COUNCIL OF THE EUROPEAN UNION

Brussels, 9 January 2013

5127/13

Interinstitutional File: 2010/0232 (COD)

EF 1
SURE 1
ECOFIN 6
CODEC 23

COVER NOTE

from:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	20 December 2012
to:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
No Cion doc.:	COM(2012) 785final
Subject:	REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL The review of the Directive 2002/87/EC of the European Parliament and the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

Delegations will find attached Commission document COM(2012) 785final.

Encl.: COM(2012) 785final

EUROPEAN
COMMISSION

Brussels, 20.12.2012
COM(2012) 785 final

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

The review of the Directive 2002/87/EC of the European Parliament and the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

1. INTRODUCTION & OBJECTIVES

1.1. Background

The rapid development in financial markets in the 1990s led to the creation of financial groups providing services and products in different sectors of the financial markets, the so-called financial conglomerates. In 1999, the European Commission's Financial Services Action Plan identified the need to supervise these conglomerates on a group-wide basis and announced the development of prudential legislation to supplement the sectoral legislation on banking, investment and insurance. This supplementary prudential supervision was introduced by the Financial Conglomerate Directive (FICOD) on 20 November 2002.[1] The Directive follows the Joint Forum's[2] principles on financial conglomerates of 1999.

The first revision of FICOD (FICOD1) was adopted in November 2011 following the lessons learnt during the financial crisis of 2007-2009. FICOD1[3] amended the sector-specific directives to enable supervisors to perform consolidated banking supervision and insurance group supervision at the level of the ultimate parent entity, even where that entity is a mixed financial holding company. On top of that, FICOD1 revised the rules for the identification of conglomerates, introduced a transparency requirement for the legal and operational structures of groups, and brought alternative investment fund managers within the scope of supplementary supervision in the same way as asset management companies.

FICOD1's Article 5 requires the Commission to deliver a review report before 31 December 2012 addressing in particular the scope of the Directive, the extension of its application to non-regulated entities, the criteria for identification of financial conglomerates owned by wider non-financial groups, systemically relevant financial conglomerates, and mandatory stress testing. The review was to be followed up by legislative proposals if deemed necessary.[4]

---

1 Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC.

2 The Joint Forum is the joint body of the international standard setters: Basel Committee for Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), and the International Organisation of Securities Committees (IOSCO).

3 Directive 2011/89/EU of the European Parliament and of the Council 16 November 2011 amending Directives 98/78/EC, 2002/87/EC, 2006/48/EC and 2009/138/EC as regards the supplementary supervision of financial entities in a financial conglomerate.

4 'The Commission shall fully review Directive 2002/87/EC, including the delegated and implementing acts adopted pursuant thereto. Following that review, the Commission shall send a report to the European Parliament and to the Council by 31 December 2012, addressing, in particular, the scope of that Directive, including whether the scope should be extended by reviewing Article 3, and the application of that Directive to non-regulated entities, in particular special purpose vehicles. The report shall also cover the identification criteria of financial conglomerates owned by wider non-financial groups, whose total activities in the banking sector, insurance sector and investment services sector are materially relevant in the internal market for financial services.
'The Commission shall also consider whether the ESAs should, through the Joint Committee, issue guidelines for the assessment of this material relevance.
'In the same context, the report shall cover systemically relevant financial conglomerates, whose size, inter-connectedness or complexity make them particularly vulnerable, and which are to be identified by analogy with the evolving standards of the Financial Stability Board and the Basel Committee on

It should be noted that since the adoption of FICOD1 some issues, such as addressing systemic importance of complex groups, and recovery and resolution tools beyond the living wills requirement in FICOD1 have been or will be resolved in other contexts and have therefore become less relevant for this review.

1.2. The purpose of the review and the Joint Forum's revised principles

This review is guided by the objective of FICOD, which is to provide for the supplementary supervision of entities that form part of a conglomerate, with a focus on the potential risks of contagion, complexity and concentration — the so-called group risks — as well as the detection and correction of 'double gearing' — the multiple use of capital. The review aims to analyse whether the current provisions of FICOD, in conjunction with the relevant sectoral rules on group and consolidated supervision, are effective beyond the additional provisions introduced by FICOD1.

The review is justified as the market dynamics in which conglomerates operate have changed substantially since the Directive entered into force in 2002. The financial crisis showed how group risks materialised across the entire financial sector. This demonstrates the importance of group-wide supervision of such inter-linkages within financial groups and among financial institutions, supplementing the sector-specific prudential requirements.

The limited approach of FICOD1 was partially based on the anticipation of the Joint Forum's revised principles, which were due to be addressed in the present review. These principles were published in September 2012[5] with the two main issues being the inclusion of unregulated entities within the scope of supervision to cover the full spectrum of risks to which a financial group is or may be exposed and the need to identify the entity ultimately responsible for compliance with the group-wide requirements. This review takes the revised principles duly into account together with the evolving sectoral legislation as presented below.

1.3. Evolving regulatory and supervisory environment

FICOD rules are supplementary in nature. They supplement the rules that credit institutions, insurance undertakings and investment firms are subject to according to the respective prudential regulations. Currently this sectoral legislation is being overhauled in a major way and the regulatory environment is evolving.

The CRD IV[6] and Omnibus II[7] are pending proposals before the European Parliament and the Council, and Solvency II includes enhanced group supervision

---

Banking Supervision. In addition, that report shall review the possibility to introduce mandatory stress testing. The report shall be followed, if necessary, by appropriate legislative proposals.'

5 http://www.bis.org/publ/joint29.htm.

6 Commission proposals COM(2011) 452 and COM(2011) 453 final for a Regulation on prudential requirements for credit institutions and investment firms and for a Directive on the access to activity of credit institutions and prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC on financial conglomerates. The proposals are here referred to as CRD IV.

7 Commission proposal COM(2011) 8 final for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

provisions which are not yet applicable. Once these provisions are applicable, the Commission will closely monitor the implementation of these new frameworks, which also comprise a number of delegated and implementing acts, including regulatory technical standards to be developed over a number of years by the Commission and the European supervisory authorities (ESAs). In addition, the changes recently made to FICOD will not be in place before mid-2013, so cannot yet be fully examined in practice before late 2014. These include the regulatory and implementing technical standards and common guidelines to be issued by the ESAs. Finally, the Banking Union Regulation[8] proposal calls for a major change in the supervision of European banks and will have an impact on the supervision of conglomerates as one of the tasks conferred to the European Central Bank would be to participate in supplementary supervision of a financial conglomerate.

As this report shows, there are areas of supplementary supervision where improvements could be made. However, as with any legislation, the benefits of amending legislation always have to be weighed against the costs connected with legislative changes. According to the European Committee on Financial Conglomerates at its meeting on 21 September 2012, the supervisory community through the ESA's advice to the Commission[9], and the industry in its responses to the consultation[10] carried out by the Commission, the optimal timing for revising FICOD will only be once the sectoral legislation has been adopted and is applicable.

2. THE SCOPE OF THE DIRECTIVE AND THE LEGAL ADDRESSEES OF THE REQUIREMENTS

2.1. Scope

2.1.1. The scope of FICOD and the sectoral legislation

Most of the groups operating in the financial sector have a broad spectrum of authorisations. Focusing on the supervision of only one type of authorised entity ignores other factors that may have a significant impact on the risk profile of the

---

8 Commission proposal COM(2012) 511 final for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

9 In order to obtain supervisory expertise, the Commission asked in 2011 for input from the Joint Committee of the European Supervisory Authorities' Committee on Financial Conglomerates (JCFC) in a Call for Advice. The JCFC was asked to explore three main areas: 1) the scope of application, especially the inclusion of unregulated entities, 2) internal governance requirements and sanctions, and 3) supervisory empowerment in the current framework. This ESAs' advice to the Commission is reflected in this report and referred to where appropriate. https://eiopa.europa.eu/consultations/consultation-papers/2012-closed-consultations/may-2012/eba-eiopa-and-esmas-joint-consultation-paper-on-its-proposed-response-to-the-european-commissions-call-for-advice-on-the-fundamental-review-of-the-financial-conglomerates-directive-jccp201201/index.html

10 The Commission carried out a consultation between February and April 2012 in order to get the views of stakeholders on the general concept of supplementary supervision of groups, on the European perspective regarding the Joint Forum principles and on certain specific elements of FICOD. http://ec.europa.eu/internal_market/financial-conglomerates/call_for_evidence_en.htm.

group as a whole. Fragmented supervisory approaches are not sufficient to cope with the challenges that current group structures pose to supervision.

The supplementary supervision framework for conglomerates is meant to strengthen and complete the full set of rules applicable to financial groups, across sectors and across borders. However, from a regulatory standpoint, additional layers of supervision have to be avoided when the sectoral requirements already cover all the types of risk that may arise in a group.

2.1.2. Coverage of unregulated entities, including those not carrying out financial activities

In order to address group risks, which was the original aim of FICOD and the Joint Forum principles, as re-affirmed by the revised principles, group supervision should cover all entities in the group which are relevant for the risk profile of the regulated entities in the group. This includes any entity not directly prudentially regulated, even if it carries out activities outside the financial sector, including non-regulated holding and parent companies at the top of the group. Each unregulated entity may present different risks to a conglomerate and each may require separate consideration and treatment.

Among unregulated entities, special importance is attached to special purpose entities (SPEs). The number of SPEs and the complexity of their structures increased significantly before the financial crisis, in conjunction with the growth of markets for securitisation and structured finance products, but have declined since then. While the use of SPEs yields benefits and may not be inherently problematic, the crisis has illustrated that poor risk management and a misunderstanding of the risks of SPEs can lead to disruption and failure. The need for enhanced monitoring of intra-group relationships with SPEs was highlighted in the Joint Forum's 2009 SPE report[11].

2.1.3. Coverage of systemically relevant financial conglomerates

The challenges of supervising conglomerates are most evident for groups whose size, inter-connectedness and complexity make them particularly vulnerable and a source of systemic risk.

Any systemically important financial institution (SIFI) should in the first place be subject to more intense supervision through application of the CRD IV and Solvency II framework, both at individual and group/consolidated level. If the SIFI is also a conglomerate, supplementary supervision under FICOD would also be applicable. Although most SIFIs are conglomerates, this is not always the case. Also, systemic risks are not necessarily the same as group risks. Therefore, it does not seem meaningful to try to bring all SIFIs under FICOD. Furthermore, discussions at international level are still continuing on insurance SIFIs, and the sectoral legislation, including the treatment of banking SIFIs, is not yet stable.

2.1.4. Thresholds for identifying a financial conglomerate

All the issues mentioned above are linked to the definition of a conglomerate and the thresholds for identifying one. The two thresholds set out in Article 3 of FICOD

[11] http://www.bis.org/publ/joint23.pdf

take into account materiality and proportionality for identifying conglomerates that should be subject to supplementary supervision of group risks. The first threshold restricts supplementary supervision to those conglomerates that carry out business in the financial sector and the second restricts application to very large groups.

The combined application of the two thresholds and the use of the available waiver by supervisors have led to a situation where very big banking groups that are also serious players in the European insurance market are not subject to supplementary supervision. Furthermore, the wording of the identification provision may leave room for different ways to determine the significance of cross-sectoral activities. It could be improved to ensure consistent application across sectors and borders.

To ensure legal clarity, it is important to have easily understandable and applicable thresholds. However, the question remains whether the thresholds and the waivers should be amended or complemented to enable supervision in a proportionate and risk-based manner.

2.1.5. Industrial groups owning financial conglomerates

While there is agreement that regulated financial entities are exposed to group risks from the wider industrial group to which they might belong, no conclusion can be drawn at this stage as to how to extend the FICOD requirements to wider non-financial groups. The FICOD1 review clause required the Commission to assess whether the ESAs should, through the Joint Committee, issue guidelines for assessment of the material relevance of the activities of these conglomerates in the internal market for financial services. Currently there is no legislation on the supervision of industrial groups owning financial conglomerates and the ESAs have no empowerment to issue guidelines. Therefore, while the ESAs will certainly play a key role in ensuring the consistent application of FICOD, it is premature to reach any conclusions on the need for the ESAs to issue guidelines on this specific topic.

2.2. Entities responsible for meeting the group-level requirements

Imposing requirements at group level will not ensure compliance unless this is accompanied by clear identification of the entity ultimately responsible in the financial group for controlling risks on a group-wide basis and for regulatory compliance with group requirements. This would allow more effective enforcement of the requirements by the supervisory authorities (discussed in section 4 below). Interaction with company law provisions governing the responsibilities of the ultimately responsible entity needs to be taken into consideration.

This ultimate responsibility might need to be extended to non-operating holding companies at the head of conglomerates, even though a limited scope may be envisaged for those holding companies whose primary activity is not in the financial sector.

3. PROVISIONS NEEDED TO ENSURE THE DETECTION AND CONTROL OF GROUP RISKS

The objective of supplementary supervision is to detect, monitor, manage and control group risks. The current requirements in FICOD concerning capital adequacy (Article 6), risk concentrations (Article 7), intra-group transactions (Article 8) and internal governance (Articles 9 and 13) are meant to achieve this

objective. Amongst other criteria, they should be assessed against the need to strengthen the responsibility of the ultimate parent entity of conglomerates.

3.1. Capital (Article 6)

The capital requirements for authorised entities on a stand-alone and consolidated basis are defined by the sectoral legislation dealing with the authorisation of financial firms. Article 6 of FICOD requires supervisors to check the capital adequacy of a conglomerate. The calculation methods defined in that Article aim to ensure that multiple use of capital is avoided.

The JCFC's Capital Advice from 2007 and 2008[12] revealed a wide range of practices among national supervisory authorities in calculating available and required capital at the level of the conglomerate. The draft regulatory technical standard (RTS) developed under FICOD Article 6(2), published for consultation on 31 August 2012,[13] specifies the methods for calculating capital. The technical standard is expected to deal sufficiently with the inconsistent use of capital calculation methods for the purpose of regulatory capital requirements and to ensure that only transferable capital is counted as available for the regulated entities of the group. Indeed, as this RTS should ensure a robust and consistent calculation of capital across Member States, when negotiating the CRD IV proposal, it appeared that no changes to FICOD to address Basel III objectives regarding a potential double counting of capital investments in unconsolidated insurance subsidiaries were necessary[14].

However, the discussions accompanying the development of this technical standard revealed further concerns regarding group-wide capital policy. Supervisors sometimes lack insight into the availability of capital at the level of the conglomerate. This could be addressed by requesting the supervisory reporting and market disclosure of capital on an individual or sub-consolidated basis in addition to the consolidated level.

3.2. Risk concentrations (Article 7) and intra-group transactions (Article 8)

Articles 7 and 8 on risk concentrations and intra-group transactions set out reporting requirements for undertakings. Combined with the potential extension of supervision to unregulated entities and identification of the entity ultimately responsible for compliance with FICOD requirements, including reporting obligations, these requirements should provide an adequate framework for supplementary supervision with regard to risk concentrations and intra-group transactions.

The guidelines to be developed by ESAs, as requested by FICOD1, should ensure that the supervision of risk concentrations and intra-group transactions is carried out in a consistent way.

---

12 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002L0087:20110104:EN:PDF.

13 http://www.eba.europa.eu/cebs/media/Publications/Consultation%20Papers/2012/JC%2002/JC-CP-2012-02-on-RTS-on-Article-6-2-FICOD.pdf.

14 See recital 56 of the proposal for Regulation on prudential requirements for credit institutions and investment firms.

3.3. Governance (Articles 9 and 13)

Given the inherent complexity of financial conglomerates, corporate governance should carefully consider and balance the combination of interests of recognised stakeholders of the ultimate parent and the other entities of the group. The governance system should ensure that a common strategy achieves that balance and that regulated entities comply with regulation on an individual and on a group basis.

FICOD, as amended, contains a requirement for conglomerates to have in place adequate risk management processes and internal control mechanisms, a fit and proper requirement for those who effectively direct the business of mixed financial holding companies, a 'living will' requirement, a transparency requirement for the legal and organisational structures of groups, and a requirement for supervisors to make the best possible use of the available governance requirements in CRD and Solvency II.

CRD III and the proposal for CRD IV require, as will Solvency II, further strengthening of corporate governance and remuneration policy following the lessons learnt during the crisis. The living will requirement in FICOD1 would be strengthened by the Bank Recovery and Resolution Framework.[15]

What these frameworks do not yet cover is the enforceable responsibility of the head of the group or the requirement for this legal entity to be ready for any resolution and to ensure a sound group structure and the treatment of conflicts of interest. The Bank Recovery and Resolution Framework would require the preparation of group resolution plans covering the holding company and the banking group as a whole.

4. SUPERVISORY TOOLS AND POWERS

4.1. The current regime and the need to strengthen supervisory tools and powers

Article 14 enables supervisors to access information, also on minority participations, when required for supervisory purposes. Article 16 empowers the coordinator to take measures with regard to the holding company, and the supervisors of regulated entities to act against these entities, upon non-compliance with requirements concerning capital, risk concentrations, intra-group transactions and governance. The Article only refers to 'necessary measures' to rectify the situation, but does not specify such measures. Omnibus I gave the ESAs the possibility to develop guidelines for measures in respect of mixed financial holding companies, but these guidelines have not yet been developed. Article 17 requires Member States to provide for penalties or corrective measures to be imposed on mixed financial holding companies or their effective managers if they breach provisions implementing FICOD. The Article also requires Member States to confer powers on supervisors to avoid or deal with the circumvention of sectoral rules by regulated entities in a financial conglomerate.

---

[15] Commission proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010.

The wording of Article 16 and the lack of guidelines have led to a situation where there is no EU-wide enforcement framework specifically designed for financial conglomerates. As a result, the supervision of financial conglomerates is sectorally based with differences in national implementation. Furthermore, the ESAs point out that strengthening the sanctioning regime as advocated in the CRD IV proposal may create an uneven playing field between financial conglomerates depending on whether they are bank or insurance-led. At the same time, according to the ESAs, most national supervisory authorities consider that the measures available for sectoral supervision are equally appropriate for the supervision of financial conglomerates. Strengthening the supervision of financial conglomerates could therefore be achieved by improving the actual use of the existing instruments.

As to the Article 17 requirement for Member States to provide for credible sanctions to make the requirements credibly enforceable, no such sanctioning regime is known for conglomerates.

The ESAs provide eight recommendations[16] both to enhance the powers and tools at the disposal of supervisors and to strengthen enforcement measures, also taking into account the differences in national implementation. Those recommendations include establishing an enforcement regime for the ultimately responsible entity and its subsidiaries. This implies a dual approach, with enforcement powers to deal with the top entity for group-wide risks and to hold the individual entities to account for their respective responsibilities. In addition, the supervisor should have available a minimum set of informative and investigative measures. Supervisors should be able to impose sanctions upon mixed activity holding companies, mixed activity insurance holding companies or intermediate financial holding companies.

4.2. The possibility to introduce mandatory stress testing

The possibility to require conglomerates to carry out stress tests might be an additional supervisory tool to ensure the early and effective monitoring of risks in the conglomerate. FICOD1 introduced the possibility (though not an obligation) for the supervisor to perform stress tests on a regular basis. In addition, when EU-wide stress tests are performed, the ESAs may take into account parameters that capture the specific risks associated with financial conglomerates.

5. CONCLUSION

The criteria for the definition and identification of a conglomerate, the identification of the parent entity ultimately responsible for meeting the group-wide requirements and the strengthening of enforcement with respect to that entity are the most relevant issues that could be addressed in a future revision of the financial conglomerates directive. The identification of the responsible parent entity would also enhance the effective application of the existing requirements concerning capital adequacy, risk concentrations, intra-group transactions and internal governance.

16 See footnote 10.

The regulatory and supervisory environment with regard to credit institutions, insurance undertakings and investment firms is evolving. All the sectoral prudential regulations have been significantly amended on several occasions in the last few years, and even more significant changes to the regulatory rules are pending before the legislators. Furthermore, the proposal for the Banking Union significantly changes the supervisory framework. Therefore, and taking into account also the position of the European Financial Conglomerates Committee, the supervisory community and the industry, the Commission considers it advisable not to propose a legislative change in 2013. The Commission will keep the situation under constant review to determine an appropriate timing for the revision.