requirements. Last but not least supervisors would need exclusive powers to access information when approaching entities in a conglomerate.

The Financial Conglomerates Directive[2] (FICOD), a short directive of about 20 articles, was adopted in 2002 as a response to the need for supplementary supervision of complex groups laid out in those Joint Forum principles. The objective of supplementary supervision has been supported ever since by stakeholders when consulting on this initiative.

FICOD supplements the two relevant sectoral directives: the Capital Requirements Directive (CRD)[3] and the insurance directives. CRD provides for the prudential supervision of deposit-taking banks and electronic money institutions. The activities of such firms build on the leveraging of available capital,[4] and the directive aims at the protection of depositors through ensuring prudential soundness. The capital requirements relate to bank-specific risks, which are applicable to all regulated banking entities, stand alone and in a group. The insurance directives, aimed at the protection of policyholders, provide for the prudential supervision of firms conducting insurance activities and whose activities build on the investment of paid up premiums in such a way that the cashflows from these investments ensure that insurance claims can be paid out. To this end, insurance companies calculate how much provisions (the so-called technical provisions) they should keep for these claims. The capital requirements for insurance companies are related to insurance-specific risks, more specifically to the uncertainty implicit in the calculation of technical provisions.[5] CRD and the insurance

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1 Joint G10 Committee of Basel Committee of Banking Supervisors, International Association of Insurance Supervisors, and International Organization of Securities Committees

2 Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

3 Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and directive 2006/49/EC on the capital adequacy of investment firms and credit institutions

4 CRD Annex I contains a list of relevant activities.

5 Solvency II Annex I contains a list of non-life insurance activities, Solvency II Annex II contains a list of life-insurance activities.

directives can be applied on a solo level to each licensed entity, and on a consolidated level so that all licensed legal entities subject to the same directive are aggregated.

While banking and insurance directives are thus aimed at calculating sufficient (capital) buffers for the protection of depositors and policyholders, FICOD, on the other hand, is concerned with the supplementary supervision of group risks, which are not bank- or insurance specific, but are rather inherent in controlling a group of many regulated entities that operate in different kinds of financial markets. This implies that entities which have a mutual relationship that affects the risk profiles of each of them must be included in the supervisory scope. For example, if a group were to invest in an airport, the CRD would require the bank in that group to determine a relevant exposure to the airport, if any, and keep sufficient capital for it. FICOD, for its part, would require the conglomerate to assess the potential contagion risks arising from difficulties or extreme stress scenarios experienced by the airport, and have contingency plans, ringfencing alternatives or other governance measures available.[6]

(1) FICOD envisaged a review of its provisions some years after implementation. In addition to this formal requirement, a review of the effectiveness of the directive is also justified by the economic and supervisory environment. Markets have developed in a direction where the distinction between banking business and insurance business is not always clear and where the largest groups are active in many countries. The traditional supervisory perspective of monitoring whether a single authorized legal entity complies with its obligations is no longer adequate for groups that contain more than 1,000 licenses in all sectors and in many countries. Both the revision of the 1988 Basel Accord in 2004, and its European implementation by the CRD in 2006, and the introduction of a comprehensive set of regulations for insurance companies in Solvency II (S2)[7] 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 regulatory framework to address the additional complexity and the additional risks stemming from combinations of licenses, as set out in the FICOD, has not yet been evaluated. This review of the FICOD effectively started in 2008 and formed the basis of the legislative proposal that this impact assessment accompanies. A couple of non-controversial technical issues were included in the Commission's proposal for Omnibus Directive[8] in October 2009, accompanying the Regulations[9] establishing the new European Supervisory Authorities.

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6 A typical example of the complexity caused by non-regulated entities in the financial conglomerate is the Macquarie group in Australia, which started with technology, aeroplanes and an airport. Now the group also has a bank and an insurer. This implies that the management of the group and the supervisor of the financial sector has to be aware of the effects of the safety on the airport (e.g. the possibilities of terrorist attacks) on consumers' behaviour vis-à-vis the bank – what is called reputation risk or franchise risk. Europe has no experience of this kind of conglomerate, but some American groups (GE, GM) do have (small) banking licenses that operate in the EU, which calls for a specific supervisory perspective.

7 Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), but until Solvency II is implemented, the FICOD supplements the directives presently in place

8 COM(2009) 576 final, proposal for a directive of the European Parliament and of the Council amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority

(2) The review process has indicated that "group risks" arise across the whole financial sector, underscoring the importance of the supplementary supervision of links within financial groups and between financial institutions. While the Commission Services, with the help of the supervisors gathered in the Joint Committee on Financial Conglomerates (JCFC),[10] were reviewing the FICOD, similar initiatives were undertaken in the US[11] and Australia[12] based on the original principles published by the Joint Forum.

(3) The review revealed that where the supplementary supervision was applied as intended, objectives of the FICOD were met. However, the review also showed that achievement of these objectives could be obstructed by issues in the areas of supervisory scope, including supervision at the holding company level, and coordination, financial conglomerate identification and supervisory treatment of participations. For instance, during the crisis several supervisors found themselves not being able to simultaneously apply both sectoral consolidated supervision and supplementary supervision (see Section 3.3.1). This specific problem, which relates to the inclusion of "mixed financial holding companies" in the FICOD, the CRD and the Insurance Group Directive (IGD)[13], calls for an immediate solution. Other issues for improvement were found, in the areas of supervisory scope and regulatory capital, which need more time to mature because of international developments, especially in the Basel Committee and the Joint Forum, as well as ongoing debates about CRD and Solvency II.

This report accompanies a legislative proposal to amend the FICOD which is primarily aimed at eliminating unintended consequences and technical omissions in the original directive that were identified during the review and ensuring that FICOD's objectives are achieved more effectively. The proposal is meant as a quick fix for these unintended consequences, which need to be restored urgently. The other issues which were found during the review, e.g., in the areas of supervisory scope, especially with respect to the non-regulated entities in a group, and regulatory capital, need to mature because of international developments, including those in the Basel Committee and the Joint Forum, and ongoing debates about the sectoral directives (CRD III, CRD IV; S2).[14] These issues are being investigated by the Commission services and discussed with stakeholders publicly, among others, in a Conference of 7 June 2010, already.

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9 COM(2009) 501 final, proposal for a regulation of the European Parliament and of the Council establishing a European Banking Authority; COM(2009) 502 final, proposal for a regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority; COM(2009) 503 final, proposal for a regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority

10 Advisory committee for financial conglomerates at Lamfalussy level 3

11 The Obama Administration proposed to Congress that supplementary supervision of large, complex financial groups should be carried out by the Federal Reserve, on top of the existing license-based supervision by the several existing authorizing bodies. The proposal does not distinguish explicitly between pure banking groups, pure insurance groups or conglomerates. It acknowledges that large, complex financial groups can pose additional risks to society.

12 The Australian Prudential Regulation Authority, which has a long experience of integrated and supplementary prudential supervision, is considering how to oversee the contagion arising from non-regulated entities of financial groups. See http://www.apra.gov.au/media-releases/10_06.cfm

13 Directive 98/78/EC on the supplementary supervision of insurance undertakings in an insurance group

14 Regulatory capital is being discussed in the Basel committee, the inclusion of non-regulated entities is being discussed in the Joint Forum.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Consultation process

Consultation with three key groups of stakeholders - member states, supervisors, the industry - has been taking place since the first plans for the FICOD review in early 2008 (see Table 1 for a chronological overview of main events in the consultation process; see Annex III for a more detailed overview of the FICOD review process). The Commission services took stakeholder responses into account in order to determine which issues to address, which policy options to consider and assess for their impact.

The member states' regulators, represented by the European Financial Conglomerates Committee (EFCC)[15], have been involved in the review since April 2008, and have been kept up-to-date about its progress, including via an EFCC newsletter which is available on the Commission's website.

The supervisory community, represented by the JCFC, was informed and involved immediately after the regulators had supported the Call for Advice of April 2008. The JCFC set up a FICOD review working group, consisting of about 20 supervisors from across the EU and meeting approximately once a month. The JCFC has been updating regularly the EFCC about the progress of its work. This impact assessment report and the legislative proposal that it accompanies build to a large extent on the JCFC's preparatory work.

The industry has been involved since May 2008 by means of the EFCC first newsletter and dialogues. It was invited to establish an industry "mirror group" consisting of the major financial conglomerates in the EU.[16] The mirror group of bank-led conglomerates was facilitated by the European Banking Federation (EBF) and the mirror group of insurance-led conglomerates by the Commission Européenne d'Assurance (CEA). Other European associations such as the European Association of Co-operative Banks (EACB), the European Association of Savings Banks (EASB) and the European Association of Public Banks (EAPB) participated in the hearings and consultations. Also, the industry presented its views at the EFCC meetings on several occasions.

In May 2008 a Call for Evidence to the industry was published in the EFCC newsletter. Several individual groups, national associations and European associations responded to this Call. Industry's main messages, as expressed at the Roundtable on 8 September 2008 in Brussels and at the EFCC meeting on 22 January 2009, and confirmed on 8 July 2009 in Frankfurt, were as follows:

– Harmonize the definition of capital across the sectoral directives (CRD and S2);

– Make the FICOD identification criteria more risk-based;

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15 Lamfalussy level 2 committee for financial conglomerates

16 Some or all of the following usually participate: Deutsche Bank, ING, BNP Paribas, (Fortis), AXA, Allianz, British Bankers Association representing, among others, HSBC, HBOS, RBS, Barclays. Given the two different perspectives of the CRD and S2, the banking-led groups and the insurance-led groups tend to have specific positions.

– Address the interaction of the three directives to ensure a predictable level playing field and converged supervisory practices, particularly with regard to the inclusion and treatment of participations;

– Allow for a supervisory review process (i.e., Pillar 2), including assessment of internal group-wide risk strategies, model development, internal control and related policies at the top level; and

– Clarify which accounting rules should be applied to capital aggregation methods.

– Also, the industry expressed its support for the concept of supplementary supervision as defined in the FICOD for the purpose of supervising conglomerates.

– The draft proposal to amend the FICOD reflects the industry's views with respect to the identification criteria and, by allowing for guidelines, with respect to the supervisory treatment of participations and methods of capital aggregation, as well as alignment between the CRD, S2 and the FICOD in order to to allow for a group-wide supervisory review process. Any harmonization of the definition of capital will be proposed only after the conclusion of sectoral debates, especially on the amendments to the Basel II bank capital framework that are currently ongoing at the Basel Committee.

In May 2009, the JCFC published their review findings and policy recommendations for a consultation which ran from 29 May until 28 August 2009. As mentioned above, the draft advice was discussed with the industry in a hearing on 8 July 2009 in Frankfurt. A public consultation on the remaining questions and potential policy alternatives, considered by the Commission services, ran from 6 November 2009 until 15 January 2010.

Both consultations were targeted at both member states and the industry. Responses to the Commission's public consultation from both large and small bank- and insurance-led conglomerates, revealed a broad support for its suggestions in four main areas: restoring supervisory powers at the top level of conglomerates, risk-based identification, inclusion of asset management companies and treatment of participations.[17]

Table 1: Overview of main events and milestones in the consultation process

Time	Event / milestone	Description	Stakeholders involved		
			Regulators (EFCC)	Supervisors (JCFC)	Industry
Apr 2008	Call for advice to JCFC	Launch by EFCC	√	√	
May 2008	Industry mirror group	Set up			√
May 2008	Call for evidence to the industry	Issued	√		√
Sep 2008	Roundtable in Brussels	Discussion of main issues	√	√	√
Dec 2008	Public hearing in London	Discussion of JCFC's initial findings		√	√
Jan 2009	EFCC meeting	Discussion of interim findings of the JCFC and the industry	√	√	√
May 2009	Draft advice of JCFC	Published		√	

[17] http://ec.europa.eu/internal_market/consultations/2009/fcd_review_en.htm

Time	Event / milestone	Description	Stakeholders involved		
			Regulators (EFCC)	Supervisors (JCFC)	Industry
May - Aug 2009	Consultation on draft JCFC advice	Consultation conducted by the JCFC			√
Jul 2009	JCFC meeting in Frankfurt	Discussion of JCFC's draft advice		√	√
Nov 2009 - Jan 2010	Public consultation on policy alternatives	Consultation conducted by the Commission services	√	√	√

2.2. Inter-services steering group

The Commission services' impact assessment steering group, chaired by Directorate-General for Internal Market and Services, was set up to follow progress and provide views from other services of the Commission, including Directorates-General for Competition, Economic and Financial Affairs, Employment, Secretariat General, Legal Services and Health and Consumers. The group met three times in March and July 2009, and in April 2010. Before the launch of the Commission Services consultation in October, the group was consulted in a round of written comments.

2.3. Impact Assessment Board of the Commission

The draft impact assessment was discussed with the Impact Assessment Board (IAB)[18] on 19 May 2010. This revised impact assessment report reflects the comments of the IAB as follows:

– Extent, to which the FICOD achieved its objectives, has been elaborated by further explaining how and in which specific areas the effectiveness of supplementary supervision has been compromised during the financial crisis and by including stylised examples;

– Presentation of economic statistics on conglomerates has been improved by including an overview of their market share (with and without the groups that have been waived by national supervisors from the supplementary supervision) in the total financial sector, comprising both banks and insurers;

– The rationale behind maintaining the materiality thresholds in the conglomerate identification process has been clarified;

– A more detailed overview of the several other policy initiatives related to financial conglomerates, including the Omnibus Directive, the Crisis Management Communication and the upcoming fundamental review of FICOD has been included;

– A list of acronyms and a glossary have been added, use of technical language reduced and a number of other more detailed comments by the IAB have been reflected throughout the report.

[18] The IAB is an independent internal body of the Commission set up to ensure more consistent and higher quality of impact assessments prepared by various Commission departments. The IAB works under the direct authority of the Commission President. Its members are appointed in their personal capacity and on the basis of their expert knowledge.

3. PROBLEM DEFINITION

3.1. Nature and size of the market

The current directive covers 69 European groups (end 2009 figures) and 6 third country groups, which are identified as a financial conglomerate.[19] About 35 of them are small and operate mainly domestically with a relatively small number of licenses.[20] Although the revision is also intended to simplify the supervision on the smallest conglomerates, it specifically deals with the supervision of the 30 or so biggest financial groups in Europe. These are engaged in both the banking and insurance businesses, and the majority also carry on asset management business.[21] A typical large conglomerate has over 400 licenses in several jurisdictions and several sectors (banking, life and/or non-life insurance, asset management). The biggest conglomerates may have over 900 legal entities or licenses. Total assets of the 30 largest financial groups as of end 2009 exceeded €25 trillion,[22] which is equivalent to about 208% of the EU GDP and represents a substantial share of the EU banking market of roughly €42 trillion assets[23] and the EU insurance market of roughly €10 trillion assets.[24] Since the total assets of the remaining 39 groups make up a considerably smaller amount, the total assets of all 69 groups covered by the directive can be assumed to be also equal to €25 trillion while their share in the combined EU banking and insurance market of €52 trillion can be approximated to 48%.

Chart 1 below shows the distribution of these financial conglomerates - both bank- or insurer-led – in terms of size. The Y-axis shows the arithmetic average of two ratios: i) balance sheet total of the smallest sector to the consolidated balance sheet total, and ii) regulatory capital requirements of the same sector to total regulatory capital requirements of the group. It indicates the proportional shares of the respective sectors within a conglomerate can vary substantially. It also shows that insurer-led conglomerates are smaller in general. This is because the economic impact of insurance groups is usually measured in terms of total

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19 A financial conglomerate is broadly defined as a group that has at least one entity in the banking sector and one entity in the insurance sector, and whose activities in the smallest sector (either banking or insurance) according to Article 3 is more than 10% of the group. The 10% threshold is the average of the part of the smallest sector in i) total assets and ii) total solvency requirement. Article 3 also defines a financial conglomerate if the absolute threshold of €6 billion of assets in the smallest sector is met, but allows for a waiver if the aforesaid 10% threshold is not met. These provisions were intended to examine whether the group is sufficiently cross-sectoral to constitute a financial conglomerate.

20 A license is a legal entity that is authorized by a competent (supervisory) authority to conduct a range of business activities in a specifically defined and confined part of the financial sector, for example, a banking license, a life-insurance license. In some countries, licenses can be restricted to a specific set of activities, e.g. a mortgage bank license, or a savings bank license. Each jurisdiction authorizes its own legal entities, but the European passport allows financial institutions to provide financial services throughout the internal market while being authorized in one of its member states. Groups usually make sure they have authorization to conduct all the kinds of businesses in financial services their clients might ask for, in several member states, as well as outside the EU.

21 The net list, the list without waived groups, is published: http://ec.europa.eu/internal_market/financial-conglomerates/docs/200907_conglomerates_en.pdf

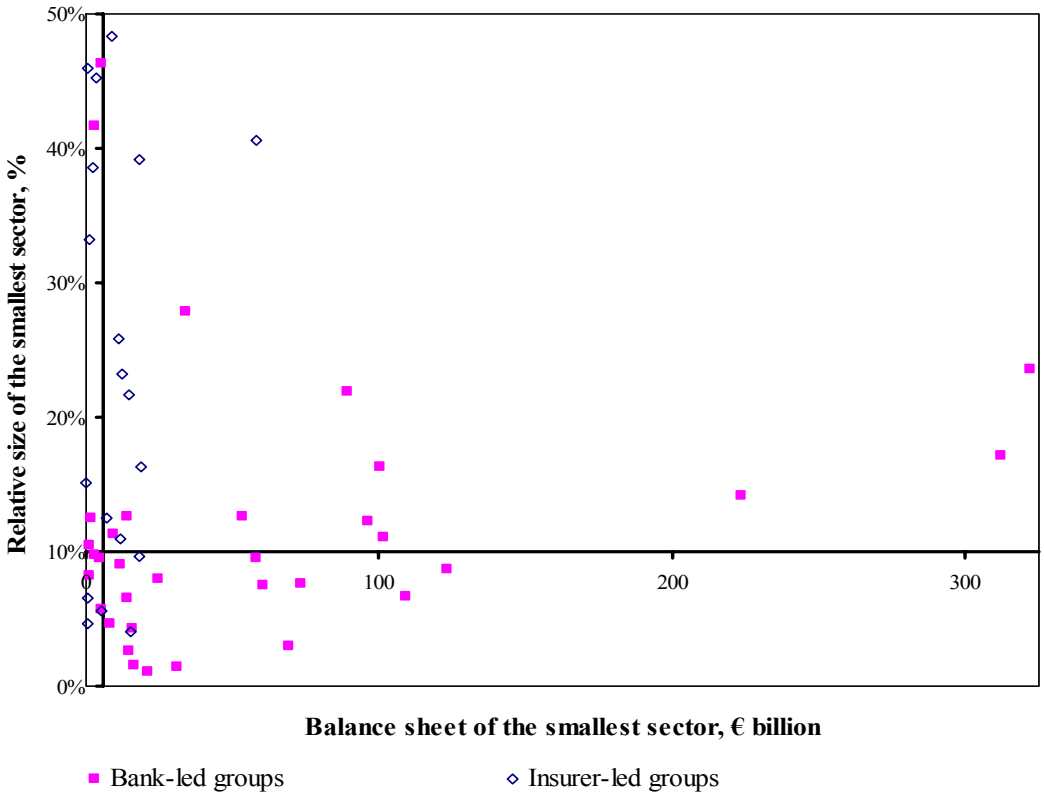
22 Including assets of non-regulated parts/entities of these groups

23 As of end 2008, source: ECB

24 Whereas gross insurance premiums written by these 30 groups constituted almost a half of the EU insurance market of €1 trillion gross premiums in 2008

premiums collected, which is not plotted in this chart.[25] Also, current identification provisions for financial conglomerates do not clearly cover asset management companies. As a result, practices as to the inclusion of asset management companies vary, with the result that the conglomerates plotted in the Chart are not fully comparable (more about this problem in section 3.3.3).

Chart 1: Distribution of EU financial conglomerates in terms of size of the smallest sector within a group as of 2007



Source: JCFC

As to the drivers for establishing a conglomerate business model, academics claim that conglomerates are set up for commercial reasons: new businesses and markets can be accessed by combining banking and insurance and by exploiting existing distribution channels, but that this combination results in extra risks that are discounted by the market. Knot & Van Lelyveld[26] and Schmid & Walter[27] show how large and complex financial institutions (LCFIs) are valued at a discount, in their view, probably for various group risk related reasons. Bigger groups that combine many activities suffer from a perception of higher

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25 Comparing insurance and banking business based on their asset size is not a fair exercise, since importance of insurers is usually gauged by the size of their paid up premiums, while banking business is based on leveraging the capital base. Based on balance sheet figures only, the banking activities would by definition be over-stated compared to insurance activities.

26 Knot K., Van Lelyveld I., *Do financial conglomerates create or destroy value? Evidence for the EU*, Journal of Banking & Finance, 2009

27 Schmid M., Walter I., *Do financial conglomerates create or destroy economic value?*, Journal of Financial Intermediation, 2009

complexity and opaqueness. Völz & Wedow[28], on the other hand, find a premium for potential bail outs (the too big to fail premium) which decreases the discount for groups which are regarded as systemically important. Thus, although the markets know that LCFIs face a risk management challenge, they consider the same groups of such systemic importance that they factor in the 'inevitability' of government rescue.[29] Both views, however, would confirm that LCFIs contain additional risks (complexity and systemic) on top of the specific sector-related risks, and that supplementary supervision is justified.

3.2. EU legislative and international frameworks

As said in the introduction, FICOD supplements the two sectoral directives, the CRD and insurance directives. A consolidated picture of entities authorized under one directive is usually referred to as a sector-silo, or a 'silo'. Supplementary supervision comes on top of the silo-supervision.

In 2008, the Joint Forum evaluated its principles of 1999 identifying the following concerns:

– Regulatory arbitrage possibilities due to misalignment of sectoral capital definitions;

– Pillar 2 supervision (part of the Basel II framework) is equally justified for non-banking entities in conglomerates, both regulated and non-regulated;

– Funding liquidity under stress circumstances, and

– Lack of legal certainty when capital needs to be transferred between entities located in different jurisdictions (i.e., asset transferability problem).

The first problem must be dealt with by aligning capital eligibility provisions in the CRD and S2, however, sectoral debates would have to be completed first. Regulatory arbitrage is also possible when a group structures itself as a holding company, acquires significant activities in another sector, and thus escapes consolidated sectoral supervision at the ultimate parent level (see Section 3.3.1). The second concern was part of this review but relates to a more fundamental question of regulatory scope, and will be addressed in the fundamental review following this initiative (FICOD II). The third concern is assessed by the EU stress testing exercise and a possible proposal of the Commission to introduce a new global standard for bank liquidity risk, whereas the fourth one is dealt with in the Commission's Communication[30] published in October 2009 and its follow up in 2010 and 2011 . Although this initiative focuses on banks, the character of the crisis-related problems, as well as their solutions, are not bank-specific, which implies that solutions presented by the Commission

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28 Völz M., Wedow M., *Does banks size distort market prices?: evidence for too-big-to-fail in the CDS market*, Discussion Paper Series 2: Banking and Financial Studies, Deutsche Bundesbank, 2009

29 The crisis prompted a discussion on systemically important financial institutions (SIFIs), for which supplementary supervision as well as additional capital requirements would be justified. The groups which are mentioned in this debate regard part of theidentified conglomerates in the EU. Of the 13 European bank-led SIFIs mentioned by the Financial Times, 12 are conglomerates under this directive (Standard Chartered is not), while of the 6 insurer-led SIFIs, 5 are conglomerates (Aviva is not). Some important conglomerates were not in the FT's list, such as Generali and Credit Agricole.

30 COM(2009) 561 final, an EU Framework for Cross-Border Crisis Management in the Banking Sector, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the European Court of Justice and the European Central Bank

may become applicable to conglomerates as well. The Joint Forum's evaluation thus revealed four fundamental issues which cannot be solved in a straightforward technical revision. Therefore, this revision of the FICOD will have to be followed up by a more fundamental debate on scope and capital quality, and how the FICOD interacts with the two silo-directives.

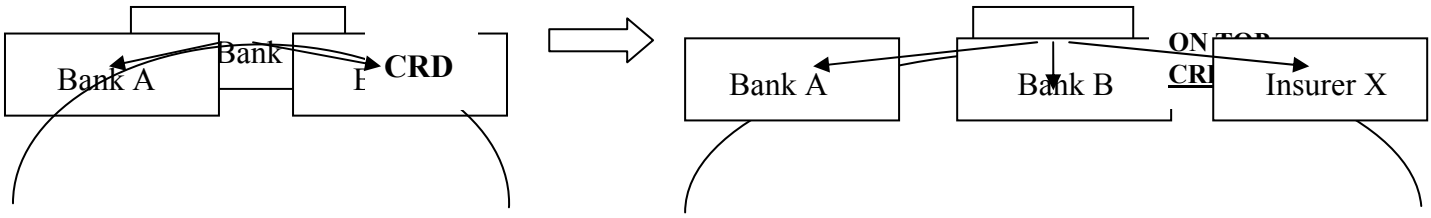
3.3. Problems

The FICOD review showed that the achievement of its objectives is mostly obstructed by issues in the areas of supervisory scope, including supervision at the holding company level, and coordination, financial conglomerate identification and supervisory treatment of participations. The remainder of section 3.3 elaborates on these issues in more detail[31]. At the end of the section, a "problem tree" is presented to visually illustrate linkages between problem causes and drivers, and the actual problems that they result in for various stakeholder groups.

3.3.1. Supervision at the holding company level

Supervision at the level of the holding company is affected by the combination of the current provisions of the FICOD, the CRD and the IGD, referring 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 ultimate parent level, change when the ultimate parent level becomes an MFHC and can no longer be an FHC or an IHC. Figures 1 and 2 below demonstrate that the identification of a financial conglomerate can impact the application of sectoral group supervision differently, depending on the structure of a group.

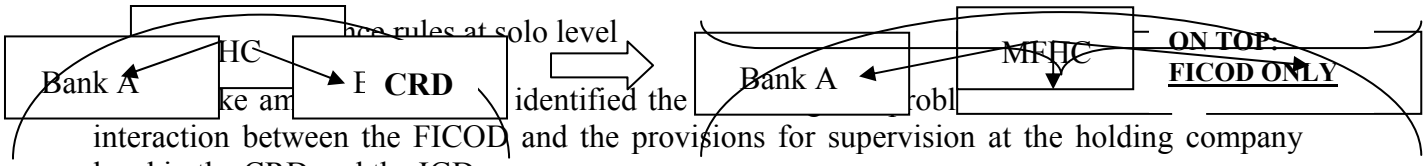
Figure 1[32]**:** FICOD supplements and partly replaces sectoral supervision if a sectoral banking or insurance group becomes a conglomerate. Before the acquisition, a bank or an insurer is subject to consolidated supervision requirements, as laid out in either the CRD or the IGD. After the acquisition, consolidated supervision can only be applied to a top level banking or insurance entity, if there is such an entity on top of all banking and insurance licenses. FICOD supplements that consolidated supervision.



[31] Annex 2 of the JCFC's Capital Advice contains a detailed explanation of the existing legal provisions and their consequences

[32] The same is true for insurance groups, with reference to the application of the CRD replaced by the IGD

Figure 2: FICOD replaces sectoral supervision at the ultimate parent level. If an MFHC replaces an FHC and/or an IHC and if the ultimate parent is not a banking or insurance entity (i.e., all licenses are owned directly by an MFHC), consolidated or group supervision provisions can no longer be applied. Solo and sub-consolidated supervision remains for the licenses.

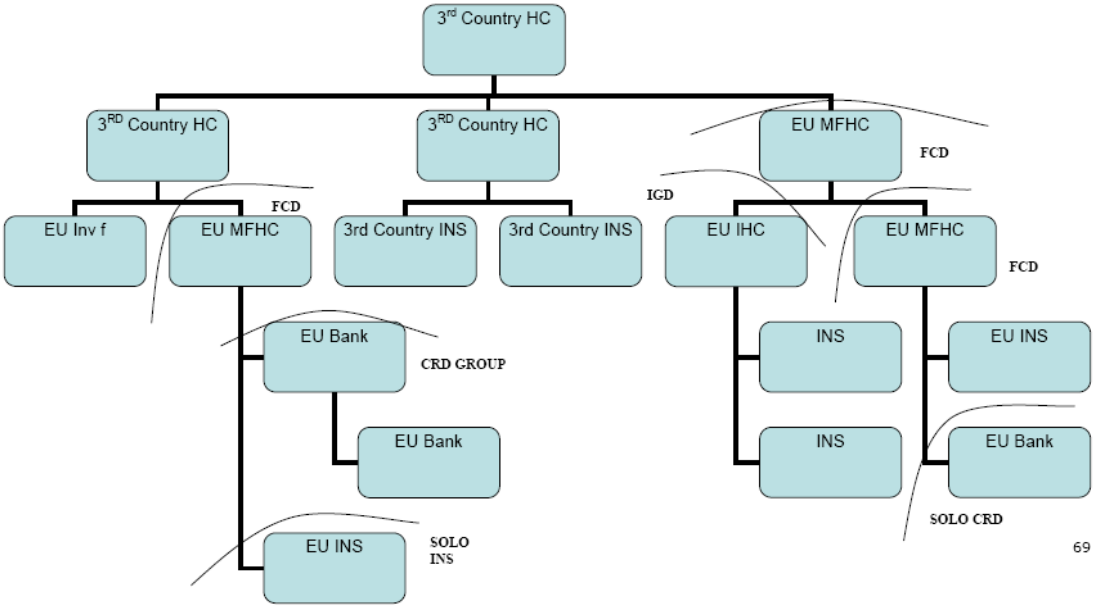


ke an identified the roblem in the interaction between the FICOD and the provisions for supervision at the holding company level in the CRD and the IGD:

– Certain tools of sectoral group supervision that can be applied at the level of an FHC or an IHC can not be applied to the whole group when it is determined an MFHC (see Figure 2). This regards, among other things, the waiving of solo-supervision on subsidiaries, the application of provisions on disclosure (Pillar 3) and the internal capital adequacy assessment process and supervisory review (Pillar 2) on a consolidated basis. In other words, the application of sectoral or supplementary group supervision is determined by group structure; acquiring a license in the other sector and becoming an MFHC, can result in a group which has increased in size and complexity, and therefore representing a higher risk to the financial system, being subject to regulations (solo and FICOD) which may not be as comprehensive as before the acquisition.

In practice, structure-related problems as described with Figure 2 can also appear at sub-consolidated conglomerate levels, leading to additional complications for effective supplementary supervision. The AIG case was a typical example of consolidated sectoral supervision disappearing because of holding structures as illustrated by Figure 3:

Figure 3: Impact on consolidated sectoral supervision in case of groups with complex structures:



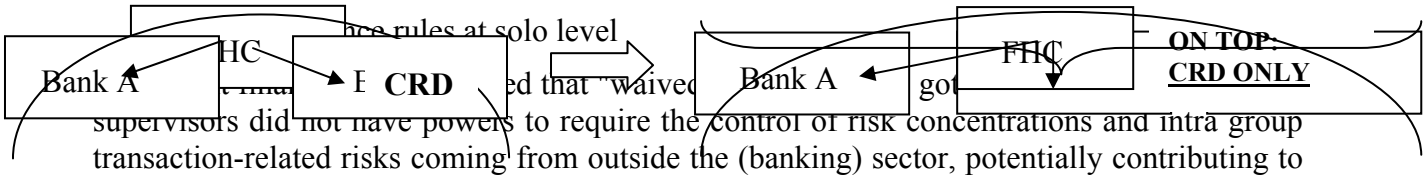
Source: JCFC

The JCFC expects that almost all of the approximately 30 largest international financial conglomerates have an MFHC at the ultimate parent level, but this information is not confirmed.

– As a consequence, the use of a waiver[33] by supervisors 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 prudent (see Figure 4). This happened to at least 8 large banking groups in Europe whose combined assets constituted some €9 trillion in 2009, effectively reducing the relative size of EU banking and insurance market covered by the scope of the FICOD by a third, i.e., from 48% as indicated in section 3.1 to 31%. Application of the waiver may result in: i) additional prudential risks due to the increase of the group in size and complexity, which would otherwise have been addressed by the supplementary aspects of the FICOD, that translated into risks to the financial stability and impairment of the intra-EU and international competitiveness position of groups that have suffered financial losses as intra-group contagion risk materialised; and ii) differences in supervisory treatment (based on the structure rather than on the risk profile) of conglomerates and thus an unlevel playing field among the largest players in the European financial sector.

[33] Article 3(3) allows supervisors to apply this waiver for financial conglomerates where the balance sheet size of the smallest financial sector is in excess of €6 billion, but the smallest sector constitutes less than 10% of the group in terms of its balance sheet and solvency requirement

Figure 4: FICOD replaces sectoral supervision at the ultimate parent level, which is why a supervisor chooses to waive supplementary supervision, if the thresholds allow so. If an MFHC replaces an FHC and/or an IHC and if ultimate parent is not a banking or insurance entity (i.e., all licenses are owned directly by the holding company), supplementary supervision may be waived and only consolidated or group supervision remains. Contagion and other cross-sectoral group risks cannot be controlled.



supervisors did not have powers to require the control of risk concentrations and intra group transaction-related risks coming from outside the (banking) sector, potentially contributing to the financial instability (see a stylised example in Box 1).

Box 1: Example of the application of waiver under Article 3(3)

Suppose a large bank, having more than 500 bank licenses in several countries as well as in the USA, and a few insurance licenses, has a financial holding company as its ultimate parent. The Board of executives in this holding company takes group wide decisions such as strategic decisions on the business model and markets it wishes to operate in, the gathering of capital, the allocation of capital to various businesses, the risk appetite and return targets, the internal governance and risk management functions, etcetera. The group is supervised as a banking group on a consolidated basis subject to the CRD. Then the Board decides to strategically expand its business model to a specialized insurance business, for which its banking experience is a competitive advantage, especially in the American market. It acquires this specialized insurance business and thus expands the number of licenses in the group to about 800, and the share of insurance business in its total business to 9% . The holding company becomes by definition a mixed financial holding company (MFHC).

Now the supervisor has to choose to either apply consolidated banking supervision at the ultimate parent level, opting for a waiver in the conglomerates directive, or to apply supplementary supervision but not the consolidated banking supervision to the MFHC. Finding themselves between Scylla and Charybdis, they chose the first. This ensures that they keep the full picture of the banking entities at the level where strategic decisions are taken, but it implies that they forego the tool to monitor or control the impact of the specialized insurance business on the bank, and its contagion coming from the US. Now the business in the US turns out to be not only disappointing, but also contagious to the banking business. The supervisor is left barehanded. Had the consolidated banking supervision been possible at the level of the MFHC, they would have had a tool to monitor and control the contagion coming from this insurance business to the banking activities, supplementary to the consolidated picture of banking business.

– The discretion to exempt a subgroup that is a financial conglomerate within a larger financial conglomerate from supplementary supervision under the FICOD[34] presents a challenge in avoiding duplication and unnecessary costs arising from applying sectoral group requirements at multiple entities of a group.

For instance, insurance rules permit supervisors to waive insurance sub-groups of an insurance group from sectoral group supervision, and supervisors have applied this waiver in

[34] Article 5

order to avoid regulatory duplication that would arise if the same insurance directive were to be applied at multiple levels of the same group. However, while supervisors are able to apply this waiver to sub-groups of an insurance group with a regulated entity on top or an IHC, they are no longer able to apply the waiver if the group had an MFHC as the parent. If an insurance group has ten such sub-groups before becoming a conglomerate, it could go from being subject to one IGD consolidation requirement to ten such requirements under the IGD upon becoming an MFHC.

This would subject the group to a significantly greater supervisory burden that would generate few additional benefits, which is an unintended effect of the interaction between the FICOD and sectoral group directives. This is further complicated when the sectoral sub-groups are located in different jurisdictions, for example, if a pan-European group were identified as a financial conglomerate and had sectoral sub groups located in different European jurisdictions.

JCFC's confidential stocktake in 2006 revealed that identification practices varied enormously among supervisors. The exercise also showed that supervisors usually tried to apply consistent group supervision within a sector within a jurisdiction (for example to all French bank-led groups). Most importantly, the stocktake revealed that all supervisors sought the most prudent outcome when applying group supervision and/or supplementary supervision. Although the objective was the same for all banking or insurance or integrated national supervisors, the identification choices were made to avoid unintended consequences of combinations of directives and keep as much prudence as possible.

The application of group supervision and supplementary supervision at the right level from a prudential point of view, i.e., the ultimate parent level of a financial group, is what is requested now by the JCFC in its advice. During the consultation, this was echoed by the industry who acknowledged the unlevel playing field problem and called for a more predictable application of supervision at the holding company level.

3.3.2. Supervisory coordination

FICOD supplements the CRD and insurance directives for additional supervision at the ultimate parent level of a group. To that end, it also contains provisions for coordination between different supervisors of a group, a necessity that was already recognized in the IGD which dealt with group risks in insurance groups.

FICOD defines who is a relevant competent authority (RCA), providing for obligatory consultation by the coordinator (the ultimate parent level supervisor) with respect to several supervisory questions. Other competent authorities who granted licenses to parts of the conglomerate are in those cases not consulted.[35] The directive describes which elements should be covered by the coordination. The coordination is carried out mainly by means of information exchange and consultation within the "college" of a coordinator and RCAs. FICOD coordination provisions regarding supervisory arrangements are thus clear that they were copied into S2 and the CRD, albeit extended with other elements of coordinated supervision. The coordination provisions are found to be supportive of the FICOD's

[35] The coordinator and the RCAs are published in the list of identified conglomerates on the Commission's website: http://ec.europa.eu/internal_market/financial-conglomerates/docs/200809_conglomerates_en.pdf

objectives, although the JCFC's stocktake showed that coordination practices may vary with respect to determination of RCAs. The current provisions leave room for various RCA interpretations, for instance, both the combination of a subsidiary with a foreign branch and all subsidiaries within a country could be considered as a group. Any supervisor of more than one authorized entity in his jurisdiction could knock on the coordinator's door and ask to be granted an RCA status despite the additional indicators (market size and importance in the group) in the same provision. As a result, the number of RCAs who should be consulted by the coordinator at the financial conglomerate level could become rather high, which is not conducive for an effective and efficient coordination of the work to be carried out by a group of RCAs. Considering that the FICOD is a supplementary directive to the CRD and the insurance directives, also the college for the assessment of group risks and multiple gearing of capital throughout the group should be supplementary to the sectoral colleges, and, thus, proportionally composed, i.e., not duplicating their work but effectively adding value.

3.3.3. Identification

Another problem area regards the application of the conglomerate identification provisions in combination with the directive's definition of "a financial sector".[36] The analysis of the findings of the MTG and the stocktake of the JCFC showed that provisions on thresholds and the scope for differences in their application present three sub-problems:

– 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, however, it requires including AMCs in the scope of supplementary supervision. They were added to the scope at the very end of the negotiation process, without sufficient clarity as to how and when they should be included in either the identification or the supervision, or both.

AMCs can facilitate the asset management of a banking or an insurance silo, or both, which may increase potential group risks, but the directive is silent on whether that should make the group a conglomerate. If an AMC is part of a banking or an insurance silo, it is consolidated automatically, but if it is structured outside the silo, it can be excluded. Some supervisors include them, others do not. AMCs can also be part of MiFID[37] investment firms or AIFM[38] firms, which may not be subject to the CRD. In general, the different scopes of the CRD, insurance directives, the MiFID and the proposal for a directive on AIFM[39] leave regulatory arbitrage opportunities to keep entities out of the scope of supplementary supervision under the FICOD and give rise to unlevel playing field among AMCs. More specifically, if groups structure their AMCs directly under the ultimate parent holding company, they can escape supplementary supervision of the combination of asset management business on the one hand and banking or insurance business on the other, or escape being identified as a conglomerate altogether (see Box 2 for a stylised example).

Box 2: Example of regulatory arbitrage in identifying conglomerates with an AMC

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36 The definition of 'financial sector' in Article 2.8 (a) and (c) FICOD states that all financial institutions fall within the bank / investment firm sector and not within the insurance sector. Article 2.8 (b) refers to insurance companies as a separate sector.

37 Markets in Financial Instruments Directive

38 Alternative Investment Fund Managers

39 COM(2009) 207 final, proposal for a directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/…/EC

A large European insurance-led group is providing pension funds products, by using an investment subsidiary which invests the pension fund assets of policyholders. The legal entity of the investment subsidiary is owned directly by the ultimate parent holding company. The funds under management are formally structured as off balance sheet assets, but the supervisor regards them as bank business assets and wishes to identify the group as a conglomerate. The supervisor cannot regard the group as a conglomerate, because it cannot include the asset management entities in the insurance subgroup. The pension fund business is left outside the supervisory scope and potential contagion, concentration or conflicts of interest between the insurance business and the investment services business cannot be monitored or controlled by the supervisor.

– The threshold tests can be based on different parameters with respect to assets and capital requirements and the current directive is ambiguous as to how to calculate the tests arising from, for example, different accounting treatments of assets.

Also, some financial institutions, e.g., brokers that are not part of a banking group which is supervised on a consolidated basis, do not always have a solvency requirement. As a result, the significance of activities within the banking / investment firm sector versus those within the insurance sector have to be determined based on numbers that are not necessarily available or "fair".

Third, insurer-led conglomerates are identified with the same indicators, assets and capital, but the economic impact is usually measured against gross premiums, which is not yet included as an indicator in the identification process.

– The threshold conditions, given their fixed amounts, are not risk-based. 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. For instance, the upper-left box in Chart 1 contains ten small groups, all of them smaller than €11 billion in combined banking and insurance assets, yet included in the current scope of the directive. The lower-right box contains seventeen groups which could be waived, because their smallest sector is smaller than 10% of total assets, even though that smallest sector can be as big as €123 billion. While some big bank-led groups are subject to supplementary supervision, others are waived (see section 3.3.1); of the insurer-led groups only one smaller one is waived. The lack of risk sensitivity of the conglomerate identification process with respect to the latter sub-sample of financial conglomerates, therefore, may have significant implications both for the protection of creditor / policyholder interests and the financial stability.

In conclusion, by identifying conglomerates that are not really considered as such, and are therefore subject to additional supplementary supervision that may not be proportionate to the risks presented by a group, while not identifying others that might be considered as such when assessing potential group risks, the current provisions on identification can have a negative impact on the effective achievement of the underlying objectives of the directive.

3.3.4. Participations – identification and supervision

The term "participation" is defined differently in the CRD, in the insurance directives and the FICOD[40]. They all refer to Article 17 (defining "participating interest") of the Fourth Council Directive[41], which combines two elements in its definition of participation: i) ownership/control, and ii) durable link. The specific definitions in the respective directives are fine-tuned to their respective objectives. For the CRD and insurance directives this is the adequacy of capital in view of the risks taken by the banking and insurance entities, respectively. The definition in these directives needs to make clear at what entity-level capital must be held for the risks in the entities below a parent entity, including for partially owned/controlled entities or entities on which significant influence is exercised.

As said in the introduction, FICOD is about the supplementary supervision on group risks, which requires a broader scope of potential sources of group risks and thus a wider definition of participations.

Therefore, the definitions in the three directives are justified by their specific objectives. The control-element (i) is more important for the sectoral supervision; the durable link concept (ii) is more important for the supplementary supervision. However, the interpretation of a durable link appears to vary quite a bit throughout the EU, which implies that supervisors include or exclude seemingly similar participations in/from the scope of supplementary supervision. The industry complains about the lack of clarity with respect to which entities they might expect to be included in the supervisory scope. They add the inconsistency with international accounting standards as a complicating factor.[42]

From the supervisory perspective, consistent treatment of participations on the day-to-day basis is hampered by the lack of guidance on how to effectively account for their heterogeneity which in turn is driven by various factors such as relative versus absolute ownership figures or longer-term business contracts not accompanied by material ownership. The above lack of clarity has indirect negative effects for the industry as well.

The uncertainty about the supervisory treatment is related to the lack of available relevant information to assess group risks, which is not so straightforward when participations are held in listed firms. National company law may prohibit one minority shareholder from receiving more information about that firm than its other shareholders. If information, for instance, about risks with respect to participations in insurance and reinsurance companies cannot be obtained by bank-led conglomerates, they cannot provide their supervisors with evidence on the satisfactory level of integration of management and internal control with these entities and, subsequently, consolidate them, which gives rise to deduction of such participations from their own funds. After all, consolidation assumes the control of the risks, which is not assured if the parent cannot access the relevant risk management information. Article 59 of the CRD

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40 Article 2(11) of the FICOD defines participations based on the first sentence of Article 17 of Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies (which, in turn, specifies that participating interest shall mean rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company's activities), or the direct or indirect ownership of 20% or more of the voting rights or capital of an undertaking

41 Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies

42 See Annex III of the JCFC's Advice to the European Commission on the review of the FICOD

and Article 228 of S2 allow for consolidation as meant in the FICOD "if the competent authority is confident about the level of integrated management and control".[43] If information cannot sufficiently be obtained, for whatever reason, there is no way the parent can control the risks of the participation, and consequently, the parent bank or the parent insurer will have to deduct the participation from own funds. Based on the JCFC data, at the end of 2007 EU groups had participations in the financial sector entities of €415 billion, of which participations held by bank-led conglomerates constituted €398 billion with the remainder held by insurer-led conglomerates.

3.3.5. Problem tree

The below problem tree illustrates the linkages between problem causes and drivers, and the actual problems described in sections 3.3.1 - 3.3.4. Problem drivers represented by boxes that are not shaded have already been, partially or fully, addressed by legislative initiatives that are very closely linked to the current proposal to amend the FICOD (please see section 4.1).

3.3.6. Subsidiarity and proportionality of EU action

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

The principle of subsidiarity for action at the EU level is substantiated further by a need to amend an existing EU-level legislative tool in order to remove potential regulatory arbitrage opportunities which are made possible by it and to enhance level playing field for European financial conglomerates by ensuring a consistent EU approach for tackling various issues covered by the scope of this legislative initiative.

The supplementary supervision provided by the FICOD is only justified when institutions are potentially exposed to group risks, and / or when management complexity could cover up the potential double use of capital. The sectoral directives, the CRD and insurance directives, deal with the required assessment and management of sector-specific risks and the appropriate capital adequacy thereof. The proportionality of the FICOD is rooted in its supplementary nature: it supplements the sectoral directives and is not meant to replace them. This legislative initiative is aimed at enhancing the effectiveness of supplementary supervision at the ultimate

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[43] Article 59 of the CRD entails discretion for supervisors to allow their credit institutions, as an alternative to deduction of participations from own funds, to apply mutatis mutandis methods 1, 2 or 3 of Annex I to the FICOD for participations envisaged in Article 57(o) & (p). Method 1 (accounting consolidation), however, may be applied only when supervisors are confident about the level of integrated management and internal control regarding the entities which would be included in the scope of the consolidation.

parent level of conglomerates where decisions about attraction and allocation of capital across businesses, and group-wide risk management are taken.

4. OBJECTIVES

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, represented by the FICOD, is enhanced while maintaining the competitive position of these groups. This translates into the following three general policy objectives to:

– *Enhance financial stability (G-1)*;

– *Enhance safeguarding of creditor and policyholder interests (G-2)*;

– *Enhance international competitiveness of EU financial groups (G-3).*

In light of the problems presented in section 3.3, three sets of operational objectives (see Table 2) have been identified to address the specific problem drivers. Effective realization of such operational objectives should contribute to the achievement of the following longer-term specific policy objectives to:

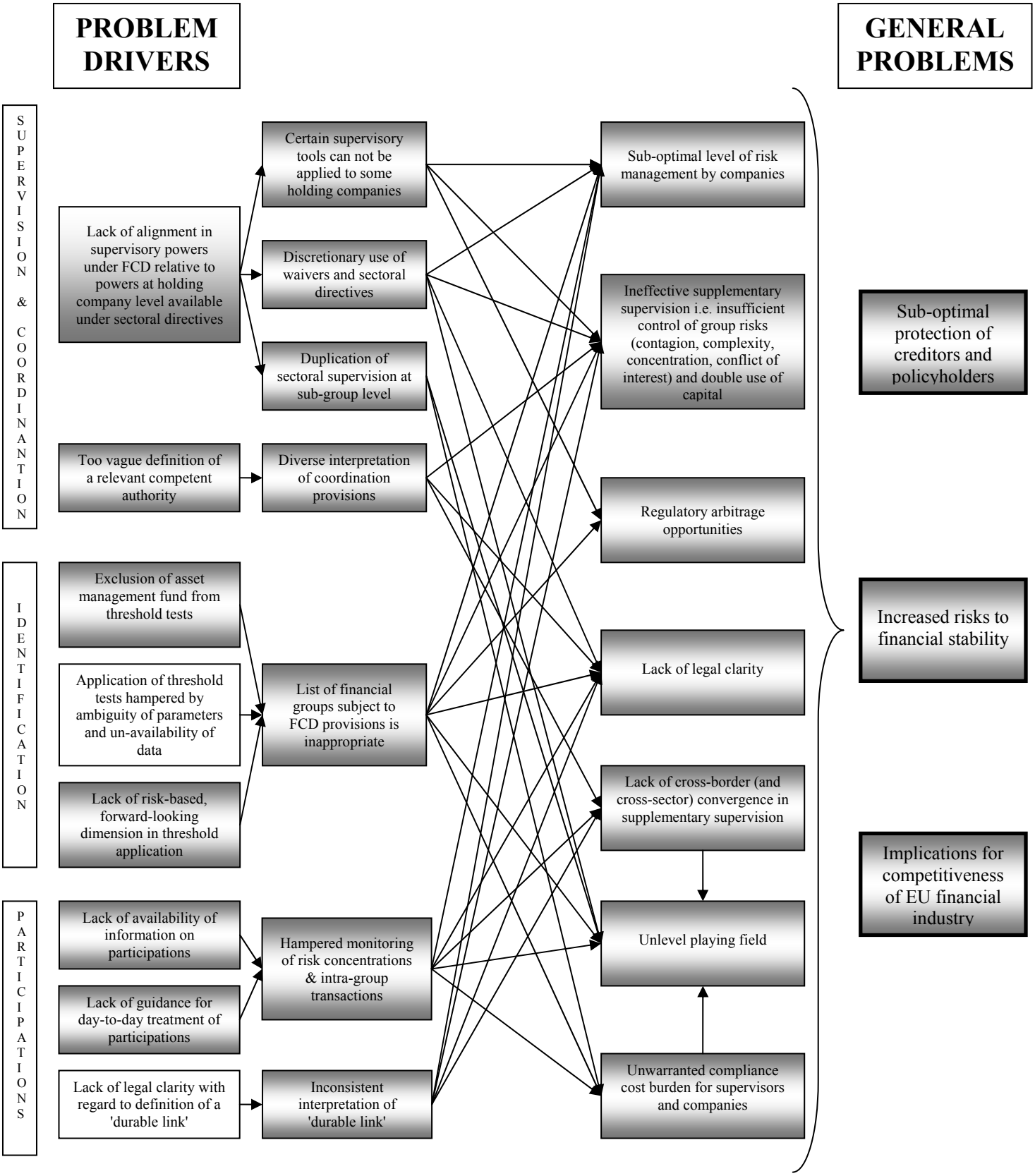
– *Enhance effectiveness of supplementary supervision (S-1)*. This means that managers responsible for the risk management, internal governance and capital allocation for the whole group should be held accountable by their supervisors for compliance with sectoral and supplementary supervisory provisions, regardless of whether the top level is a regulated entity or an MFHC. Also, the identification criteria should allow for a supervisory assessment of the nature, scale and complexity of the groups and assure supervisors that the supplementary supervision will not weaken the relevant sectoral supervisory frameworks. Supervisors must be able to assess consequences of the ties between different parts of a group and participations in other firms.

– *Reinforce financial conglomerates' risk management (S-2).* Internal governance and risk management of financial conglomerates should be enhanced due to a more effective and risk-based supplementary supervision.

– *Eliminate regulatory arbitrage opportunities (S-3)*. Possibilities to circumvent the current FICOD or sectoral provisions, in particular, by creating group structures that limit the application of sectoral or supplementary rules, shall be eliminated.

– *Reduce compliance burden (S-4)*. Unnecessary compliance costs for the industry should be cut, among others, by removing small and simple financial groups from the scope of the legislation.

PROBLEM TREE: FICOD REVISION



– *Enhance level playing field (S-5)*. Level playing field conditions for cross-border groups shall be strengthened by limiting the scope for application of national discretions, such as use of waivers in the financial conglomerate identification process.

– *Enhance supervisory cooperation and convergence (S-6)*. Cross border cooperation and convergence of the supplementary supervision is important since the FICOD is mainly about LCFIs. A lack of convergence of the interpretations by various supervisors of the directive's provisions hampers the achievement of its objectives.

– *Enhance legal clarity (S-7).* More legal clarity is warranted from the industry's perspective with respect to outcomes of the financial conglomerate identification process, particularly on issues such as treatment of asset management companies and participations, and application of waivers. From the supervisory perspective, more legal clarity is necessary on identification of relevant competent authorities.

Achievement of the specific policy objectives, in turn, should facilitate the attainment of the three aforementioned general policy objectives. Table 2 provides an overview of the identified problems, drivers underlying them as well as operational, specific and general objectives, by indicating linkages between them.

4.1. Coherence of objectives with other initiatives of the Commission

Several problem drivers and problems that they cause that were described in section 3.3 have been already addressed with the proposal for the Omnibus Directive that was adopted by the Commission in October 2009. This does not change the legal text of the FICOD as the proposed Omnibus Directive aims at the convergence of supervisory practices. The proposed Omnibus Directive dealt substantively with the issues of (i) application of the durable link concept and the treatment of participations in the calculation of capital (see section 3.3.4) and (ii) alternative indicators in the conglomerate identification process, when data necessary for threshold calculation are not available (see section 3.3.3).

The main impact of these technical standards, as explained in the proposal for the Omnibus Directive, will be further convergence of supervisory practices, thus improving the level playing field, increasing predictability of practices and decreasing compliance costs. Therefore, policy objectives of these legislative initiatives, i.e., proposals for Omnibus Directive and revision of the FICOD, are closely aligned.

Like all initiatives in the supervision package, the revision of the FICOD also contributes to the Commission's aim for more convergence and coherence in the supervisory approaches across countries given that cross border financial conglomerates are exactly the case in point for stronger co-ordination and supervision. These amendments constitute an important element in the total package.

While the problem definition and objective sections of this impact assessment have captured the above areas in order to provide a more complete background for the policy proposals included in the legislative proposal to amend the FICOD, further sections of the report tackle only outstanding issues.

For a broader overview of the Commission's initiatives linked to financial conglomerate supervision please see Box 3.

Box 3: Overview of the Commission's initiatives related to financial conglomerate supervision

- **Omnibus** directives I and II contain examples of provisions for which the new European Supervisory Authorities should get a role in promoting supervisory convergence (such as the list of items which should be monitored when supervising intra-group transactions i.e. potential contagion channels), as well as alignment of provisions that appear in all financial directives and for which the new Authorities should get a role (such as the harmonization of authorization and notification procedures, but also a consistent use of the durable link concept). Omnibus dealt with the existing provisions that needed harmonisation or convergence.

FICOD I aims at addressing urgent issues that are outlined in this impact assessment, such as the MFHC problem or the flaws within identification process, in order to include or exclude those groups in the scope which should have been included in or excluded from the scope as from 2002. In addition, provisions to promote supervisory convergence, in the areas related to the amendments, are included in FICOD I.

FICOD II must address fundamental problems that not only relate to lessons from the crisis, but also to the sectoral directives. These relate to the inclusion of non-regulated entities in the scope of supplementary supervision, a fundamental review of the definition of financial conglomerate in the light of blurring sector-boundaries, and the alignment of eligibility requirements of regulatory capital across directives. However, this has to account for international progress on these issues and conclusions of sectoral initiatives. MARKT will kick off this debate with a conference on 7 June, then discuss a Call for Advice to the Joint Committee of Financial Conglomerates with the member states at level 2 in October 2010, follow the development of the Advice with the JCFC, and prepare for a proposal in the course of 2011.

Communication on EU Framework for Cross-Border Crisis Management in the Banking Sector is about banks, because of the urgency of the resolution problem for banks. However, both the character of the problems and the solutions thereto, are not bank specific. Solving problems like supervisory cooperation and asset transferability for banks implies solving it for all kinds of groups in the financial market.

Table 2: Summary of problem drivers and objectives

Problem Area	Problem Drivers	Operational Objectives	Specific Objectives							General Objectives		
			S-1	S-2	S-3	S-4	S-5	S-6	S-7	G-1	G-2	G-3
			Enhance effectiveness of supplementary supervision	Reinforce financial conglomerates' risk management	Eliminate regulatory arbitrage opportunities	Reduce compliance burden	Enhance level playing field	Enhance supervisory cooperation and convergence	Enhance legal clarity	Enhance financial stability	Enhance safeguarding of creditor and policyholder interests	Enhance int'l competitiveness of EU financial groups
Supervision on holding company level and supervisory cooperation	Loss of certain supervisory powers at holding company level available under sectoral directives if MFHC replaces FHC or IHC	Align supervisory powers under the FICOD with powers at holding company level under sectoral directives, regardless of group structure	√	√	√		√		√	√	√	√
	Loss of certain waivers at sectoral level when MFHC replaces FHC or IHC	Prevent duplication of supervision at consolidated (sub) levels				√	√					
	Definition of 'relevant competent authority' too vague	Enhance legal clarity with regard to the determination of 'relevant competent authority'	√					√	√			
Financial conglomerate identification	Exclusion of asset management companies from threshold tests	Account for the role of asset management companies, when identifying financial conglomerates	√	√	√		√		√	√	√	√
	Application of quantitative threshold tests hampered by ambiguity of certain parameters and data unavailability	Enhance identification process by allowing for more leeway to qualitatively assess potential group-wide risks, that quantitative tests alone do not capture	√	√		√	√		√			
	Lack of risk-based, forward-looking dimension in threshold application											
• Treatment of participations	Lack of legal clarity with regard to definition of a 'durable link'	• Provide a more clear definition of 'durable link' or improve clarity on the application of the durable link criterion	√	√				√	√	√	√	√
	Lack of availability of information on participations	• Devise appropriate prudential treatment for situations where necessary information on participations is not available	√	√		√		√				

5. POLICY OPTIONS, IMPACT ANALYSIS AND COMPARISON

This section presents the policy options and their impacts on stakeholders for each of the major problem areas. As pointed out above, the analysis covers possible policy options with respect to those problems that are still outstanding following the adoption by the Commission of a proposal for the Omnibus Directive. The identification, analysis and comparison of policy options have been combined for each area to allow for a more coherent presentation. Cumulative impacts of all preferred options are discussed at the end of the section.

5.1. Supplementary supervision on holding company level and supervisory coordination

5.1.1. Alignment of supervisory powers

In order to align supervisory powers at the ultimate parent 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, four options have been considered:

- **Policy option 1.1:** Retain current approach;
- **Policy option 1.2:** Allow an MFHC to be at the same time an FHC or an IHC;
- **Policy option 1.3:** Add to the MFHC level supervisory powers that are lost at the sectoral level;
- **Policy option 1.4:** Allow supervisors at the MFHC level to exercise discretionary powers that are lost at the top sectoral level.

Policy option 1.1: Retain current approach

The current provisions in the FICOD, applying supplementary supervision at the MFHC[44] level, exclude the form of an MFHC as the top level of a banking group[45] or an insurance group[46]. This exclusion was explicitly preferred when the directive was negotiated in 2002, in order to prevent an increase in supervision of (non-regulated) top level holding companies.

An unforeseen and unintended consequence of the FICOD appeared to be the loss of supervisory reporting waivers at sub-consolidated levels under the IGD that were applicable to IHCs. Another unforeseen and unintended consequence transpired after the adoption of the CRD which introduced supervision at the consolidated, i.e., the FHC level. The interaction of different holding company forms was not considered during the negotiations of the CRD, which focused on the European transposition of the 2004 Basel II framework. The inability to apply several rather important CRD provisions at the MFHC level prompted the waiving from the supplementary supervision of several, mainly larger, banking groups. Without a change to the current provisions problems outlined in section 3.3.1 would remain unaddressed.

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44 Article 2(15)
45 Article 29(1)
46 Article 28(1)

In short, the FICOD would continue to provide for a substituting or duplicating supervision, rather than the intended supplementary supervision. Secondly, the waiving of groups from the supplementary supervision by supervisors who wish to retain the powers at the sectoral top level would continue to contribute to the unlevel playing field conditions. As importantly, for European citizens this policy option implies that these complex groups would not be supervised in a comprehensive and prudent way that was aimed for when establishing the FICOD, impairing the supervisory toolkit essential for safeguarding of creditor and policyholder interests and provision of the financial stability.

Policy option 1.2: Allow an MFHC to be at the same time an FHC or an IHC

This policy option entails a legal amendment to end the exclusion of the form of an MFHC as the top level holding company of a banking or an insurance group. This amendment would imply that provisions and powers regarding the 'old' FHC or the 'old' IHC do not disappear when a group is identified as an MFHC as a result of an acquisition in the other sector. All consequences listed in section 3.3.1 are prevented, and consistency is ensured with any future provision added to the sectoral directives which will be applicable at the top level holding company. To ensure consistency, the provisions of the sectoral directives referring to holding companies should include references to an MFHC, too.

Also, those supervisors who decided to waive their conglomerates from supplementary supervision, because of the loss of powers at the sectoral top level, would be enabled to apply supplementary checks on group-wide available capital, internal control mechanisms and group-wide management of risk concentrations and intra group transactions (this regards especially the largest bank-led conglomerates, see section 3.3.1). This would not only provide for a level playing field , legal clarity[47] and smaller compliance burden (as sectoral sub-group supervision could be "waived" under this option) to firms as well as more legal clarity to those supervisors who did not have a possibility to apply the group level provisions of the CRD, the IGD and the FICOD as intended, but also enhance the effectiveness of group supervision, thus, aiding the financial stability and better protection of the interests of bank creditors and insurance policyholders.

The "open" character of this policy option might give rise to concerns about the duplication of supervision, in case a sectoral directive contains similar provisions. In the CRD this concerns the large exposures regime only, one element of the supervision of risk concentrations. In the IGD there is no provision that could be duplicated. In case the same policy option were chosen for S2 (for which level 2 measures are being developed), a mapping of provisions for concentrations of risks, contagion through intra-group relationships, and group-wide internal governance would be necessary. In order to ensure that only once supplementary supervision is applied, this policy option may need to be accompanied by a general safeguarding provision

[47] The study conducted by Europe Economics looked at, among others, compliance costs of financial institutions with the FICOD. It found that for the sample of 44 banks and financial conglomerates, one off implementation costs of this directive were about 0.01% of their operating costs (for a sub-sample of only financial conglomerates the respective estimate was 0.019%). In terms of implementation cost drivers, some 30% of them were caused by legal advice costs, consultancy fees and familiarisation with the directive. Therefore, a share of this 30% of overall implementation costs may be potentially saved by banks as a result of enhanced legal clarity pertaining to supplementary supervision. Source: Europe Economics, *Study on the Cost of Compliance with Selected FSAP Measures*, 2008

in specific parts of the legal text, allowing for waivers of either sectoral or top-level supervision on aspects already dealt with by one of the other directives.

Policy option 1.3: Add to the MFHC level supervisory powers that are lost at the sectoral level

This is a version of policy option 1.2 which would entail an amendment of a "closed" character by listing precisely which sectoral top level provisions can also be applied at the conglomerate level. This would pertain especially to (sectoral) group-wide internal capital adequacy assessment process (ICAAP) and capital requirements on a consolidated basis, group-wide internal governance, reporting waivers, and fit & proper management provisions.

Similar to option 1.2, this option would ensure that important supervisory powers at the consolidated level and important waivers for the industry are no longer lost. Similar safeguards to prevent duplication of supervision would be necessary. The main difference with option 1.2 is that the amendment would only affect the legal text of the FICOD, and leave aside the CRD and insurance directives. This difference also implies, however, that any subsequent addition or amendment of the sectoral top level provisions would have to be added to the FICOD as well.

More importantly, this policy option would also imply a deviation from the underlying principle of the FICOD, i.e., supplementary supervision. Currently, top level sectoral supervision is provided for in the sectoral directives and the FICOD is meant to supplement supervision in case complexity is introduced by acquisitions in the other sector. If it were also to correct for losses of powers at the sectoral level, the FICOD would no longer be a solely supplementary legislation.

Policy option 1.4: Allow supervisors at the MFHC level to exercise discretionary powers that are lost at the top sectoral level

An amendment allowing discretion to supervisors to apply sectoral top level powers also at the MFHC level, could have an "open" character, as in option 1.2, or a "closed" character, as in option 1.3. The main difference with policy options 1.2 and 1.3 would be that supervisors themselves would decide whether to apply the sectoral top level powers at the MFHC level.

This policy option would address supervisors' concern of not being able to apply certain checks at the top level, but would provide no legal clarity whatsoever to the supervised firms. Also, convergence of practices would be difficult to achieve and, thus, unlevel playing field from the perspective of financial conglomerates would be maintained.

Conclusion

Retaining the current scenario (option 1.1), implies that the current problems would persist and, therefore, contribution of the supplementary supervision of financial conglomerates towards all the relevant policy objectives would remain sub-optimal. While policy options 1.2, 1.3, and 1.4 seem to be comparable in terms of their effectiveness as regards contribution towards the objectives of reinforced risk management of financial conglomerates (S-2) and reduced compliance burden (S-4), policy option 1.2 is the most effective among them with respect to objectives of enhanced supplementary supervision (S-1), elimination of regulatory arbitrage opportunities (S-3), enhanced level playing field (S-5) and enhanced legal clarity (S-7). Policy option 1.2 also appears to be the most efficient from the regulatory angle as it

preserves a supplementary nature of the FICOD and, therefore, is a preferred option. This preference is in line with the supervisors' advice. Feedback of the industry to the public consultation showed that it prefers this option as well, provided that potential duplication is explicitly addressed. The member states gathered in the EFCC expressed a similar preference to change the definitions and to make provisions across directives consistent.

Table 3: Summary of policy options' effectiveness and efficiency

Policy Options	Policy Option Comparison Criteria						
	Effectiveness						Efficiency
	Enhance effectiveness of supplementary supervision	Reinforce financial conglomerates' risk management	Eliminate regulatory arbitrage opportunities	Reduce compliance burden	Enhance level playing field	Enhance legal clarity	
1.1 Retain current approach	4	4	4	4	4	4	4
1.2 Allow an MFHC to be at the same time an FHC or an IHC	1	1-3	1	1-3	1	1	1
1.3 Add to the MFHC level supervisory powers that are lost at the sectoral level	2	1-3	2	1-3	2	2	2
1.4: Allow supervisors at the MFHC level to exercise discretionary powers that are lost at the top sectoral level.	3	1-3	3	1-3	3	3	3

Scale of option ranking: 1=most effective / efficient, 4=least effective / efficient
Effectiveness measures extent to which options achieve relevant objectives
Efficiency measures extent to which objectives can be achieved for a given level of resources

5.1.2. Identification of RCAs

To address the lack of clarity stemming from Article 2(17)(a), defining RCAs as "Member States competent authorities responsible for the sectoral group wide supervision of any of the regulated entities in a financial conglomerate", the following two policy options have been considered:

- **Policy option 1.5:** Retain current approach;
- **Policy option 1.6:** Narrow down the definition of RCA to supervisors of ultimate parent entities within individual sectors and supervisors regarded as relevant by the supervisor of the ultimate parent.

Policy option 1.5: Retain current approach

Under this policy option, the lack of clarity with respect to the interpretation of current provisions, as outlined in section 3.3.2, would remain.

Policy option 1.6: Narrow down the definition of RCA to supervisors of ultimate parent entities within individual sectors and supervisors regarded as relevant by the supervisor of the ultimate parent

The original objective of the definition under Article 2(17)(a) was to determine the RCA as a supervisor of the ultimate parent within a sector. Policy option 1.6 would make this explicit in the RCA definition. This option in the first place would enhance the legal clarity for the supervisors. Secondly, it would increase the effectiveness of the financial conglomerate determination process, as it focuses on the right sub-group of competent authorities. Most importantly, clarifying the definition by explicitly pointing to the group-wide supervisor of the ultimate parent entity in a sector would be consistent with the objective of the supplementary supervision and is expected to contribute to both the efficiency and

effectiveness thereof. The other part of the definition, i.e., those supervisors who are regarded as relevant by the supervisor of the ultimate parent, would remain.

Conclusion

Policy option 1.6 is a preferred option as it is more effective and efficient than option 1.5 in contributing to the attainment of the policy objectives of enhanced supplementary supervision (S-1), enhanced supervisory cooperation and convergence (S-5) and enhanced legal clarity (S-7). This is what both the JCFC and the EFCC would prefer, since they are currently facing a confusing legal provision and would welcome clarity, so that they can focus on the relevance of authorities when determining the college, not on the interpretation of a vague provision. The effectiveness of the amendment will be re-enforced by guidelines regarding its application, as well as the possibility that the Joint Committee of newly established European Supervisory Authorities may mediate in case of disputes.

Table 4: Summary of policy options' effectiveness and efficiency

Policy Options	Policy Option Comparison Criteria			
	Effectiveness			Efficiency
	Enhance effectiveness of supplementary supervision	Enhance supervisory cooperation and convergence	Enhance legal clarity	
1.5 Retain current approach	2	2	2	2
1.6 Narrow down definition of RCA to supervisors of ultimate parent entities within individual sectors and supervisors regarded as relevant by the supervisor of the ultimate parent	1	1	1	1

Scale of option ranking: 1=most effective / efficient, 2=least effective / efficient
Effectiveness measures extent to which options achieve relevant objectives
Efficiency measures extent to which objectives can be achieved for a given level of resources

5.2. Financial conglomerate identification process

5.2.1. Inclusion of AMCs in the identification process

To address the identification issues pertaining to the inclusion of AMCs in the supplementary supervision, the following three policy options have been considered:

- **Policy option 2.1:** Retain current approach;
- **Policy option 2.2:** Inclusion of AMCs at all times complemented with guidance on indicators for inclusion;
- **Policy option 2.3:** Inclusion of AMC' proprietary business only.

Policy option 2.1: Retain current approach

No change implies an unlevel playing field among conglomerates, as the current FICOD provisions regarding AMCs are not structure-neutral: if an AMC is part of a banking or an insurance silo, it is consolidated automatically, but if it is structured outside the silo, it can be excluded. Without a change to the current provisions this and other problems pertaining to AMC identification, outlined in section 3.3.3, would remain unaddressed.

Policy option 2.2: Inclusion of AMCs at all times complemented with guidance on indicators for inclusion

The addition of AMCs to the scope of the directive in 2002 was justified from a group risk point of view: AMCs are adding risks of complexity, contagion, concentration and conflicts of interest to a financial group. Experience from the recent financial crisis has not revealed any counter-arguments to this justification. This policy option, therefore, entails inclusion of AMCs in the conglomerate identification process at all times. The specific character of AMCs, however, justifies additional guidance from the Joint Committee of the newly established European Supervisory Authorities with respect to the use of alternative indicators for their inclusion, which more specifically reflect the character of their business.

Policy option 2.2 would provide an effective solution to the problems - from the industry's angle - of unlevel playing field and lack of legal clarity, whereas from the supervisory perspective it would ensure that the scope of conglomerates subjected to the supplementary supervision is made more appropriate, which should in turn enhance both the effectiveness of supplementary supervision and groups' own risk management. As a result, both financial stability and interests of bank creditors and insurance policyholders would be enhanced.

This policy option entails compliance costs for supervisors in terms of their envisioned role to develop an alternative set of indicators pertaining to AMCs to be used in the conglomerate identification process as well as for groups that may be identified as financial conglomerates following this policy option. However, the anticipated impact in this regard for both groups of stakeholders is deemed to be immaterial.[48] [49]

Policy option 2.3: Inclusion of AMCs' proprietary business only

This policy option for AMC identification has been put forward by the industry. It is based on the distinction between provision of services to customers, who themselves bear the ultimate risk (non-proprietary management), and to owners' own account, which implies a risk for the financial undertaking (proprietary management). While no respondent to the Commission services' public consultation reported a relative importance of more than 10% of proprietary business in their total asset management, the responses, however, did not clarify how the contagion channels coming from one or the other type of AMC business could be distinguished. Both proprietary and non-proprietary businesses typically appear to be part of

[48] Responses to the public consultation showed that in cases where groups would cease falling within the scope of the FICOD, they would realise cost (e.g., information provision- and capital-related) savings in the range of €10 - 500 thousand per year. For the 30 largest conglomerates this is equivalent, on average, to 0.00003% to 0.00156% of their revenues. By extension, this estimate may be used to approximate incremental compliance costs for groups that would be captured in the scope of the supplementary supervision following the proposed legislative changes. However, given the limited number of groups potentially affected by policy option 2.2, the effect on the compliance costs of the industry overall is deemed to be immaterial.

[49] One-off implementation costs of the FICOD for financial conglomerates were estimated to be approximately 0.019% of their current operating expenses; whereas ongoing compliance costs with the directive were estimated to equate approximately 0.006% of their current operating expenses; source: Europe Economics, *Study on the Cost of Compliance with Selected FSAP Measures*, 2008

one and the same legal entity and are often difficult to distinguish[50]. Moreover, regardless of the type of business, both types can imply substantial operational risk for a group.

Even though policy option 2.3 may imply lower compliance costs for the industry, as it has direct implications on determining which groups fall within the scope of the supplementary supervision, due to the reasons outlined above it would not provide for the optimal legal clarity, may give rise to additional regulatory arbitrage possibilities and, overall, less effective supervision of complex financial groups, which may have ramifications for the financial stability.

Conclusion

Retaining the current scenario (option 2.1), implies that the current problems would remained unaddressed. Policy option 2.3 implies an improvement compared to policy option 2.1 as it would lead to at least a partial solution for identified problems. Policy option 2.2 is a preferred option as it is more effective than policy option 2.3 in terms of contributing towards the objectives of enhanced supplementary supervision (S-1), reinforced risk management of financial conglomerates (S-2), elimination of regulatory arbitrage opportunities (S-3), enhanced level playing field (S-5) and enhanced legal clarity (S-7). Even though compliance costs for the industry are lower under option 2.3, it may be argued that option 2.2 is more efficient than option 2.3 as well since in spite of higher compliance costs it allows for the attainment of policy objectives to a far greater extent. Both the JCFC and the EFCC expressed a preference for this option.

Table 5: Summary of policy options' effectiveness and efficiency

Policy Options	Policy Option Comparison Criteria					
	Effectiveness					Efficiency
	Enhance effectiveness of supplementary supervision	Reinforce financial conglomerates' risk management	Eliminate regulatory arbitrage opportunities	Enhance level playing field	Enhance legal clarity	
2.1 Retain current approach	3	3	3	3	3	3
2.2 Inclusion of AMCs at all times complemented with guidance on indicators for inclusion	1	1	1	1	1	1
2.3 Inclusion of AMC' proprietary business only	2	2	2	2	2	2

Scale of option ranking: 1=most effective / efficient, 3=least effective / efficient
Effectiveness measures extent to which options achieve relevant objectives
Efficiency measures extent to which objectives can be achieved for a given level of resources

5.2.2. Risk-based identification

To address the problem of the lack of a risk-based identification of conglomerates, five policy options have been considered:

– **Policy option 2.4:** Retain current approach;

– **Policy option 2.5**: Guidelines on the application of the "waiving option" in Article 3(3);

[50] Only one respondent to the Commission services' public consultation indicated that its two types of AMC business are organised as separate legal entities, whereas eleven respondents reported otherwise

– **Policy option 2.6**: Guidelines on the application of the "waiving option" in Article 3(3) combined with a lower relative threshold for groups whose smallest sector exceeds absolute threshold;

– **Policy option 2.7**: Guidelines on the application of the "waiving option" in Article 3(3) combined with an option to waive groups whose smallest sector is below absolute threshold;

– **Policy option 2.8**: Supervisory discretion as regards waivers at all times beyond materiality thresholds.

Under policy options 2.5 – 2.8, the current materiality thresholds would remain to ensure that groups whose smaller sector has a balance sheet of less than €6 billion assets (absolute threshold) and is less than 10% of the group in terms of the average of the ratios of (i) its balance sheet to the total balance sheet of the group and ii) its regulatory capital requirement to the total capital requirement of the group (relative threshold) be excluded from the scope of the directive. Even thought the industry in its response to the public consultation argued that such exclusion could not be justified, as even the smallest groups could be exposed to group risks, especially when a group structure comprises many non-regulated Special Purpose Entities, the Commission services consider that such materiality threshold is justified for proportionality reasons, but may revisit this aspect at the time of a more fundamental debate on the scope of the supplementary supervision. Given a limited capacity of the supervisory community, the Commission services regard the allocation of this capacity towards supplementary supervision of the largest conglomerates as more appropriate, considering the externalities that the largest groups my have on the European scale, and, thus, favour maintaining the absolute materiality threshold. Also, the FICOD is a supplementary directive, and with regard to the smallest groups the sectoral directives are deemed to be sufficient.

- Furthermore, changing the materiality thresholds only would not be sensible, since the review showed that group risks have little to do with size, other than the observation that the smallest groups were not always exposed to group risks as assumed by the directive. This is another reason why the materiality threshold should be kept.

Policy option 2.4: Retain current approach

Retaining the current approach would leave the problem drivers, described in section 3.3.3 un-tackled. The identification process would remain predominantly quantitative, which complicates the appropriate coverage of institutions with potential group risks. It would be inconsistent with the underlying spirit of the Basel II bank capital framework and S2 towards a more risk based supervisory approaches. FICOD review clearly revealed that the identification process should be made more risk-based.

Policy option 2.5: Guidelines on the application of the "waiving option" in Article 3(3)

This policy option entails development of guidelines with respect to the application of the option, which is available to supervisors under Article 3(3) of the FICOD, to waive conglomerates whose smallest sector is above the absolute threshold but below the relative one from the supplementary supervision. Therefore, this policy option entails compliance costs for the Joint Committee of the newly established European Supervisory Authorities who would be in charge of developing guidelines on the application of the waiver. Application of such guidelines would allow for a converged risk-based approach to conglomerate identification, enhancing the effectiveness of supplementary supervision by ensuring that it focuses on the appropriate sample of large groups. Larger conglomerates would benefit from enhanced level playing field conditions and strengthened legal clarity.

While adding of such guidelines may solve the problem pertaining to the inclusion of larger conglomerates on risk-based basis, this, however, would not solve the unwarranted compliance burden placed on small and simpler groups whose smaller sector is less than €6 billion but in excess of the relative threshold as they would remain to be included in the scope.

Policy option 2.6: Guidelines on the application of the "waiving option" in Article 3(3) combined with a lower relative threshold for groups whose smallest sector exceeds absolute threshold

This policy option modifies option 2.5 by introducing a legal amendment to lower the relative threshold, e.g., from 10% to 5%, for groups exceeding the absolute threshold of €6 billion. This approach may, to a certain extent, address the observed problem of identifying the larger groups, however, such identification would be only partially carried out on risk-based basis as guidelines under this option would not be applied to groups whose smaller sector is above the relative threshold of 5% but below the relative threshold of 10% (which is implied under policy option 2.5). Therefore, while this option would yield a higher number of conglomerates to whom supplementary supervision is applied, their identification would be less risk-based than under option 2.5. Moreover, this option forgoes the tackling of the issue of automatic inclusion of smaller groups that was also applicable to option 2.5.

Policy option 2.7: Guidelines on the application of the "waiving option" in Article 3(3) combined with an option to waive groups whose smallest sector is below absolute threshold

In order to allow supervisors to assess whether a small group is so complex that its supplementary supervision is justified, but also to waive supplementary supervision if it is regarded disproportionate, this policy option entails inclusion of provisions in the FICOD to allow for the waiving of those groups where the balance sheet of the smallest sector does not exceed the absolute threshold of €6 billion, but the sector itself exceeds the relative threshold. Guidelines may be developed as to the application of this waiver.

Similarly to policy options 2.5 and 2.6, in order to provide for more legal clarity and more levelled playing field, guidelines would be developed as well for the application of the waiver under Article 3(3) to the larger groups that are exceeding the absolute but not the relative threshold.

This policy option would result in a sample of identified conglomerates that are regarded, after a supervisory assessment, as groups which are active in several financial sectors and which could be exposed to risks of contagion, concentration, complexity and conflicts of interest. The supplementary supervision would be applied to those groups for which supplementary checks on capital, risk concentration, intra group transactions and group-wide internal governance are justified while unwarranted compliance costs, including administrative costs, for smaller, simpler groups would be avoided. With respect to the latter, incremental cost savings as reported in the public consultation varied between €10.000 and 500.000 per group per year.[51]

However, for the industry as whole impact on compliance costs is expected to be immaterial as cost savings for smaller conglomerates would be offset by costs incurred by larger conglomerates[52], as some of them may no longer be waived from the supplementary supervision following the implementation of the proposals to amend the FICOD. Yet in terms of the financial stability benefits are expected to be substantial, as the total assets of large groups, whose current waiving from the supplementary supervision would be re-considered, added up to €9 trillion as of the end of 2009[53].

Policy option 2.8: Supervisory discretion as regards waivers at all times beyond materiality thresholds

Policy option 2.8 entails full supervisory discretion with respect to the application of supplementary supervision for all groups. While such an approach would address the problem of smaller groups without significant group risks and may provide for more effective supplementary supervision vis-à-vis the baseline scenario (policy option 2.4), it would result in unacceptable level of legal clarity for the larger groups and may bring about an increase in compliance costs due to a less certain identification process. The conglomerate identification process would become more work intensive and, therefore, costly from the supervisory angle as well. A concomitant lack of convergence of national practices would have a negative impact on the level playing field conditions.

Conclusion

While options 2.5, 2.6, 2.7 and 2.8 have all been shown to be effective in aiding – to various degrees - the identification process with a qualitative assessment of potential group risks, therefore, implicitly contributing to the achievement of objectives of enhanced supplementary supervision (S-1) and reinforced financial conglomerate risk management (S-2), only policy option 2.7 is expected to be simultaneously effective in limiting compliance costs (S-4), increasing legal clarity (S-7) and enhancing level playing field (S-5) for the industry, as it would introduce a waiver to be applied, where appropriate, to smaller groups and add guidelines on the application of the current waiver for larger groups. This option was also

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51 See footnote 49

52 At the end of 2007, there were 10 groups (represented by the upper left box in Chart 1) where the balance sheet the smallest sector did not exceed the absolute threshold of €6 billion but the sector itself exceeded the relative threshold and 17 groups (represented by the lower right box in Chart 1) where the smallest sector exceeded the absolute but not the relative threshold, and of which several bank-led conglomerates had been waived

53 Source: company annual reports

preferred by most industry respondents to the Commission services' public consultation, as they currently observe an unlevel playing field.

In the long run, amending the non risk based thresholds into a set of risk based parameters would be preferable. However, at the G20 level, the Joint Forum, the IMF and the FSB are still investigating how to detect a group that is exposed to significant group risks. Interim reports mention size, interconnectedness and substitutability as potential parameters. By giving the JCFC the opportunity to develop the risk based identification process along with gained insight at the G20 level, the Commission supports the preferred direction.

Table 6: Summary of policy options' effectiveness and efficiency

Policy Options	Policy Option Comparison Criteria					
	Effectiveness					Efficiency
	Enhance effectiveness of supplementary supervision	Reinforce financial conglomerates' risk management	Reduce compliance burden	Enhance level playing field	Enhance legal clarity	
2.4: Retain current approach	5	5	5	5	5	5
2.5: Guidelines for the "waiving option" in Article 3(3)	1-3	1-3	2	1-3	1-3	2
2.6 Guidelines for the "waiving option" in Article 3(3) combined with a lower relative threshold for groups whose smallest sector exceeds absolute threshold	1-3	1-3	3	1-3	1-3	3
2.7 Guidelines for the "waiving option" in Article 3(3) combined with an option to waive groups whose smallest sector is below absolute threshold	1-3	1-3	1	1-3	1-3	1
2.8 Supervisory discretion as regards waivers at all times beyond materiality thresholds	4	4	4	4	4	4

Scale of option ranking: 1=most effective / efficient, 5=least effective / efficient
Effectiveness measures extent to which options achieve relevant objectives
Efficiency measures extent to which objectives can be achieved for a given level of resources

5.3. Participations

The objective of detecting potential group risks and double use of capital, requires, among other elements, a check on relationships among group entities that take form of a participation. As described in section 3.3.4, participations under the FICOD can be defined not only by control or ownership, but also by durable links. The review of the FICOD found a lack of predictability of the application of the durable link concept which entails the detection of interconnectedness in a group of legal entities. The Commission addressed this problem in October 2009 by adopting a proposal for the Omnibus Directive which included a possibility for the new European Supervisory Authorities to adopt technical standards in this area.

Another problem that was identified during the review pertains to the treatment of participations in supplementary supervision and is triggered by the fact that company law prohibits a minority owner from accessing information which is not accessible to other shareholders. In order to address this problem, three policy options have been considered:

– **Policy option 3.1:** Retain current approach;

– **Policy option 3.2:** Guidelines with respect to treatment of participations in various situations;

– **Policy option 3.3:** Require inclusion of participations in the full spectrum of supplementary supervision when they can be consolidated or a full deduction from capital otherwise.

Policy option 3.1: Retain current approach

Both the industry and the supervisory community agree that the provisions in this area are not clear and that under certain circumstances requirements cannot be fulfilled. Without a change to the current provisions problems outlined in section 3.3.4 would remain unaddressed.

Policy option 3.2: Guidelines with respect to treatment of participations in various situations

This policy option would provide for a more consistent treatment of "detected" participations. When assessing the impact of the supervisory treatment of participations, the JCFC observed a wide diversity in the character of the existing participations explained by, among others, relative versus absolute ownership figures, alliances with connected owners (consortia), longer term business contracts not accompanied by material ownership and, last but not least, diversity in the application of the participation definition. Therefore, this policy option entails a development of guidelines on how to supervise participations in the various thinkable situations. Since relationships underlying a participation can be very different, while quantitatively similar holdings can imply either a strategic alliance, or just an investment, or anything in between, this policy option would also facilitate more effective outcomes of the supplementary supervision.

Under this policy option, each and every case would be assessed while respecting the confidentiality obligations of supervisors who have access to information vis-a-vis the conglomerate under supervision and other stakeholders[54]. Supervisors could share experiences on individual cases and learn how to circumvent the minority shareholders' problem of access to information. This may solve the problem in several individual cases, however, would not provide for the most effective solution to the legal problem and, therefore, would not be entirely effective in minimising compliance costs for the financial groups.

Unfortunately, the character of the participations problem, given the limited insight available today, makes a legally binding requirement for the treatment of participations impossible, which is why the JCFC should start developing guidelines on how to deal with this problem. Where appropriate, and when there is more clarity about the legal problem of company law hampering access to information (despite the exclusive supervisory powers to access information in Article 14 of the FICOD) the aforementioned guidelines could be transformed into more binding tools.

Policy option 3.3: Require inclusion of participations in the full spectrum of supplementary supervision when they can be consolidated or a full deduction from capital otherwise

Policy option 3.3 reinforces the supervision of participations in the framework of supplementary supervision. It would entail the alignment of the FICOD with the sectoral directives in terms of capital-related treatment. This option would clarify what to do once the character of a participation is detected, i.e., a) consolidation if information is sufficiently

[54] Article 14 allows supervisors to obtain this information but is silent about its transfer to the supervised minority shareholder

available to enable prudent group-wide risk management, including the participation, or, b) deduction from capital if such information is not sufficiently available.

The feasibility of this option, however, depends on the outcomes of the sectoral capital debates, in particular, with regard to the treatment of participations, as well as an adequate solution to the lack of access to information, caused by national company law in some member states, despite the exclusive supervisory powers allowing them to access information under Article 14 of the FICOD. Therefore, consideration of this option would have to wait for conclusions of debates on capital and scope in cross-sectoral cases in order to ensure coherence with sectoral provisions. After all, the FICOD was meant as a supplementary directive; adding capital-related elements to it would require a debate beyond the currently carried out technical review.

The cause of the problem linked to the provisions of company law that hamper the control of risks in a group that has one or more participations, would have to be examined thoroughly in the broader context of appropriate regulatory response to the recent financial crisis. Option 3.2, in this context, could pave the way for option 3.3.

Conclusion

Retaining the current scenario (option 3.1), implies that outstanding problems pertaining to supervisory treatment of participations would remain unaddressed. While policy option 3.3 may be more effective than policy option 3.2 with respect to contributing towards the objective of reducing compliance burden (S-4), its viability is driven by the outcome of sectoral debates on capital and the feasibility of revision of relevant company law provisions. Option 3.2, given the more consistent and appropriate supervisory outcomes it entails, on the other hand, seems to be more effective and efficient with respect to attaining the objectives of enhanced supplementary supervision (S-1), reinforced risk management of financial conglomerates (S-2) and enhanced supervisory cooperation and convergence (S-5) and, therefore, has been identified as a preferred option. It shall be noted, however, that option 3.3 may be viewed as complementary to policy option 3.2 and, as such, could be pursued in the longer run. In its responses to the public consultation, the industry simply asked not to require risk management information regarding the participations anymore; the industry realizes that that would imply deduction from capital, so it welcomes the interim solution. Both the JCFC and the EFCC would support this option as an interim solution, which would be addressing the problem, even though it could not solve it entirely.

Table 7: Summary of policy options' effectiveness and efficiency

Policy Options	Policy Option Comparison Criteria				
	Effectiveness				Efficiency
	Enhance effectiveness of supplementary supervision	Reinforce financial conglomerates' risk management	Reduce compliance burden	Enhance supervisory cooperation and convergence	
3.1 Retain current approach	3	3	3	3	3
3.2 Guidelines for various situations	1	1	2	1	1
3.3 Inclusion of participations in supplementary supervision when they can be consolidated	2	2	1	2	2

Scale of option ranking: 1=most effective / efficient, 3=least effective / efficient
Effectiveness measures extent to which options achieve relevant objectives
Efficiency measures extent to which objectives can be achieved for a given level of resources

5.4. The package of preferred policy options and its impact

The following table shows the five preferred policy options.

Table 8: Package of preferred policy options

Policy Option Set	Policy Options
Supplementary supervision on holding company level and supervisory coordination	***Alignment of supervisory powers***
	Policy option 1.2: Allow an MFHC to be at the same time an FHC or an IHC
	Identification of RCAs
	Policy option 1.6: Narrow down definition of RCA to supervisors of ultimate parent entities within individual sectors and supervisors regarded as relevant by the supervisor of the ultimate parent
Financial conglomerate identification process	***Inclusion of AMCs in the identification process***
	Policy option 2.2: Inclusion of AMCs at all times complemented with guidance on indicators for inclusion
	Risk-based identification
	Policy option 2.7: Guidelines for the "waiving option" in Article 3(3) combined with an option to waive groups whose smallest sector is below absolute threshold
Treatment of participations	Policy option 3.2: Guidelines for various situations

The proposed policy changes are expected to render the supplementary supervision framework more robust in the long run, leading to more effective risk management incentives and practices, which, in turn, should also help to enhance the international competitiveness position of EU financial groups. The proposals should contribute positively to containing the risks to the financial stability and the concomitant costs to society in the future. At the level of individual stakeholder groups and systemic concerns, expected impacts of the proposals are as follows:

– Certain smaller EU financial groups having a simple structure and not more than a few licenses in both sectors may be excluded from supplementary supervision and, therefore, should see compliance cost savings. Some ten smaller financial groups with combined assets of approximately €69 billion may be considered for this possibility. 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 up to 8 of such groups, representing about €9 trillion assets in the financial sector, may be included in the scope of the supplementary supervision. Incremental compliance costs would also be incurred by those financial groups whose structure includes asset management business and that are identified as financial conglomerates following proposed changes to the conglomerate identification process with respect to asset management companies. Compliance costs for financial groups that are added to the scope of the supplementary supervision should be, given their overall size, immaterial in relative terms. Furthermore, they should be offset with benefits coming from more effective risk management practices, induced by incentives implicit in this legislative proposal. Another positive impact can be expected from a greater visibility and trust in the markets, when a company is identified 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 aforementioned changes to the conglomerate identification process will be guided by the guidelines developed by the supervisory community. These changes will make the scope of the supplementary supervision more appropriate and, thus, will enhance the effectiveness of supervisors' monitoring of the risks that financial groups are exposed to, which should outweigh the costs of developing such guidelines. Combined with a more

streamlined - without duplicating or substituting sectoral top level supervisory powers and regardless of group structure - supervision at the top conglomerate level and improved supervisory toolkit for detection of contagion, concentration, complexity issues and conflicts of interests in firms connected to a conglomerate through participations, this should produce a positive contribution to the financial stability;

– The enhanced clarity of provisions as regards the inclusion of asset management companies in the identification and supplementary supervision as purported in 2002, should provide for a more level playing field in this area;

– Protection of depositors and policyholders will be enhanced as improved effectiveness of the supplementary supervision and risk management of financial conglomerates will lead to a reduction of their default risk; this shall also have a positive impact on long-term investors in financial conglomerates such as pension funds[55];

– As regards clients of the affected financial groups, the impact is expected to be negligible with respect to the availability of products and their pricing, given the overall materiality level of the net incremental effect of this proposal on the latter. Clients should not even worry about the differences between the regulatory treatment of banks, insurers and conglomerates. They trust that the supervisory framework is comprehensive and prudent, and this revision is especially aimed at enhancing that notion.

The Commission's Better Regulation strategy is aimed at measuring administrative costs and reducing administrative burden. The distinction between the two is that the latter denotes costs linked to providing the information that businesses would not incur in the absence of legislation. In the area of prudential regulation of financial groups, certain information requirements are necessary to provide for the desired level of financial stability and creditor / policyholder protection and, hence, should be set at a level that ensures an equilibrium between ensuing administrative burdens and the benefits that they yield. However, administrative burden associated with the current FICOD provisions is assumed to be low. According to a study conducted by Europe Economics, one-off implementation costs of the FICOD for financial conglomerates are approximately 0.019% of their current operating expenses; whereas ongoing compliance costs with the directive are approximately 0.006% of their current operating expenses.[56] Since administrative costs and, in turn, administrative burden are part of such total compliance costs, they would represent even a smaller share of financial conglomerates' operating costs. Areas where proposed policy changes may have implications for the administrative costs incurred by conglomerates, have been identified throughout the report (see sections 5.1.1, 5.2.1 and 5.2.2), some of them resulting in cost increases while others - in reduction. Overall net effect, particularly, given the limited number of institutions affected by various individual proposals, is expected to be immaterial for the industry.

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55 E.g., for top 100 largest investments of ABP (a Dutch pension fund that is one of the largest pension funds in the world) in 2008 please see the following link: http://www.abp.nl/abp/abp/images/01%200002%2008C_top100ENG%20(def%20versie)_tcm108-59128.pdf

56 http://ec.europa.eu/internal_market/finances/docs/actionplan/index/090707_cost_of_compliance_en.pdf

In terms of the social impacts, this legislative initiative, as mentioned above, is expected to contribute to strengthening of the financial stability and, hence, shall benefit the society at large. No major implications of the proposal on environment are anticipated.

6. MONITORING AND EVALUATION

It is expected that the proposed amendments will enter into force in 2011. The Commission, in co-operation with Member States will monitor the effectiveness of the proposals once implemented. The Commission will also have regard to other stakeholders such as the industry and supervisors while assessing whether the objectives outlined in this impact assessment are fulfilled. The JCFC, and later the conglomerates' subcommittee of the Joint Committee is monitoring the application of the directive on a continuous basis[57].

(4) The proposed amendments are tightly inter-linked with a recent proposal of the Commission for the Omnibus Directive. As indicated earlier, they also are likely to be followed up with a more fundamental review of the FICOD that may include provisions pertaining to the quality of capital buffer and scope as regards non-regulated entities. The Commission services started such fundamental debate with a conference on 7 June 2010 in Brussels and will work on developing appropriate proposals in the course of 2011.

(5) Normally, the practice at the Commission is to conduct an evaluation of a legislation some four years after its implementation. However, given the possibility of additional amendments to the FICOD in the near future and its close ties to the Omnibus directives, as well as initiatives at the G20 level in the Joint Forum and the FSB, it might be sensible to conduct a comprehensive evaluation that would be based on the entirely overhauled legislative framework, for which a target date should be set accordingly.

[57] This could be supplemented by reports to the European Commission regarding the application of (i) capital calculations (Article 6), (ii) internal control of group risks (Articles 7, 8 and 9), and (iii) supervisory coordination (Section 3)

7. ANNEX I: ACRONYMS

AIFM: Alternative Investment Fund Manager

AIG: American International Group, Inc.

AMCs: Asset Management Companies

APRA: Australian Prudential Regulation Authority

EBF: European Banking Federation

CEA: Commission Européenne d'Assurance

COM: European Commission

CRD: Capital Requirements Directive

EACB: European Association of Co-operative Banks

EAPB: European Association of Public Banks

EASB: European Association of Savings Banks

EEC: European Economic Community

EFCC: European Financial Conglomerates Committee

FC: Financial Conglomerate

FCD: Fourth Council Directive

FHC: Financial Holding Companies

FICOD: Financial Conglomerates Directive

FT: Financial Times

FSB: Financial Stability Board

GE: General Electric

GM: General Motors

ICAAP: Internal Capital Adequacy Assessment Process

IGD: Insurance Groups Directive

IHC: Insurance Holding Companies

INS: Insurance groups

ITE: Intra-group Transactions and Exposures

JBF: Journal of Banking and Finance

JCFC: Joint Committee on Financial Conglomerates

JFI: Journal of Financial Intermediation

LCFI: Large and Complex Financial Institution

MFHC: Mixed Financial Holding Companies

MiFID: Markets in Financial Instruments Directive

MTG: Mixed Technical Group

RC: Risk Concentrations

RCA: Relevant Competent Authority

S2: Solvency II

SIFI: Systemically Important Financial Institution

UCITS: Undertakings for Collective Investments in Transferable Securities

8. ANNEX II: GLOSSARY

Bail outs: act of giving capital to an entity (a company, a country, or an individual) in danger of failing in an attempt to save it from bankruptcy, insolvency, or total liquidation and ruin, or to allow a failing entity to fail without spreading contagion.

Capital Requirement Directive: introduces a supervisory framework in the EU which reflects the Basel II rules on capital measurement and capital standards for the financial services industry.

Compounding effects: the opposite of diversification effects, i.e. acceleration of risks in case they materialize at the same time **Conflict of interest**: a situation in which the same person or entity would both benefit and suffer from the same decision

Contagion: transmission of a financial shock in one entity to other interdependent entities

Depositors: a person who has deposited money in a financial institution

Diversification effects: To the degree that correlations across risks are imperfect, there is a diversification benefit that the firm faces less risk, and would therefore require less capital to operate safely, than would otherwise be the case. In other words, the aggregate risk is less than the sum of the individual risks that are being aggregated. This is found across all of the major types of market risk factors, including interest rates, foreign exchange rates and equity prices.

Group risks: Adverse developments which affect the soundness of a firm, when it is part of an aggregate of many different entities. The group risks are the risk of contagion, I.e.e the spreading of risks throughout the group because of intra-group relationships, management complexity, concentration of risks (i.e. the same risk materializing throughout the group at the same time) and conflicts of interests. Group risks arise incrementally when licenses for different financial services are combined under the same roof.

Home-host relationships: Relationships between authorities from both the country where a supervised entity has its headquarters, and the country where the same group has its foreign activities.

Leveraging: use of debt capital to supplement equity capital.

Management complexity: Difficulty of controlling many legal entities at the same time.

Mixed Technical Group: created by the European Commission following the Joint Forum's recommendations, in order to guide the implementation of the FICOD in the European Union. It consists of experts from regulatory and supervisory authorities for banking, insurance and securities, the European Commission (chair) and the European Central Bank (ECB). The MTG reports to its sectoral committees, and it is active in the area of financial conglomerates.

Mixed Financial Holding Company: a parent undertaking, other than a regulated entity, which together with its subsidiaries, at least one of which is a regulated entity which has its head office in the Community, and other entities, constitutes a financial conglomerate

Own Funds: a bank's available capital and reserves for the purposes of capital adequacy rules.

Regulated entity: legal entity which is authorized by an authority to perform certain defined activities in the financial sector. Synonym for licensed entity or authorized entity.

Ringfence: The legal walling off of certain assets or liabilities within a corporation. For example, a firm may form a new subsidiary to protect, or ring-fence, specific assets from creditors

Scope: groups subject to the provided supplementary supervision

Technical provisions: accounting magnitudes which the insurer must fund in order to be able to meet the undertakings signed with its insured.

9. ANNEX III: FICOD REVIEW PROCESS

The review envisaged in FICOD started in 2008. It was preceded by two earlier evaluation exercises with respect to financial conglomerates regulation. The first exercise, conducted by the so-called Mixed Technical Group (MTG) in 2005 focused on the implementation of the FICOD and produced answers to questions about implementation. The second exercise, Advice no. 2 of the Interim Working Committee on Financial Conglomerates (a predecessor of the JCFC) in 2008, examined the consequences of the differences in sectoral rules on the calculation of own funds of financial conglomerates – this is usually referred to as "the Capital Advice". A smaller but significant contribution regarding the application of the concept of "relevant competent authority", which relates to supervisory coordination arrangements better known as "home-host" relationships, was sent by the JCFC to the Commission services on a confidential basis in April 2008.

In April 2008 the EFCC approved the launch of the required review of the FICOD with a Call for Advice to the JCFC. The Call for Advice was essentially a backward-looking exercise and confined to a review of provisions with the biggest impact, grouped in three categories:[58]

– Language, i.e., clarity and consistency of definitions and terminology used;

– Scope, i.e., which groups should be subject to the provided supplementary supervision; and

– Internal control requirements that cover the supplementary checks on risk management processes, monitoring of risk concentrations, and on intra-group transactions and exposures (aspects of "Pillar 2"[59] within the meaning of the CRD and S2).

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58 As regards the evaluation of remaining provisions, review of the provisions on capital adequacy was already included in the Capital Advice, whereas before addressing other necessary supplementary supervision issues (e.g., supervisory coordination articles) the EFCC wanted to wait for the conclusion of debates on a revision of the CRD and on the Commission's S2 proposal.

59 Pillar 2 is a general term, which emanates from the revised Basel Framework for bank supervision and refers to many aspects related to the supervisory review process, assessing a group's risk management and internal control processes.