JCFC 09 10

28 May 2009

The review of the Financial Conglomerates Directive[1]

JCFC welcomes comments from interested parties on this consultation paper.
In order to allow for a focused consultation, the JCFC has developed some concrete questions on which it would be very keen to hear market participants' views.
The consultation will last for three months and will end on Friday 28th August 2009. Please send any comments to fcdadvice@c-ebs.org and to Secretariat@ceiops.eu, indicating the reference "JCFC-09-10",using the attached template, by 28th August 2009.
All comments received will be published on the CEBS and CEIOPS websites.

[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 of the European Parliament and of the Council.

Contents

Chapter 1

Executive summary and recommendations

1. The European Commission issued a Call for Advice to the Joint Committee of Financial Conglomerates[2] (JCFC) in April 2008 (the Third Call for Advice to the JCFC), asking the JCFC to undertake a stocktake of existing national implementation practices of the Financial Conglomerates Directive (FCD) in the context of the European Commission's review of this Directive.
2. The request focused on definitions, scope and internal control requirements, and how these areas and their implementation within the existing legislative framework[3] may impact on the fulfilment of the objectives of the FCD.
3. A Progress Call for Advice was issued in February 2009, asking the JCFC to identify policy options to address the issues identified in the stocktake and to specify which policy options the Committee would recommend to address them.
4. The objectives of the FCD are to supplement the existing sectoral directives to address the additional risks of concentration, contagion and complexity presented by cross sector financial groups. The challenges presented by these types of groups have been highlighted by the recent financial crisis.
5. The review takes account of the current framework. Although this review acknowledges some of the recent changes to European sectoral legislation, it does not anticipate the changes to the FCD that may be necessary as a result of these developments. The issues and recommendations in this paper should be considered in this context.
6. This paper builds on the work already carried out by the JCFC in relation to the FCD, including the work of the Joint Task Force on Capital. It does not cover issues that have been considered by the JCFC in response to previous requests from the European Commission.

Issues

7. The JCFC has identified four issues where the FCD may not achieve its objectives:

- **Definitions of different types of holding companies and their impact on the application of sectoral group supervision (Chapter 2).** The interaction of the definitions of "mixed financial holding company" (MFHC), "financial holding company" (FHC) and "insurance holding company" (IHC) in the FCD may cause the scope of sectoral group supervision to change or fall away automatically, depending on the structure of the conglomerate.

- **The definition of "financial sector" and the application of the threshold conditions in Article 3 FCD (Chapter 3).** There are three areas where this issue arises: first, the FCD does not contain an explicit requirement to consider Asset Management Companies (AMCs) regulated under the UCITS Directive when identifying a financial conglomerate. Second, there should be clarification for interpreting the terms "off balance sheet" and "income structure". This clarification should address how to include AMCs in the identification process. Third, the threshold conditions for the identification of conglomerates may not be

[2] On 29th January 2009 the EU Official Journal published the revised Decision 2009/78/EC establishing the Committee of European Banking Supervisors and Decision 2009/79/EC establishing the Committee of European Insurance and Occupational Pension Supervisors. Within these decisions reference is made to the JCFC, and as a consequence the Interim Working Committee on Financial Conglomerates was renamed the Joint Committee on Financial Conglomerates.

[3] The Capital Requirements Directive, Insurance Groups Directive and existing Solvency I Insurance framework

sufficiently risk based, particularly for heterogeneous and small groups whose risk profile might justify exemption from supplementary supervision.

- **Implications of different treatments of participations for the identification and scope of supplementary supervision of financial conglomerates (Chapter 4).** The definition of “participation” in Article 2 (11) FCD can be applied in different ways, depending on how the term “durable link” is interpreted. Different interpretations can lead some Member States to include participations which other Member States would have excluded in their identification exercises or in their conglomerate supervision. Additionally, the treatment of participations in the identification process may not reflect the risk they represent in particular groups. For instance, the inclusion of participations in the scope of supplementary supervision may cause difficulties in cases where a participation is the sole trigger for the identification of a group as a financial conglomerate.

- **The treatment of ”participations" in respect of risk concentrations (RC) and intra-group transactions (IGT) supervision and internal control mechanisms (Chapter 5).** Groups have difficulty in obtaining reporting information from and cannot implement internal control and risk management processes in participations of which they do not have control. Greater clarity around how exposures arising from participations should be weighted for the purpose of reporting RC and IGT, would assist the FCD meeting its objectives.

Recommendations to address the issues noted

8. The paper sets out detailed analysis of various options for addressing the issues identified by the JCFC and the reasons for the recommending particular solutions to these issues. The paragraphs below set out a high level summary of the solutions that the JCFC proposes to recommend that the European Commission considers as part of its review of the FCD. It is not the intention that solutions recommending level 3 guidance will be developed in advance of the conclusion of the European Commission’s review of the FCD.

9. In Chapter 2 it is proposed that the definitions of IHC and FHC are amended to allow an IHC or FHC to constitute a MFHC at the same time. This ensures that sectoral powers continue to apply at the same level as before a group is identified as a financial conglomerate.

10. In Chapter 3 a legal change is proposed to ensure the inclusion of AMCs in the identification process. It is recommended that Level 3 guidance should provide clarification on how to use the concepts of “off-balance sheet” and “income structure” and how to include AMCs for the purposes of identification.

11. Regarding the threshold conditions, a legal change is proposed to allow supervisors to waive small and heterogeneous groups if their risk profile justifies exemption. It is proposed that Level 3 guidance should be developed to assist supervisors when applying the waiver to groups. These proposals should provide tools to treat small groups flexibly and apply the waiver according to adaptable criteria that focus on addressing the risks posed by groups, particularly large groups with large, but relatively small interests in another sector.

12. In Chapter 4 it is proposed to develop Level 3 guidance on how to interpret and apply the “durable link” criterion in the definition of participation.

13. In cases where a group has only a participation in another sector, a legal change introducing supervisory discretion not to treat a group as a conglomerate is recommended. Also, Level 3 guidance is proposed to clarify how participations

should be weighted in order to calculate the sizes of the different sectors.

14. In Chapter 5 it is proposed that Level 3 guidance should be developed to clarify how participations should be weighted for the purpose of RC and IGT reporting and how problems of obtaining information from non-controlled participations can be addressed.

15. The Joint Committee on Financial Conglomerates discussed and noted the following other issues:

- The application of risk concentration rules for insurance led conglomerates prior to the adoption of Solvency II;
- The application of the threshold for defining significant intra-group transactions;
- Issues stemming from the work of the Joint Task Force on Capital;
- Treatment of notional capital requirements for non-regulated financial entities; and
- The need to update the definition of regulated entities in light of the Reinsurance Directive.

Analysis by the JCFC concluded that these issues have insufficient impact on the achievement of the objectives of the FCD to justify further discussions for identifying any options and solutions as part of this workstream or have been considered as part of other work undertaken as part of the review of the FCD.

Questions for industry

16. This paper is being submitted for public consultation. In order to allow for a focused consultation, the JCFC has developed some concrete questions where market participants are encouraged to relay their views. The consultation will last for three months and end on Friday 28th August 2009.

17. All comments received will be published on the CEBS and CEIOPS websites.

Chapter 2

Definitions of different types of holding companies and their impact on the application of sectoral group supervision

Overview

18. This chapter contains analysis of how the holding companies definitions in the FCD impacts on the application of sectoral supervisory tools under sectoral supervision. Identification of a banking/insurance group as a financial conglomerate involves reclassifying the holding company at the top of a sectoral group (insurance holding company - IHC or financial holding company - FHC) into a mixed financial holding company. Depending on the structure of the group, the scope of sectoral group supervision could change. At one extreme it could apply just below the holding company and at the other fall away completely. The structure of the group can therefore determine how sectoral group supervision applies to a financial conglomerate.

19. At present, pursuant to Article 3 (3) FCD, under certain conditions national supervisors may decide not to regard the group – which satisfies the conditions stipulated in the FCD – as a financial conglomerate. As a consequence, supervisors may preserve their ability to use sectoral supervisory tools which are not necessarily available under the FCD regime. This possibility may influence the decision whether to apply the FCD to a cross sector group.

20. The combination of the current provisions of the FCD, CRD[4] and IGD[5] applicable at the level of a holding company at the top of a group affects the scope of sectoral supervisory tools available at this level, and may impact on the effective supervision at the level of that holding company.

A. Relevant provisions of the Financial Conglomerates Directive

21. The objective of the FCD is to complement the sectoral directives to address complexity, contagion and concentration caused by cross sector holdings. The FCD defines three different types of holding companies: the mixed financial holding company (of conglomerates)[6], the insurance holding company (of sectoral insurance groups)[7] and the financial holding company (of sectoral banking groups)[8]. According to these definitions, a mixed financial holding company cannot at the same time constitute a sectoral holding company.

22. The interaction between the definitions of mixed financial holding company (MFHC), insurance holding company (IHC) and financial holding company (FHC) has implications for the application of sectoral group supervision and makes supplementary supervision dependent on the structure of the group.

23. The FCD and the sectoral group directives explicitly say that consolidation of holdings does not imply in any way solo supervision of the holding company.

[4] Directive 2006/48/EC and Directive 2006/49/EC. Nonetheless, throughout this paper "CRD" refers to the former.
[5] Including the future Solvency II regime
[6] Article 2 (15) FCD.
[7] Article 28 (1) FCD, which amends Article 1(i) of Directive 98/78/EC.
[8] Article 29 (1) FCD, which amends Article 1 (21) of Directive 2006/48/EC.

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

24. The stocktakes of supervisors identified four aspects to the issue resulting from the interaction between the definitions of the FCD and the sectoral group supervision directives:

   a. certain tools of sectoral groups supervision may not apply to the whole group when it is determined as financial conglomerate;

   b. groups can affect the application of sectoral group supervision by their group structure;

   c. it may affect the use of Article 3 (3) of the FCD by supervisors in determining whether a group is a financial conglomerate; and

   d. a change in scope of sectoral group supervision can affect the continuation of waivers from group supervision that are applicable to sectoral sub-groups under sectoral directives.

25. The first aspect relates to the different tools available to supervisors under the FCD compared to those provided for by IGD and CRD. The objective of the FCD is to ensure that financial conglomerates are subject to appropriate supervision, which takes into account the risk stemming from their size and complexity. Therefore, the FCD aims to:

   a. build on existing sectoral supervision;

   b. avoid undue burdens for regulated entities with consistent application of supervisory tools; and

   c. be neutral on the effects of structure on the application of supervisory tools.

26. The following examples present some of the sectoral supervisory tools, which do not apply to the entire group with a holding company at the top after it is identified as a financial conglomerate[9]:

   a) Article 69 (2) CRD provides possibility to waive solo supervision with regard to Internal Governance (Article 22), minimum level of own funds (Article 75) and large exposures (Section 5) over credit institutions being subsidiaries of a FHC set up in the same Member State, under condition that the parent FHC is subject to the same supervision as exercised over credit institutions;

   b) Article 71 (2) CRD – credit institutions controlled by a parent FHC in a Member State shall comply with obligations laid down with Articles 75 (Pillar I), 120 (qualifying holdings outside the financial sector), 123 (Pillar II – ICAAP) on the basis of the consolidated financial situation of that FHC;

   c) Article 72 (2) CRD – credit institutions controlled by an EU parent FHC shall comply with the obligations regarding disclosure (laid down in Chapter 5) on the basis of the consolidated financial situation of that FHC;

   d) Article 211 (2b) SII – group supervision as envisaged by Articles 216 to 262 applies to (re)insurance undertakings the parent undertaking of which is an insurance holding company (IHC). Group supervision includes provisions on several areas such as solvency, risk management and internal control, supervisory reporting and public disclosure, fit and proper requirements, enforcement measures, and supervisory cooperation (group supervisor and colleges of supervisors);

[9] For more details please refer to definitions in Annex I and comparison of relevant provisions in Annex II

e) Article 213 (1) SII – concerning the level of application of group supervision: where the IHC is itself a subsidiary undertaking of another IHC, which has its head office in the Community, Articles 216 to 262 shall apply only at the level of the ultimate parent IHC, which has its head office in the Community;

f) Article 233 SII – concerning group solvency when the parent undertaking is IHC: for the purpose of the calculation the IHC is treated as if it were a (re)insurance undertaking;

g) Article 260 SII – public disclosure of the group report on the solvency and financial condition at the level of the group, also if headed by IHC;

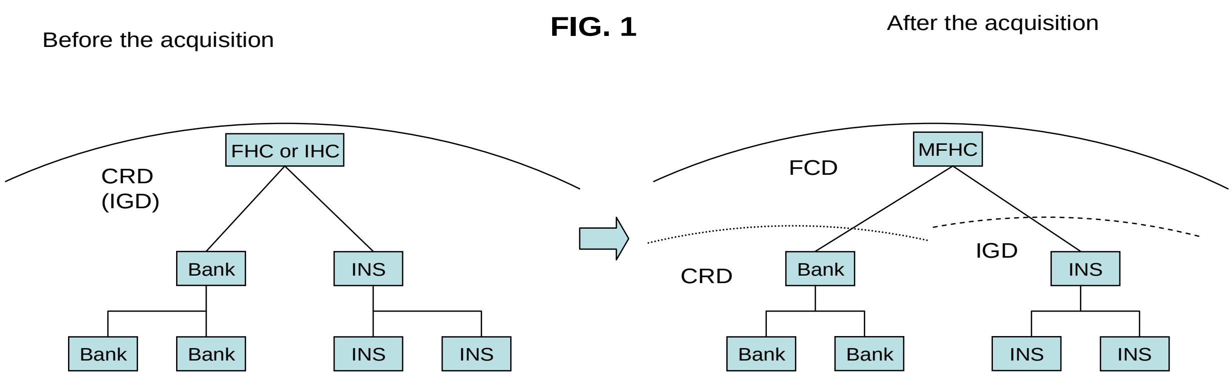
h) Article 261 SII – fit and proper requirements set up for (re)insurance undertakings (Article 42) are to be applied by analogy to IHC;

i) Article 262 (1 and 2) – concerning enforcement measures to be applied to IHC.

27. Since the tools available under the FCD and the sectoral regimes differ from one another, the interaction between the definitions of MFHC, FHC and IHC may prevent the objectives of the FCD from being achieved (in particular may prevent the FCD to be added to sectoral directives).

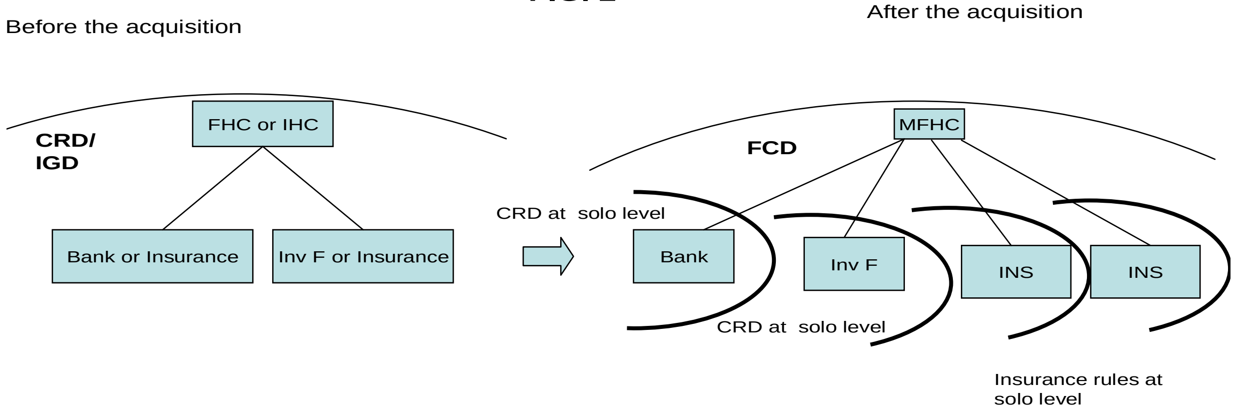
28. The two figures below demonstrate how the identification of a financial conglomerate can impact the application of sectoral group supervision differently, depending on the structure of the group.

FIG. 1



Before the acquisition, a holding company heads a group of regulated entities. Below the holding company, the banking sector is headed by a credit institution and the insurance sector by an insurer. If the holding company is a FHC, the group including the holding company will be covered by the sectoral group supervision for credit institutions under the CRD (according to Article 1 (2) CRD). If the holding company is an Insurance Holding Company (IHC), the group including the IHC will be covered by the IGD (according to Article 2 IGD). Articles 28 and 29 FCD amended CRD and IGD to address cross sector holdings.
When the group is identified as a financial conglomerate, for example after an acquisition, the holding company becomes a MFHC and is by definition no longer a FHC or IHC. The FCD will apply to the whole group, including the MFHC. However, even though the holding company has become a MFHC, the bank and insurance elements of the conglomerate will still be subject to sectoral group supervision because the sectoral elements beneath the MFHC level constitute banking groups and insurance groups headed by regulated entities instead of a holding company as before the acquisition.
In this case, after the acquisition, the FCD supplements the sectoral group regimes, which will apply from the first regulated entity beneath the MFHC and not from the top company of the whole group, as before the acquisition.

FIG. 2



> This group is subject to either of the sectoral group regimes set out in the CRD and the IGD depending on whether the entities below the holding are financial/banking entities or insurance entities.
>
> When the group is identified as a financial conglomerate, for example after an acquisition, the holding company becomes a MFHC and is by definition no longer a FHC or IHC. The FCD will apply to the whole group, including the MFHC. However, the regulated entities of the group are no longer subject to sectoral group supervision as these elements comprise solo regulated entities that are no longer headed by a sectoral holding company as it is now a MFHC and they do not have subsidiaries within the same sector as in Figure 1.
>
> In this case, the FCD appears to be a substitute for the banks' consolidated or insurance supplementary regime as they cease to apply in this structure.

29. Figure 1 highlights that the FCD may supplement sectoral group supervision after the creation of a financial conglomerate. Figure 2 highlights that sectoral group supervision could fall away automatically when the sectoral holding company becomes a MFHC after the creation of a financial conglomerate. This causes a situation where a group, which may have increased in size and complexity and represents greater risks, is subject to regulations (solo and FCD), which may not be as comprehensive as before the acquisition. The issue could be further complicated when the coordinator of the financial conglomerate is different to the supervisor of the sectoral group as a whole.

30. Second, Figure 1 and Figure 2 highlight that the application of sectoral group supervision and the level within a group, at which sectoral group supervision is performed, depends on the structure of the group. This puts cross-sectoral groups in a position to structure themselves in order to avoid sectoral group supervision (rather than for commercial considerations) if they were to be identified as a financial conglomerate.

31. Third, as a consequence, the interaction between the sectoral group supervision and the FCD (especially with respect to top holding companies) may change the nature of supervision. This can be a factor that supervisors consider when responding to the question of whether the group should be granted a waiver under Article 3 (3) FCD. This was considered in previous work carried out by the JCFC and further in Chapter 3.

32. A supervisor could choose not to apply supplementary supervision according to the FCD through the use of Article 3 (3) waiver in order to ensure that tools

available under IGD and CRD continue to apply at the top of the sectoral group (this is highlighted in Figure 2). This could result in:

a) additional prudential risks due to the increase of the group in size and complexity not being covered by the supplementary aspects of the FCD;

b) differences in treatment (based on the structure rather than on the risk profile) between conglomerates that are structured as in Figure 1 or in Figure 2. As said, in Figure 1 the application of the FCD from the top MFHC implies just a redirection of sectoral group supervision from the top regulated entity. For conglomerates structured as in Figure 2, the application of the FCD from the MFHC implies that the sectoral group supervision can not be applied unless the waiver is granted.

33. The fourth aspect relates to the interaction between the definitions in the FCD and the sectoral directives. A change in scope of sectoral group supervision can prevent the continuation of waivers from group supervision that are applied to sectoral sub-groups under sectoral directives. This presents a challenge to avoid duplication and unnecessary costs arising from applying sectoral group requirements at multiple levels of a group.

34. For example, the IGD permits supervisors to waive insurance sub-groups of an insurance group from sectoral group supervision. Supervisors have applied this waiver in order to avoid regulatory duplication that would arise, if the same directive were to be applied at multiple levels of the same group. However, becoming a financial conglomerate may lead to the discontinuation of such waivers. This is the case when a sectoral sub group becomes a standalone sectoral group and sectoral group supervision applies to these sub-groups.

35. If an insurance group has ten sub-groups in a horizontal structure before becoming a conglomerate, it could go from being subject to one IGD consolidation requirement to ten such requirements upon becoming a conglomerate. Thus, the group would be subject to a significantly greater supervisory burden that would generate few additional benefits. It is likely that this is an unintended effect of the interaction between the FCD and sectoral group directives.

36. 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 has sectoral sub groups that are located in different European jurisdictions.

37. The issues highlighted will not be resolved by Solvency II and the amendments to the CRD.

C. Issues assessment in relation to the objectives of the FCD

38. Currently, the way a group is structured can determine whether sectoral group supervision is applied or not. This allows scope for regulatory arbitrage as groups have the possibility to affect the group sectoral supervision they are subject to by changing their legal structure. In economic terms, this is a case of regulatory failure.

39. If relevant solutions are not introduced in the FCD, the problem identified will remain unsolved, which means that certain supervisory tools available under sectoral regimes would not be available at the top of a financial conglomerate (see also paragraph 22) and the scope of supervision could still be influenced

by a group structure. Supplementary supervision could also be avoided by groups if supervisors would use the Article 3 (3) waiver to retain sectoral supervision at the same level as previously.

40. The status quo does not promote convergence due to the risk of different solutions being introduced to address the issue of keeping in place certain supervisory powers available at sectoral level. It also allows distortions in terms of competition among financial conglomerates (un-level playing field) and introduces inconsistent sectoral concepts that cannot substitute for one another (terminology e.g. CRD –Large Exposures regime, Solvency II – Intra Group Transactions).

D. Possible solutions

41. Option 1 proposes to provide supervisors with the same supervisory powers over MFHC which were already in place for the holding company under the sectoral regimes before the identification of a group as financial conglomerate. Option 2 proposes the introduction of explicit supervisory powers over MFHC. The major distinction between those two options is that no new regulations need to be introduced under Option 1 since those already existing would be used. Option 2 would require new regulations for MFHC to be elaborated. Option 3 proposes that supervisors should be able to apply some supervisory tools available under sectoral directives at the conglomerate level. This would mean that in general MFHC would be treated as they are now, but in certain situations some powers (not all) applicable to groups headed by holding companies under sectoral directives could apply to groups headed by MFHC.

Options	Pro	Con
1. Legal changes – allow a holding company to be a MFHC and a FHC/IHC at the same time. Powers of the sectoral directives will continue to apply at the top holding company level when the group is identified as a conglomerate	• Powers of the sectoral directives will continue to apply at the holding company level at the top level within a group • Avoids inconsistent application between sectoral Directives and FCD because both can apply at the same level • Sectoral sub-group waivers continue to apply as the scope of sectoral supervision would remain unchanged • No expansion of scope (i.e. no new companies brought within scope of FCD regulation) • Structure neutral • Consistent application of supervisory powers to holding companies in the EU because the Article 3.3 waiver will not be used to maintain the scope of sectoral group supervision in relation to some groups. • Aligns the determination of the coordinator of consolidated supervision. Further, the determination of coordinator would be more consistent across financial conglomerates, banking and insurance groups.	• (Potential) duplication.

Options	Pro	Con
2 Legal changes – to provide additional explicit supervisory power to regulate MFHCs.	• Application of supervision at the top of the conglomerate • Effective supplementary supervision to be carried out through the holding company • Clarifies the application of conglomerates requirements to Mixed Financial Holding Companies • Equal treatment between non regulated entities and regulated entities (at top of group) • Group structure neutral • Consistent application of supervisory powers to MFHCs in EU	• Represents an increase in regulatory scope / burden which may not be justified by the issue • Giving additional explicit powers over a MFHC would not be consistent with the treatment of holding companies in the existing sectoral directives • Does not address the source of the problem identified in this chapter, namely that the scope of sectoral group supervision can change when a group is identified as a financial conglomerate.
3 Legal changes – to allow discretion to apply some of the requirements from the sectoral directives at conglomerate level.	• Could avoid duplication as the additional requirements would only be applied when needed, not automatically • Flexible as the additional requirements will not apply automatically • Risk based as the additional requirements are only applied in response to risk	• Lack of convergence, due to possible application of different requirements by different supervisors (even in the presence of similar groups) • Un-level playing field • Legal uncertainty for financial conglomerates • Does not address the source of the problem identified in this chapter that the scope of sectoral group supervision can change when a group is identified as a financial conglomerate. • Not structure neutral

E. JCFC Advice

42. Option 1 enables to remove the above mentioned shortcomings of the present legislation. Namely, the scope of supervision should be based on the risk profile and not on the structure of a group and supervisors do not need to use the Article 3 (3) waiver in order to retain supervisory powers over holding companies at the top of the group. It also addresses the source of the problem (which Options 2 and 3 do not), represents a significantly lower increase in regulatory burden than Option 2 and does not involve the risk of legal uncertainty (involved in Option 3). Moreover, Option 1 eliminates legal uncertainty since after a sectoral group is identified as a financial conglomerate, IHC or FHC becoming MFHC is still subject to the same supervisory regime.

43. Therefore, Option 1 removes most shortcomings and scope for regulatory arbitrage existing at present, and does not create new problems which would hinder the FCD achieving its objectives. The other two options solve existing problems only to a certain extent, and at the same time they may create new problems which are likely to prevent efficient supervision of financial conglomerates with holding companies at the top.

44. This recommendation is relevant to the recommendation and solutions for the issues discussed in chapter 3.

F. Consultation questions

Q1	**Do you agree with the above analysis?**
Q 2	**Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal.**

Chapter 3

The definition of "financial sector" (Article 2 (8)) and the application of the threshold conditions in Article 3

Overview

45. This chapter deals with the identification of financial conglomerates following the definition of "financial sector" (Article 2 (8) FCD) and the application of the threshold conditions in Article 3 FCD. Based on the current definitions, groups which are by their nature, scale and complexity exposed to group risks are not necessarily identified as financial conglomerate, whereas smaller groups, where the need for supplementary supervision according to the FCD is questionable in terms of their risk profile, may be regarded as financial conglomerates.

46. The analysis of the findings of the Mixed Technical Group[10] (MTG) and the previous stocktake of JCFC members identified that this presents an issue. There are three aspects in this area to be considered:

    1. Are Asset Management Companies (AMCs) according to the UCITS Directive to be included in the threshold tests for identification purposes given the potential implications that their inclusion might have on the relative dimensions of sectoral business within the group?
    2. If AMCs are to be included in the identification process, how should they be included?
    3. Are the threshold conditions as set by Article 3 (2) FCD (10%) and 3 (3) FCD (€6 bn) to be considered as sufficiently "risk based"?

47. The first aspect is related to Member States´ different interpretation of Article 30 FCD in combination with Article 2 (8) FCD leading to AMCs being either recognized in the identification of a financial conglomerate or only in the ongoing supervision of a financial conglomerate after identification.

48. How to include AMCs in the identification process is dealt with in the second aspect. In this regard, in some circumstances it may be reasonable to replace the "balance sheet total" criterion with other parameters like "income structure" and/or "off-balance-sheet activities" as envisaged in Article 3 (5) FCD. Also, for the purpose of calculating the size of the insurance and banking / investment services sectors during the identification exercise, it may be helpful to set out in more detail the criteria for using "income structure" and "off-balance-sheet activities".

49. The third aspect highlights the problem that the identification conditions set out in the FCD are not risk based. This can lead to the application of supplementary supervision that does not reflect the risks of contagion, complexity and concentration. As a result of the current identification criteria, supervisors cannot waive small (below €6 bn) but heterogeneous (above 10%) groups, even though their risk profile might justify exemption from conglomerate supervision. Waivers are available for large (above €6 bn) and homogeneous (below 10%) groups under Article 3 (3) FCD, but convergence in the application of this waiver may be helpful.

[10] The Mixed Technical Group was created by the European Commission and consisted of experts from regulatory and supervisory authorities for banking, insurance and securities, the European Commission (chair) and the European Central Bank (ECB)

Part 1. Inclusion of entities for the purposes of identifying a financial conglomerate

A. Relevant definitions and provisions of the Financial Conglomerates Directive

50.Article 2 (5) FCD defines AMCs by making reference to the UCITS Directive[11]. For the purposes of identifying a financial conglomerate, the definition of "financial sector" as envisaged in Article 2 (8) FCD is relevant; in this definition, AMCs are not explicitly mentioned.

51.Under Article 3 (2) FCD, the relative size of both the balance sheet and the solvency requirements of entities within the various financial sectors are assessed. This is in order to examine whether the group is sufficiently cross-sectoral to constitute a financial conglomerate.

52.According to Article 30 FCD, for the purpose of prudential supervision, AMCs are either included:

a) in the scope of sectoral group supervision, having applied mutatis mutandis to AMCs the relevant sectoral rules on the inclusion of **financial institutions** (where asset management companies are included in the scope of consolidated supervision of credit institutions and investment firms) or of **reinsurance undertakings** (where asset management companies are included in the scope of supplementary supervision of insurance undertakings);

b) in the scope of supplementary supervision under the FCD, having AMCs treated as part of whichever sector it is included in by virtue of (a) above.

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

53.Article 30 FCD requires AMCs that are subject to the UCITS Directive to be included in the sectoral group supervision and consequently within the supplementary supervision of a financial conglomerate. However, there is an issue as to whether the FCD requires such entities to be included when undertaking the threshold calculation set out in Article 3 (2) FCD as it is unclear whether this calculation should be done before or after allocating any AMC's business to one sector or the other. Presently, Member States do not apply the FCD homogeneously with regard to the inclusion of AMC in the identification process.

54.Some Member States interpret Article 30 FCD in such a way that AMCs are only relevant for the scope of consolidated or supplementary supervision but are not taken into account in the identification process of a financial conglomerate. Such an application is based upon Article 2 (8) FCD, which does not mention AMCs as part of the financial sectors.

55.Excluding AMCs from the identification process could distort the relative balance of either sector when carrying out the threshold calculation, making one sector appear artificially large in relation to the other.

[11] UCITS Directive 85/611/EEC

C. Issues assessment in relation to the objectives of the FCD

56. Currently, no homogeneous practice exists for the treatment of AMCs under the FCD, which can lead to an un-level playing field for financial groups in the European Union. Furthermore, the groups concerned do not have legal certainty whether they are a financial conglomerate or not.

57. One of the key benefits of the supplementary supervision according to the FCD is the surveillance of risk concentrations and systemic difficulties within large and complex groups. If a large conglomerate were to fail as a result of excessive (intra-group) concentrations, contagious losses that spilled across the wider group, or losses resulting from complex transactions or relationships within the conglomerate, this could lead to large negative externalities or even to a systemic crisis. As most complex groups have AMCs on their balance sheets, it seems inappropriate in terms of potential risks linked with those entities to exclude them in the identification process of financial conglomerates.

58. Not including certain entities will affect the identification of a financial conglomerate. The costs of supplementary supervision under the FCD may, or may not be, proportionate to the risks presented by a group. In conclusion, the definitions for determining which entities are included for the purposes of applying the threshold conditions can result in the FCD not achieving its objectives.

D. Possible solutions

59. The ambiguity of the present situation and the purpose of the FCD indicate that AMCs should be included in the identification process of a financial conglomerate. An inclusion can be achieved in two ways: (1) Either the FCD remains unmodified but guidelines will instruct supervisors to include AMC for identification purposes; or (2) the FCD is altered in a way that AMC are explicitly included in the identification process.

Options	Pro	Cons
1. **No legislative change, but guidelines** to clarify Article 3 (2) and Article 30 FCD, outlining that the threshold calculation should include AMCs.	• More convergence. • It clarifies the two stages of the identification process.	• Assumption that you can allocate the AMC to either sector. • Guidance might not be in line with already existing legislation in all Member States, so not effective – still not a full level playing field.
2. **Legislative change** to ensure the inclusion of AMCs for the purpose of identification**.**	• Legal certainty. • Convergence • More risk based	• Assumption that you can allocate the AMC to either sector.

E. JCFC advice

60. For this issue Option 2 of the table is recommended. Although both possible options will lead to convergence in the application of Article 30 FCD, the problem is more effectively addressed by Option 2. A legislative change will lead to legal certainty as regards the entities that have to be included in the

identification process. Pure guidance could contradict current national laws and therefore might not be sufficiently effective or leave room for national discretion.

61. Furthermore, legislative change provides a proportionate and risk based approach to the issue. AMCs can contribute to the complexity and risks of a group and should, therefore, play a role in the identification process. If it is clear under which circumstances a group is identified as a financial conglomerate, the management can better calculate the costs of the supplementary supervision under the FCD.

62. Both legislative change and guidance for including AMCs in the identification process probably cause additional costs for regulators, supervisors and the industry because the current legal situation in some Member States will have to change and the concerned parties adapt. But altogether the number of benefits through the legislative change prevails over the disadvantage of additional costs. Level 3 guidance describing how AMCs should be included in the identification process should be developed, but this recommendation is discussed further in Part 2.

F. Consultation questions

Q3 Do you agree with the above analysis?

Q4 Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal.

Part 2. How to include AMCs in the identification process - Allocation of AMCs to a particular sector and criteria for using income structure and off-balance sheet activities to determine the significance of the various financial sectors of a group.

A. Relevant definitions and provisions of the Financial Conglomerates Directive

63. The FCD does not prescribe how AMCs should be allocated between sectors in the identification process.

64. Article 3 (5) FCD sets out alternative criteria that can be used, in exceptional circumstances and by common agreement, for the purpose of determining the significance of the financial sectors of a group. These are income structure and off-balance sheet activities.

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

65. First, some Member States already include AMCs in the identification process. They do so by allocating the balance sheet values and solvency requirements of these AMCs to the insurance or banking / investment services sector when calculating the total size of the two sectors. However, this approach might give raise to different application of the FCD with respect to certain AMCs.

66. One could take the example of AMCs that are ancillary to insurance business. The FCD does not say whether these AMCs should be allocated to the insurance

or the banking / investment services sector for identification purposes. For supervisory purposes, the FCD leaves the allocation to either sector to the Member States / supervisory authorities. Consequently, the interpretation of Article 30 FCD can lead to uncertainty.

67. Second, the alternative parameters for considering the size of the insurance and banking / investment services sectors, off-balance sheet activities and income structure, allow flexibility in identifying a financial conglomerate. This enables supervisors to assess the risks posed by the group which may not be apparent in the balance sheet.

68. However, the FCD does not define the concepts of “balance sheet”, “on balance sheet”, “off balance sheet” and “income structure”, giving scope for interpretation of their meaning. This can lead to a degree of ambiguity and can result in the concepts being interpreted in ways that can result in the objectives of the FCD not being achieved.

69. The introduction of IFRS has created further ambiguity as different parts of a group may apply different accounting standards. Therefore, this raises questions about how the balance sheet is calculated for the purposes of identification.

70. The MTG agreed that it would be impossible to identify all scenarios in which it would be appropriate to apply the alternative threshold test criteria and that national legislation should not unreasonably restrict competent authorities in this area. It was also argued that there was some logic to using net income (gross income minus charges) rather than gross income data to reflect variations across the different sectors.

71. According to the previous JCFC stocktake, many Member States allow competent authorities to consider income structure and off balance sheet activities when assessing the significance of the smallest financial sector. However, few Member States have actually used this option when identifying financial conglomerates.

C. Issues assessment in relation to the objectives of the FCD

72. In conclusion, the allocation of AMCs to the insurance or banking / investment services sector and the use of the alternative parameters for assessing the significance of the sectors are important to enable supervisors to make an appropriate decision about whether the thresholds for being a financial conglomerate are met based on the business of the group.

73. However, the scope for interpretation of the methods in order to assess the significance of the financial sectors, together with the different combinations of methods that can be used, may result in the FCD not achieving its objectives.

74. This means that, subject to different interpretations, some sectoral groups might not be identified / supervised as financial conglomerates. Following a market and regulatory failure analysis based on the issues mentioned above, the most obvious failure is caused by diverging interpretations between Member States’ regulators which would not facilitate a level playing field for the industry. However, the potential for large negative externalities associated with the possibility of systemic instability may be considered as well. This may be the case, when relevant risks associated to financial conglomerates are not

included in the scope of supplementary supervision because of different interpretations.

D. Possible solutions

75. One possible solution for this issue is to change legislation in order to create greater legal certainty with respect to the application of the alternative identification criteria and the allocation of AMCs to different sectors. However, the significance of the issue is not clear as only a few Member States have used these alternative methods. Additionally, a legislative change risks creating more problems than can be solved primarily due to the difficulty of explaining the concept in a way that can adapt quickly to changes. Another solution would be to give extra guidance to clarify the concepts of income structure and off balance sheet activities and how AMCs should be allocated between the insurance and banking / investment services sectors.

Options	Pro	Cons
1. **Legislative change** to address the issue.	• Legal certainty. • Level playing field.	• Not proportionate to the materiality of the identified problem. • Lack of flexibility. • It is not clear how different legislation could address the issues without creating other problems. • Not risk-based.
2. **Providing extra guidance** to clarify (theoretically and operationally) the concepts of “income structure” and “off-balance sheet activities” including the circumstances we expect the concepts to be used by supervisors, and to clarify how AMCs should be allocated to the insurance and bank / investment services sectors.	• It goes at the core of the problem, clarifying concepts in an explicit way and therefore delivering new identification tools “ready-to-use” for supervisors. • Aid convergence. • Proportionate to the problem identified.	• Providing extra guidance could require an in-depth study of methods and their impact, potentially demanding in terms of time and preliminary research.

E. JCFC Advice

76. For this issue Option 2 is recommended. By providing extra guidance, the concepts of income structure and off-balance sheet activities in the context of the identification of financial conglomerates as well as criteria for allocating AMCs to different sectors can be clarified in a flexible way, giving supervisors tools ready to use. In contrast to the status quo, this helps to achieve convergence. Option 1 (legal change) could create additional burdens relative to the materiality of this issue. Also, it would be very inflexible. According to the stocktake conducted by the JCFC, only a few Member States have actually used the option to consider income structure and off-balance sheet activities in the identification of the financial conglomerates. Extra guidance might help Member States to use these alternative criteria which in some cases could be more risk based and more appropriate. This would help to minimize the possible negative externalities which could be caused by large groups (not identified as conglomerates) that could fail because of contagious losses.

F. Consultation questions

Q5	**Do you agree with the above analysis?**
Q6	**Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal.**
Q7	**Could you suggest what issues the guidance should address and provide evidence to support your suggestion?**
Q8	**For the purposes of potential guidance, what are the features of the activities of an AMC that you consider are relevant for determining the appropriate sector of that company**

Part 3. Should quantitative standard thresholds determine whether supplementary supervision applies to a group?

A. Relevant definitions and provisions of the Financial Conglomerates Directive

77. An issue related to the previous ones is whether the identification criteria are risk based and deliver the objectives of the FCD.

78. The current system for identifying financial conglomerates consists of two thresholds for assessing the significance of the activities exercised in the smaller financial sector. The relative threshold[12] is calculated by determining the average of the two following ratios: (i) solvency requirements of the smaller financial sector over total solvency requirements of all financial sector entities in the group and (ii) total assets of the smaller financial sector over total assets of all financial sector entities in the group. The other one is an absolute threshold[13]. Meeting the relative threshold leads to automatic identification of the conglomerate. The significance in absolute terms is perceived to be a smaller concern: meeting the absolute threshold only allows supervisors to evaluate whether to apply supplementary supervision according to the FCD or <u>not</u> to apply supplementary supervision. This evaluation can take into account the following criteria, set by Article 3 (3) FCD as examples:

   a. the relative size of the smallest financial sector does not exceed 5% as a proportion of the whole financial sector; or

   b. the market share of the group does not exceed 5% in any Member State, measured in terms of the balance sheet total in the banking or investment services sector and in terms of gross premiums written in the insurance sector.

79. The above criteria are designed to take account of the relative importance of the activity exercised in the smallest financial sector compared with all the activities exercised by the group and the significance of a particular conglomerate in the financial system of individual Member States.

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

80. Comments from the industry and supervisors have identified that the thresholds, particularly the €6 bn threshold, "per se" may not represent a risk based criterion which ensures that the FCD achieves its objectives of delivering supplementary supervision of complex financial groups.

81. The threshold mechanics are such that the automatic application of the FCD, if the 10% threshold is met, can result in very small groups being subject to mandatory supplementary supervision. This is the case even if their nature is such that the risks they pose to the system would not justify additional supplementary supervision or may be adequately accounted for in the requirements determined by sectoral directives.

82. This approach is justified by the implicit assumption that heterogeneous groups, even when they are very small in absolute terms, do need mandatory

[12] The average of the balance sheet / solvency requirements of the smaller financial sector exceeds 10% of the balance sheet / solvency requirements of all financial sector entities in the group.

[13] The balance sheet total of the smaller financial sector exceeds €6 bn.

supplementary supervision because heterogeneity in itself generates additional risks linked to the essence of financial conglomerates and not covered by sectoral directives.

83. In conducting its analysis, the JCFC analysed data of financial conglomerates, as at 31st December 2007. This has been used to build a diagram showing European financial conglomerates along the two dimensions in which thresholds are specified.[14] In the first picture (Chart 1), the whole distribution of conglomerates is observable; areas relevant for the present analysis have been painted in yellow and grey colour. The yellow area covers groups which are small in absolute size (<€6 bn), but very heterogeneous in their business activity (>10%). The grey area includes those groups which are very large in absolute size (>€6 bn), but have a smaller sector that is less relevant in relative terms (<10%).

84. Under the current legislative framework, only financial conglomerates situated in the grey area are eligible for waiver (i.e. supervisors might choose not to apply supplementary supervision), while all financial conglomerates above the 10% threshold are not (i.e. the application of FCD supplementary supervision is mandatory).

85. Previous JCFC work has shown that Member States tend to make similar decisions when considering the eligibility of groups for the waiver. This applies even though the FCD does refer to the criteria in paragraph 75 as examples and does not require Member States to strictly follow them in order to take a final decision. However, the waiver can be used with very different results. As shown in Chart 2, the waiver has been applied to some very large financial conglomerates and not to others that just meet the €6 bn threshold.

86. It is not possible to identify a trend in the application of the waiver from looking at the charts. Chapter 2 sets out some reasons why supervisors utilise the waiver even for big groups.

87. Any revision to the FCD should aim to:

   1. deliver more flexibility with respect to smaller financial conglomerates (yellow area in Chart 1); and

   2. address waiver eligibility for financial conglomerates which are above the €6 bn, but under the 10% relative threshold (grey area in Chart 1), to develop common criteria to assess risks posed by groups that are either heterogeneous or large / systemic and the appropriateness of supplementary supervision.

[14] The data used to make the diagrams is indicative only and is only intended to give an idea of distribution of EEA groups along the dimensions of absolute and relative significance of the smaller financial sector. The charts do not in any way suggest that the thresholds should change.

Chart 1

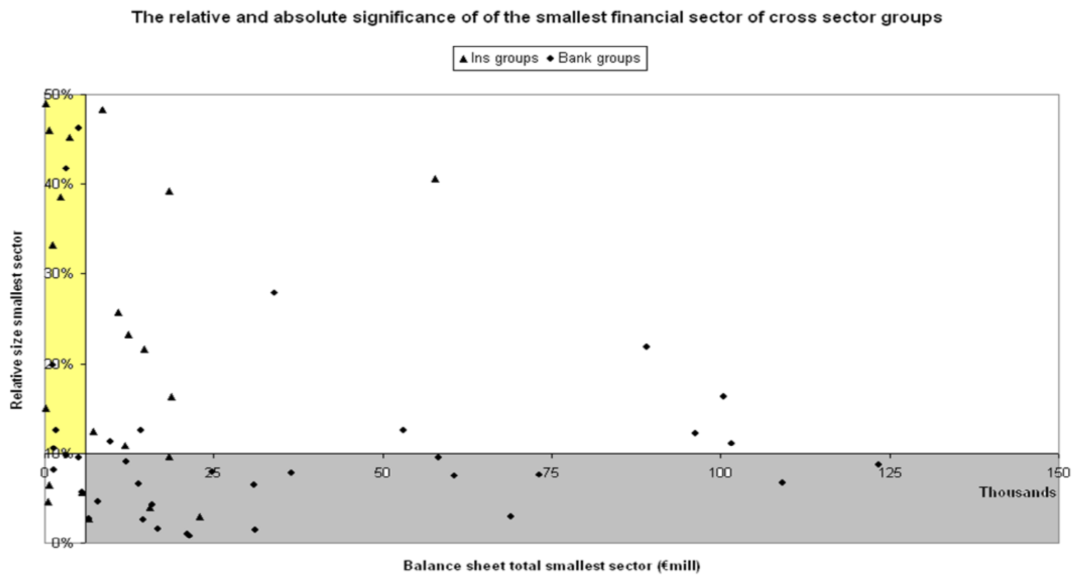
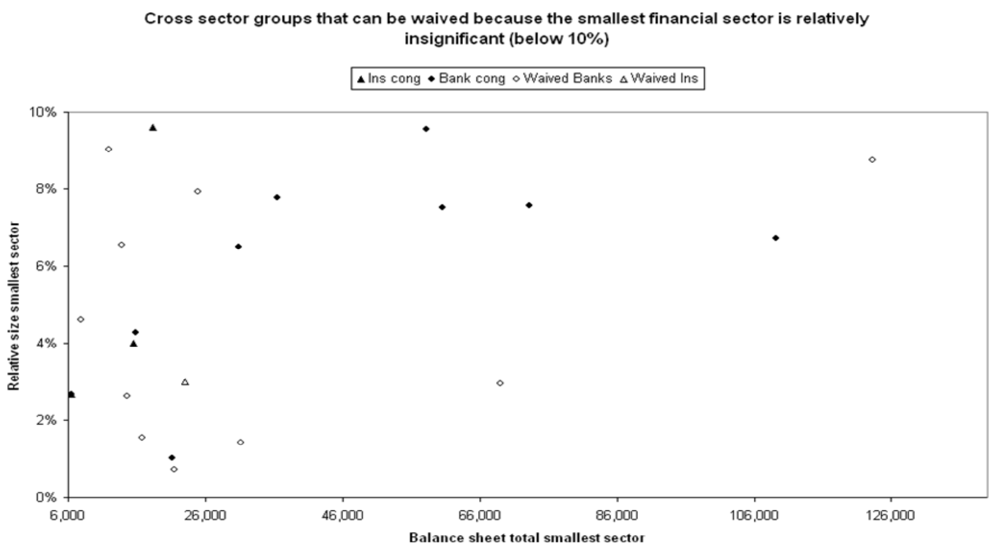


Chart 2



C. Issues assessment in relation to the objectives of the FCD

88. The industry and supervisors have identified that the criteria for determining a conglomerate are not sufficiently risk sensitive. The threshold conditions do not provide sufficient flexibility where it is needed (yellow area in Chart 1) and there is inconsistent use of flexibility where the waiver is allowed (grey area in Chart 1 and Chart 2). A discretional approach to supplementary supervision can be credible and non distortionary only if operated within transparent criteria and applied consistently across countries. For these reasons, the current legislative framework may result in the objectives of the FCD not being achieved.

89. Ineffective achievement of FCD objectives creates the potential for large negative externalities associated with the possibility of systemic instability if a large conglomerate were to fail directly because of losses resulting from improper treatment of risk concentration and/or complex intra-group transactions. Additionally, if differences in criteria for waiver eligibility among Member States' regulators are not clear to investors and potential conglomerates, it is possible that the true valuation of firms may be distorted and an un-level playing field may be created.

90. Keeping the current legislative framework unchanged is a viable option. The issue of consistent application of the Article 3 (3) waiver of eligible large financial conglomerates (see paragraphs 82 and 84) could be resolved without a legal change through the publication of appropriate guidelines from the JCFC. However, the issue of disproportionate treatment of very small financial conglomerates would not be tackled without a legal change. Hence at least part of the issues presented here would remain unsolved

91. To conclude, it is the application of the thresholds that is the issue rather than the thresholds themselves. The final objective is to avoid unnecessary burden on very small groups which do not pose any additional risk and/or systemic threat and to ensure that large and relevant financial conglomerates are assessed against common criteria for determining the benefits of supplementary supervision under the FCD.

D. Possible Solutions

Options	Pro	Con
(1) No legislative change but guidance (namely in relation to application of the waiver under Article 3(3) of the FCD. ***For this option refer to plot 1***	• May address the issue of consistent waiver application without requiring legislative change	• Supervisors would still not be able to waive the application of the FCD for smaller groups, while they can do it for larger conglomerates, therefore it would not always be risk based • It could fail to deliver cross-country convergence, if guidance is not applied consistently, and therefore causing an un- level playing field
(2) Change legislation to amend the mechanics of the **application** of thresholds and produce **Level 3 guidelines for applying the waiver under Article 3(3)**. Automatic identification would be triggered only if **both** threshold are met; if **only one** of them is met, the financial conglomerate would be eligible for waiver. ***For this option refer to plot 2***	• Makes application of the FCD more risk-based than current framework by providing tools to treat in a flexible way small financial conglomerates and to treat consistently large financial conglomerates • It leaves to guidelines the task of defining more detailed criteria for waiver eligibility, and guidelines are easier to keep updated. • It can be stated in a very clear and articulated way. • More legislative certainty • Facilitates more flexibility, e.g. enables easier update(s) • Simplification of current framework	• More room for waivers, so (potentially) might raise the risk of un-level playing field if there is a divergent use of the waiver (guidelines failure) • If guidelines are not sufficiently clear, transparent and with a well defined scope, the benefit of legislative change could be reduced
(3) Change the legislation to modify the parameters assessing the significance of the smallest financial sector for larger groups. This differs from option 2 as legislative text (rather than guidance) is proposed to rescale the thresholds to take account of the fact that the relative thresholds is less significant the larger the conglomerate is. Alternative criteria to the rescaling of threshold might also be considered. ***For this option refer to plot 3***	• Risk based • Legislative certainty • Relies less on guidelines to ensure convergence in the application of the FCD as the discretion to apply the waiver will be restricted compared with the current regime.	• Gauging appropriate parameters and bases for assessment could be a demanding task • Frequent updating of criteria for identification and waiver would not be possible as it is the FCD, not guidelines that restrict the use of the waiver as compared with the current regime.

Options	Pro	Con
(4) Change the legislation such that thresholds are not binding anymore, but remain as an indicative criterion to help supervisors decide whether or not to waive FCD requirements (i.e. groups that hold stakes in both sectors are, as a principle, considered to be financial conglomerates unless waiver is applied). In other words, waiver eligibility would be extended to cover all financial conglomerates above the existing thresholds. Production of Level 3 guidance could be considered to ensure uniform waiver policy. ***For this option refer to plot 4***	• Potentially risk based • More flexible • Proportionate approach could be ensured • It overcomes current discussion about appropriateness of the existing thresholds scheme.	• Legal uncertainty of application due to complete discretion in applying the waiver • Risk of un-level playing field if application is not consistent across Member States. • Lack of convergence unless extensive, clear and well defined guidance is delivered to supervisors across Member States. • It could raise bureaucratic cost/time consumption as the decisional process on waiver application could involve a case-by case examination for virtually all financial conglomerates.
(5) Change the legislation – to cancel waiver eligibility and introduce an **automatic absolute threshold system**. Every group trespassing one or more thresholds is automatically a financial conglomerate and cannot be waived. Given that there is no waiver, threshold would need to be adequately updated. ***For this option refer to plot 5***	• Simple to apply • Level playing field • Legal certainty • Clear	• Not risk based • Does not explicitly address the issues presented in the paper • No flexibility allowed. • Disproportionate/ burdensome

Graphical illustration of options

Note: The following plots are meant to help the reader in understanding the policy options presented in the previous table.

The current system of identification for financial conglomerate consists of two thresholds: one threshold (€6 bn) is posed on the balance sheet total asset value of the minority sector in the FC; the second threshold (equal to 10%) is posed on the average between the ratios of: (i) minority sector solvency requirement over financial conglomerate total solvency requirements and (ii) minority sector total assets over financial conglomerate total assets.

Representing the two thresholds on a Cartesian diagram, financial conglomerate can be represented by points in the plane, having their distance-to-threshold as their coordinates.

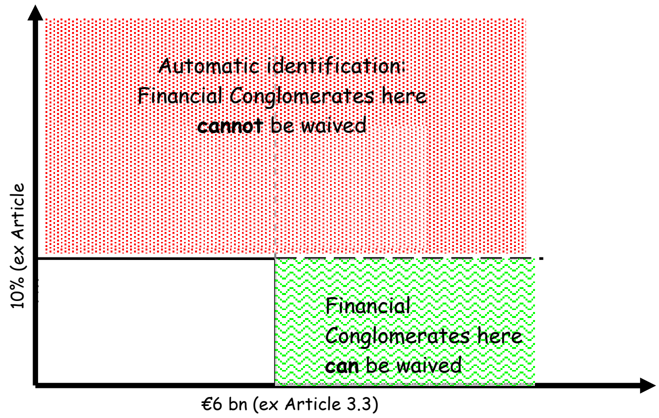
Colours:

***White area** represents the non-identification zone: groups below both thresholds are not considered to be a financial conglomerate.*

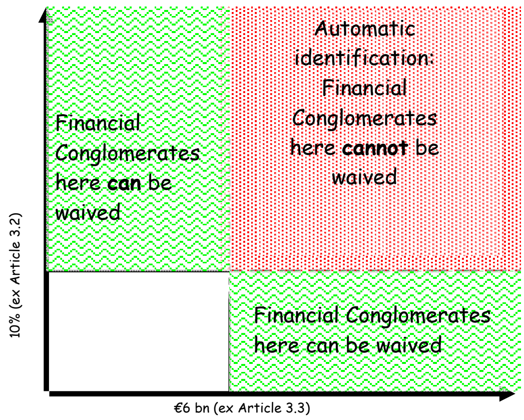
***Red area** represents the automatic identification zone: groups falling into this area are recognised as financial conglomerate and they get supplementary supervision as mandatory, i.e. with no possibility for waiver.*

***Green area** represents the discretional identification zone: groups falling into this area are recognised as financial conglomerate but supplementary supervision is at discretion of the supervision authority.*

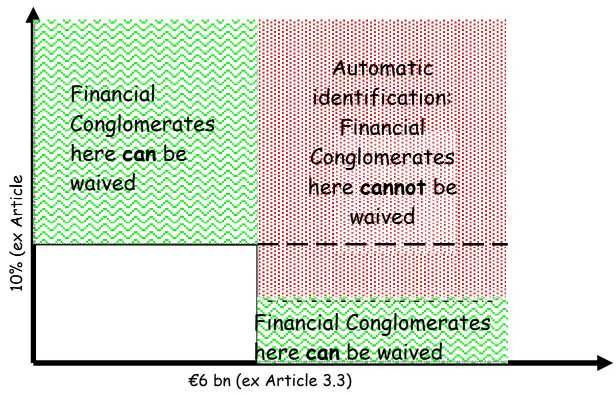
Plot 1: Thresholds identification: current scheme



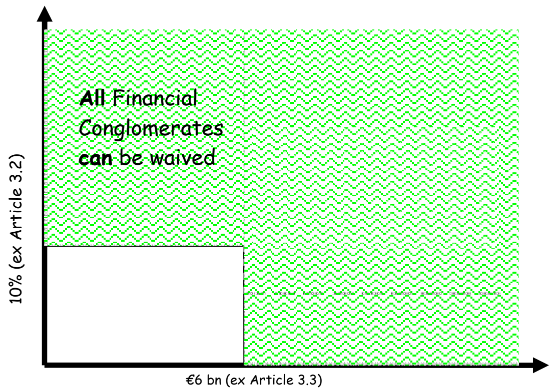
Plot 2: Thresholds identification: option 2



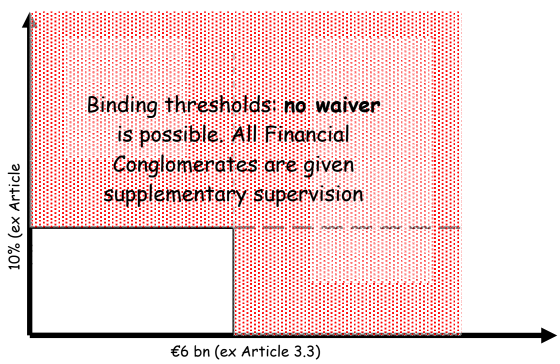
Plot 3: Thresholds identification: option 3



Plot 4: Thresholds identification: option 4



Plot 5: Thresholds identification: option 5



E. JCFC advice

92. Option 2 is recommended as it appears to offer an effective and flexible way to tackle both the issues presented in this section, i.e. it fulfils the need to have:

(i) a possibility to waive very small financial conglomerates (those in the yellow area in Chart 1); and

(ii) more consistent and coherent use of the waiver with respect to large conglomerates which do not meet the relative threshold according to Article 3 (2) FCD (those in the grey area in Chart 2), by requiring Level 3 guidance on waiver application.

93. The overall conceptual approach envisaged by Option 2 divides financial conglomerates into two classes: in one class we find those financial conglomerates which are very large in size (i.e. systemically relevant) and very heterogeneous in their business activity. These financial conglomerates cannot be eligible for waiver; supplementary supervision must be mandatory (red area in plot 2). In a second class we find those financial conglomerates which should not necessarily represent a risk of complexity, concentration or contagion given their homogeneity (<10% in the vertical axis, even if >€6 bn) or smaller size (<€6 bn in the horizontal axis, even if >10%) (green area in plot 2). Therefore these financial conglomerates should be eligible for the waiver; supplementary supervision would be exercised at the discretion of the supervisory authority according to criteria set out in guidelines.

94. This new conceptual framework behind the threshold system is aiming at making the FCD more risk-based and at the same time avoiding inconsistent and incoherent waiver application. Its key difference from the approach envisaged in Option 3 (which is very similar and tries to obtain the same results) is the choice of not inserting limitations to waiver eligibility directly in FCD text, but to leave this task to Level 3 guidelines. This could be a very positive feature insofar as it is adaptable, simple and permits the application of a waiver to groups that just meet the threshold criteria. It is also very different from the spirit of Option 4, which never prescribes mandatory supplementary supervision: even a very large and heterogeneous group could be, at least theoretically, eligible for waiver. Further, this could make the whole FCD more fragile and less credible. It is then also very distant from Option 5, which does not allow supplementary supervision to be waived for any group, even for groups that do not present additional risks due to their size or mix of business. Although this approach would render the FCD more powerful, it would create an unnecessary burden on groups without any substantial benefit for systemic stability.

95. For all these reasons Option 2 is the recommended option.

F. Consultation questions

Q9 Do you agree with the above analysis?

Q10 Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal.

Q11 Could you suggest what issues the guidance should address and provide evidence to support your suggestion?

Chapter 4

Implications of different treatments of participations for the identification and scope of supplementary supervision of financial conglomerates

Overview

96. This chapter analyses the issues arising from the concept of "participations" in the FCD and how its effects on the identification of financial conglomerates and their supplementary supervision may threaten the FCD achieving its objectives.

97. **Part 1**: The issues identified stem from the different interpretations of the definition of "participation" in Article 2 (11) FCD (particularly due to different interpretations of the term "durable link") in different Member States. This may cause the criteria for identifying financial conglomerates and the scope of conglomerate supervision to vary slightly across the EEA.

98. **Part 2**: The inclusion of participations in the scope of supplementary supervision may cause difficulties in cases where participations in the smaller financial sector are the sole trigger for the identification of a group as a financial conglomerate. This is the case where the group has no parent / subsidiary relationship in the smaller financial sector. Additionally, there may be differences as to how the balance sheet total and the solvency requirements of participations should be included for the purpose of identification and supervision of a financial conglomerate.

99. In order to overcome these difficulties, different solutions have been identified, namely the issuance of guidance on the durable link interpretation, guidance on the treatment of participations for identification purposes, legislative change to allow supervisors to exclude such participations for the purpose of identification and supervision or legislative change to replace the reference to the term "durable link" with references to the IAS concept of significant influence. Among these possibilities, guidance on durable link has been recommended, as well as amendment to FCD for allowing a more flexible treatment of the participations for identification purposes than provided by Article 3(4) of the FCD.

A Relevant definitions and provisions of the Financial Conglomerate Directive

100. The term "participation" is defined in the Capital Requirements Directive 2006/48/EC (Article 4 (10)), in the Insurance Group Directive 1998/78/EC (Article 1(f)), and in the FCD (Article 2 (11)) as (i) a participation within the meaning of 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, or (ii) the direct or indirect ownership of 20% or more of the voting rights or the capital of an undertaking. According to Article 17 Sentence 1 of the Fourth Council Directive, "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 (see Annex I).

Part 1 - The definition of participation in Article 2 (11) FCD and how the durable link criteria should be applied

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

101. While the numerical threshold of 20% does not pose any difficulty in the practical application, the third report of the JCFC Joint Task Force on Capital (Recommendations) pointed out that there exist different ways in which the "durable link" criterion is being applied domestically at sectoral group level as well as at conglomerate level.

102. Hence, it is indicated that there are different interpretations of "durable link" within the meaning of Article 17 Sentence 1 of Directive 78/660/EEC in place for FCD purpose. The box below summarises the main aspects on the durable link debate.

Durable link

The term "durable link" was introduced by the Fourth Council Directive of 25 July 1978 on the annual accounts of certain types of companies (Directive 78/660/EEC). It is used to qualify those holdings in other undertakings as participations (especially if a holding is below the 20% threshold) that create a *durable link* with these undertakings because they are intended to contribute to the company's activities.

The concept of participation is defined in the three "prudential" directives (Article 4 (10) of the Banking Directive, Article 1 (f) of the Insurance Group Directive, and Article 2 (11) of the Financial Conglomerates Directive (see Annex I), referring to the concept of "durable link" established in the Fourth Council Directive. However, neither of these directives nor the "Interpretative communication concerning certain Articles of the Fourth and Seventh Council Directives on accounting", Official Journal C 16, 20 January 1998, pages 5 to 12, provides further interpretative guidelines to the term "durable link".

Consequently, there is no common interpretation of the term "durable link" in the EEA. The following situations have been identified as examples where holdings under 20% may qualify as participations within the meaning of Article 2 (11) of the Financial Conglomerates Directive and Article 17 Sentence 1 of Directive 78/660/EC:

- the holder of the participation is represented in the governing bodies of the undertaking;
- the investor participates in policy making processes of the other undertaking;
- interchange of managerial personnel between both undertakings;
- commercial links between the undertakings (cross-selling, joint products and distribution lines) and intra-group transactions.
- some Member States have identified that a participating interest does not necessarily require the exercise of significant influence, being possibly applied in one of the cases where two companies (i) cooperate in the field of production, research and development; (ii) have long-term supply contracts and/or marketing agreements; or (iii) coordinate their behaviour on the markets.

The term "durable link" is not known in the International Accounting Standards as implemented by the Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (Official Journal of the European Union L 320/1, 29 November 2008). There are some terms that are comparable to the term "durable link" in the following Standards: IAS 24 (Related Party Disclosures), IAS 28 (Investments in Associates), and IAS 31 (Interests in Joint Venture). However, these definitions refer either to significant influence or control. More precisely, the equivalent term to "participation" in IAS 28 is "associated" and it is based on the concept of significant influence. IAS 28 includes guidelines as how to identify the existence of such significant influence (see Annex III).

Some of the criteria in IAS 28 used to determine whether a significant influence can be exercised are similar to those used by some countries to determine whether a durable link exists (e. g. representation on the board of directors or equivalent governing body of the investee; participation in policy-making processes, material transactions between the investor and the investee, interchange of managerial personnel). Both, the lack of a clear definition of durable link together with the IAS 28 guidelines on significant influence, have contributed to create confusion between both concepts.

However, an interpretation that requires a significant influence for the assumption of a durable link seems to be too restrictive. Furthermore, whereas for prudential purposes holdings of more than 20% are always presumed to be "participations" and durable link is the criteria to identify holdings below 20% as participations, for accounting purposes holdings of more than 20% are presumed to be participations (associates) but it is possible not to consider them as such if it can be proved that there is no "significant influence".

103. In addition, some industry representatives argue that the FCD should be more consistent by providing for one clear definition of participation, rather than two different definitions within Article 2 (11) and Article 2 (13) FCD. Further, the definition should also be consistent with the corresponding definition in the CRD and Solvency II.

104. The definition of "close links" in Article 2 (13) FCD includes a mention of another concept of participation meaning the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking. Although this definition is further completed with reference to control requirements, it explicitly excludes the consideration of participations below 20% based on the existence of durable links. Although Article 2 (13) FCD is only used for purposes of defining "intra-group transactions" (Article 2 (18) FCD), additional confusion is added.

C. Issues assessment in relation to the objectives of the FCD

105. In conclusion, the treatment of participations represents an obstacle to achieving the objectives of the FCD because the terms "participation" and hence "durable links" are interpreted differently across Member States. The absence of common interpretation may negatively impact the level playing field for financial conglomerates.

106. Maintaining the status quo would imply the permanence of the relevant drawbacks highlighted, namely un-level playing field, competitive distortion, lack of convergence and uncertainty as to how apply rules.

107. Following a market and regulatory failure analysis based on the issues mentioned above, the most obvious failure is caused by diverging interpretations by Member States' regulators that are not clear to the industry. However, the potential for large negative externalities associated with the possibility of systemic instability may need to be considered as well. This may be the case of relevant risks associated with financial conglomerates not included in the scope of supplementary supervision due to different interpretations / treatments of participations.

Part 2 - The treatment of participations in the identification of financial conglomerates.

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

108. There are three aspects affecting the identification of financial conglomerates that can arise from the definition of participation as set out in the FCD:

a) The inclusion of the participations in the scope of supplementary supervision may cause difficulties in cases where the participation in the smaller financial sector is the sole trigger for the identification of a group as a financial conglomerate. This is the case where the group has no parent / subsidiary relationship in the smaller financial sector.

b) The effect of the different treatments of regulated entities in which more than one regulated entity holds a participation

c) The basis on which participation is included in the calculation of the threshold conditions for being a financial conglomerate set out in Article 3 (7) FCD.

109. With respect to **aspect a):** According to Article 2 (12) FCD, a group is defined as a group of undertakings which consists of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a participation. Therefore, a financial conglomerate could consist of a regulated entity and a participation only, provided that the criteria in Article 2 (14) FCD are met. For instance, a conglomerate whose smaller financial sector consists of a participation only could be identified using the process set out in the FCD. It is possible that the identification process would not be sufficiently sensitive to the risks of complexity, contagion and concentration that such a group would represent.

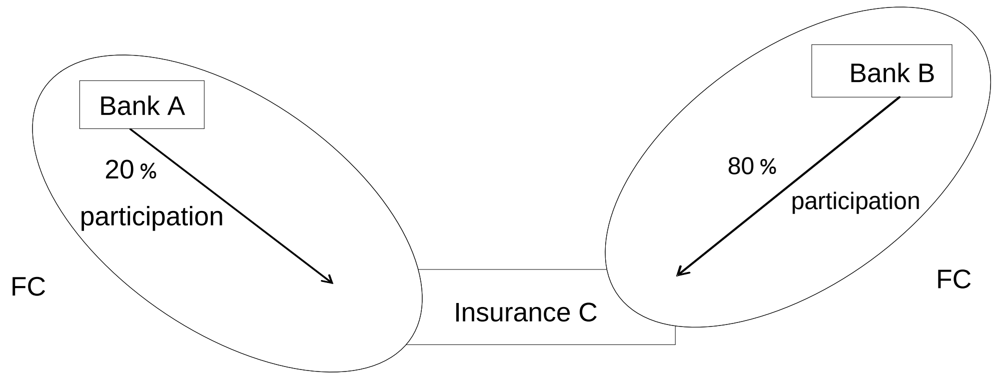
110. Article 3 (4) FCD states that the relevant competent authorities may by common agreement exclude an entity when calculating the ratios for identification purposes, in the cases referred to in Article 6 (5) FCD. Article 6 (5) FCD[15] refers to the capacity of the coordinator to exclude a particular entity in the scope when calculating the supplementary capital adequacy requirements in case the inclusion of the entity would be inappropriate or misleading with respect to the objectives of supplementary supervision.

111. Exclusion of an entity for the purposes of identifying a financial conglomerate presents different prudential considerations to exclusion under Article 6 (5) FCD. It may be inappropriate or misleading to include a participation in the identification where that participation is the only entity in the other sector. The reference in Article 3 (4) FCD to Article 6 (5) FCD can create problems of interpretation and expectation. Although a participation may be excluded from the identification, this may not mean that it should be excluded when calculating the supplementary capital requirements.

112. **With respect to aspect b)**, this issue is further complicated when, as illustrated below, a rigid application of these provisions could result in a single company (e.g. Insurance Company C) being part of two separate financial conglomerates, with resulting potential for inconsistencies and conflicting

[15] The criteria in Article 6 (5) FCD are replicated in Article 3 (3) IGD and Article 73 (1) CRD

demands as regards the supplementary supervision by two separate supervisory authorities. A less rigid application of these provisions could result in Company C just being part of one conglomerate. The example illustrates how inconsistent application of the term “participation” could lead to a situation where entities that are similar to Company C receive different treatments from different competent authorities, creating a competitive distortion between these entities.



1. Should Bank A and its 20 % participation in Insurance Company be considered as a ‘group’, and eventually as a financial conglomerate?
2. Bank B and its 80 % participation in Insurance Company C constitutes a group and may be considered an FC if the criteria are fulfilled.
3. How will supervision of the Insurance Company C be arranged if this entity is part of two separate Financial Conglomerates?

113. The inclusion of a participation in the scope of supplementary supervision is in line with the Insurance Group Directive 98/78/EC, where according to Article 2 (1) supervision of any insurance undertaking, which is a participating undertaking in at least one insurance undertaking, reinsurance undertaking, or non-member-country insurance undertaking, shall be supplemented in the manner prescribed in Articles 5 (risk management), 6 (flow of information), 8 (intra-group transactions) and 9 (solvency requirements)[16]. As a participating undertaking means an undertaking, which is either a parent undertaking or another undertaking which holds a participation (Article 1 (g)), a structure where a regulated entity holds a participation in another entity would qualify for supplementary supervision as envisaged in that directive.

114. Although this is also consistent with the definition of Parent Credit Institution in Member States for the banking sector (Article 4 (14) CRD), consolidated supervision in the banking sector is generally applied to all credit institutions and financial institutions, which are subsidiaries of a parent undertaking (Article 133 CRD). Participations in other entities of the financial sector must be either deducted or proportionally consolidated if certain criteria are satisfied. However, as an alternative to the deduction, Member States may allow their credit institutions to apply mutatis mutandis Methods 1, 2 or 3 of Annex I to the FCD for participations envisaged in Article 57 (o) & (p). Method 1

[16] The same is in Solvency 2 Directive (Article 211 (2) (a))

(accounting consolidation) may be applied only if the competent authority is confident about the level of integrated management and internal control regarding the entities, which would be included in the scope of consolidation (Article 59 CRD).

115. The inclusion of participations in the supplementary supervision also leads to the problem that an entity might be included in the risk management of several conglomerates (compare the aforementioned example of the insurance undertaking in which one bank holds a majority in the capital and another bank holds 20% of the capital). Here, it seems to be difficult to include an entity into two different risk management systems. Another problem that goes along with the inclusion of participations is that the top entity of the group cannot enforce the decisions based on the group-wide risk management system in the entities in which only a participation is held.

116. With respect to **aspect c)**, for the calculation of the cross-sectoral thresholds, Article 3 (7) FCD requires that calculations regarding the balance sheet shall be made on the basis of the aggregated balance sheet total of the entities of the group (according to their annual accounts). For the purposes of this calculation, undertakings in which a participation is held shall be taken into account as regards the amount of their balance sheet total corresponding to the aggregated proportional share held by the group. However, where consolidated accounts are available, they shall be used instead of aggregated accounts.

117. As regards the balance sheet and capital requirements of entities which are participations of a subsidiary, it remains unclear whether the value of the participation (e.g. if the subsidiary holds a 30% participation) or its value in respect of the proportion of the subsidiary (e.g. 30% x 80% = 24%, if a 30%-participation of a 80%-subsidary is concerned) is applicable. Even more, if consolidated accounts were to be considered as stated in Article 3 (7) FCD, the participation would be included following the equity method not representative of the balance sheet figures.

C. Issues assessment in relation to the objectives of the FCD

118. In conclusion, the treatment of participations represents an obstacle to the FCD achieving its objectives:

- Different interpretations of the term “participation” leads to a situation where similar types of participations are treated differently, some being included in the identification of conglomerates and some excluded, creating a competitive distortion between these entities;
- groups with no subsidiaries and one participation triggering the identification could be subject to the conglomerate regime;
- difficulties may arise out of the enforcement of the risk management system applied by the top entity of the group to a participated entity, especially when the latter is part of two separate conglomerates;
- the lack of clear understanding of how to treat participations of subsidiaries when calculating the threshold test adds further problems to determining whether it is appropriate to treat a group as a financial conglomerate.

119. Maintaining the status quo would imply the permanence of the relevant drawbacks highlighted, namely un-level playing field, competitive distortion, lack of convergence and uncertainty as to how apply rules.

120. Following a market and regulatory failure analysis based on the issues mentioned above, the most obvious failure is information asymmetry caused by diverging interpretations by Member States' regulators that are not clear to the industry. However, the potential for large negative externalities associated with the possibility of systemic instability may need to be considered as well. This may be the case of relevant risks associated with financial conglomerates not included in the scope of supplementary supervision due to different interpretations / treatments of participations.

D. Possible solutions to address issues highlighted in Part 1 and Part 2

121. After the description of the issues, the analysis of their importance and the evaluation of the need to solve them, it should be considered whether the problems identified may be solved without further regulatory changes. This may be the case for a) of Part 2, where the current wording of the FCD may be considered to provide a suitable solution for the issue.

122. The table below deals with issues highlighted in Part 1 and 2 of the paper - the definition of "durable link" and the treatment of participations for the purpose of identifying a conglomerate.

Description	Pros	Cons
1. **No legislative change, but extra guidance on** A) how the "durable link" criterion should be interpreted and applied B) how to include a participation in the calculations of the thresholds for financial conglomerates identification C) the exclusion of participations in other sectors, where there is no parent / subsidiary relationship in the smaller financial sector, for identification purposes[17]	• Achieves more harmonisation • Still allows Member States some room for risk based interpretation of the term "durable link", depending on the guidance • Makes decisions on participations transparent (comply or explain). • Can be made consistent with sectoral directives, legislation or guidance • Removes possible ambiguity of the application of Article 3 (4) and 6 (5) FCD	• Potential inconsistent supervisory implementation, unless guidance on how to induce application of Article 14 of the FCD is given. • It does not solve the issue of participations in relation to RC&IGT if guidance is not also adopted
2. **Legislative change** to allow supervisors to exclude cross sector participations from the identification exercise where there are no subsidiaries in the smaller financial sector.	• Supervisor can decide case by case on decision on application of FCD, based on risks, fairness, parent / subsidiary relationship, and proportionality • Addresses the issue • Removes possible ambiguity of the application of Article 3 (4) and 6 (5) FCD	• Un-level playing field between financial conglomerates with participations, and financial conglomerates with subsidiaries • financial No harmonisation of treatment of participations • May be disproportionate

[17] For example, in case a bank has a participation in an insurer, and this is the only involvement that the group has in the insurance sector, the insurer could be excluded from the identification process. As a result the group would not be treated as a financial conglomerate.

E. JCFC Advice

123. Recommended option for Part 1: **option 1 A. No legislative change, but extra guidance on how the "durable link" criterion should be interpreted and applied**. It is considered the most proportionate solution allowing for higher levels of harmonization while preserving some flexibility and maintaining consistency with reference made to "durable link" in banking and insurance directives.

124. Recommended option for Part 2 aspect a) and b): **Recommendation is option 2: There should be scope not to treat a group as a financial conglomerate where the group has only participations in the smallest sector.** Article 3 (4) FCD does not provide enough clarity because of its interaction with Article 6 (5) FCD, and therefore it is recommended to amend the FCD to clarify that a supervisor can exclude a participation in the smaller sector from the identification exercise if it is the sole trigger for such identification and if it is adequately captured under sectoral supervision.

125. Recommended option for Part 2 aspect c): **option 1 B No legislative change, but extra Level 3 guidance on how to include a participation in the calculation of the thresholds for financial conglomerates identification**. The proposal of any legislative change to solve this issue would be disproportionate.

F. Consultation questions

Q12 Do you agree with the above analysis?

Q13 Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal.

Q14 Could you suggest what issues the guidance should address and provide evidence to support your suggestion?

Chapter 5

The treatment of "participations" in respect of risk concentrations (RC) and intra-group transactions (IGT) supervision and internal control mechanisms (respectively, Articles 7, 8 and 9 of the FCD)

Part 1. The treatment of Participations in respect of RC and IGT

Overview

126. Since financial conglomerates tend to have no control over participations in the context of supervising RC and IGT, they may not have access to information that would be of interest to the supervisor. The industry has confirmed that financial conglomerates have difficulties obtaining all information on participations required by the FCD.

127. Another important point for supervisors is the supervision of RC and IGT that involve unregulated group entities.

128. Also, it appears to be unclear how quantitative data on participations should be weighted for the purpose of inclusion in group reports on RC and IGT. It is recommended that extra guidance should be developed to clarify how the Directive should be applied to address these issues.

A. Relevant definitions and provisions of the Financial Conglomerates Directive

129. Once a group is identified according to the FCD, supplementary supervision of the regulated entities at the top of the conglomerate or under the roof of a mixed financial holding company consists of supplementary capital adequacy at the group level and a group-wide risk management, in particular with respect to risk concentrations and intra-group transactions. While in the calculation of the supplementary capital adequacy regulated and non-regulated financial sector entities are included[18], the management of risk concentrations and intra-group transactions should also include non-financial entities within the group.

130. According to Article 2 (19) FCD, "Risk concentration" shall mean all exposures with a loss potential borne by entities within a financial conglomerate, which are large enough to threaten the solvency or the financial position in general of the regulated entities in the financial conglomerate; such exposures may be caused by counterparty risk / credit risk, investment risk, insurance risk, market risk, other risks, or a combination or interaction of these risks.

131. Additionally, in accordance with Article 2 (18) FCD, "Intra-group transactions" shall mean all transactions by which regulated entities within a financial conglomerate rely either directly or indirectly upon other undertakings within the same group or upon any natural or legal person linked to the undertakings within that group by "close links", for the fulfilment of an obligation, whether or not contractual, and whether or not for payment.

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[18] In the case of a non-regulated financial sector entity, the notional solvency requirement means the capital requirement with which such an entity would have to comply under the relevant sectoral rules as if it were a regulated entity of that particular financial sector; in the case of asset management companies, solvency requirement means the capital requirement set out in Article 5a (1(a)) of Directive 85/611/EEC; the notional solvency requirement of a mixed financial holding company shall be calculated according to the sectoral rules of the most important financial sector in the financial conglomerate.

132. In Articles 7 (1) and 7 (2) (for RC) and in Articles 8 (1) and 8 (2) (for IGT) the FCD addresses the scope of application of supplementary supervision of RC and IGT of regulated entities in a financial conglomerate, which shall be exercised in accordance with the rules laid down in Articles 9 (2) to 9 (4) and in Annex II. In particular, the FCD requires that:

i. the head of the financial conglomerate, be it a regulated entity or a mixed financial holding company, shall report on a regular basis to the coordinator any significant RC and IGT which will provide for the supervisory overview of such RC (Articles 7 (1), 7 (2), 8 (1) and 8 (2));

ii. the coordinator, in consultation with the other Relevant Competent Authorities[19], shall identify the type of risks and transactions to be reported and, for that purpose, will take into account the specific group and risk management structure of the financial conglomerate (Annex II);

iii. all undertakings included in the scope of supplementary supervision in application of Article 5 (i.e. the regulated entities referred to in Article 1), must have adequate internal control mechanism for the production of any data which would be relevant for the purposes of supplementary supervision (meaning, information and accounting procedures to identify, measure, monitor and control RC and IGT, as required under Articles 9 (3) (b) and 9 (4) FCD).

133. According to Articles 7 (2) and 8 (2) FCD any significant RC or IGT at the level of the financial conglomerate has to be reported on a regular basis. The Directive also envisages the possibility of setting quantitative or qualitative limits, or taking other supervisory measures, with regard to RC and IGT (Articles. 7 (3) and 8 (3) FCD). In fact, Annex II of the FCD states that in order to identify significant RC and IGT to be reported, appropriate thresholds based on regulatory own funds and/or technical provisions will be determined by the coordinator, after consulting with the relevant competent authorities and the financial conglomerate itself.

134. Notwithstanding such general provisions, in relation to IGT the FCD states that, pending the determination of the thresholds mentioned above, IGT are presumed to be significant when their amount exceeds 5% of the capital adequacy requirement at conglomerate level.

135. As mentioned above, the FCD establishes, without prejudice to the sectoral rules, supplementary supervision of RC and IGT of regulated entities in a financial conglomerate. Consequently, Member States shall require regulated entities or mixed financial holding companies to report on a regular basis significant RC and IGT at the level of the financial conglomerate.

136. When reviewing RC and IGT supervisors shall in particular monitor the risk of contagion, the risk of a conflict of interests, the risk of circumvention of sectoral rules (regulatory arbitrage), and the level or volume of risks.

137. The scope of application envisaged by the FCD, including for RC and IGT monitoring, is wide as it encompasses not only entities which are under control of a financial conglomerate parent undertaking, but also entities in which the conglomerate has a participation (but which it does not control). Such scope

[19] Article 2 (17) FCD defines Relevant Competent Authorities

stems from the combination of Articles 2 (14), 2 (12) and 2 (11) FCD (definition of “financial conglomerate”, “group” and “participation”, respectively).

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

138. The question arising from the FCD in the context of RC and IGT supervision (and reporting) is how to handle such participations, as several issues could be raised in this regard, such as how to:

1. access all the relevant information (see paragraphs 136);
2. treat participations which are unregulated entities (see paragraph 138);and
3. treat exposures arising from participations (see paragraph 139).

139. Article 14 (1) FCD states that Member States shall ensure that there are no legal impediments preventing the exchange of relevant information between all the entities in the financial conglomerate, regulated or not. Also, Article 14 (2) FCD sets the possibility that supervisors can ask both regulated and unregulated entities for relevant information for the purposes of supplementary supervision. In spite of such provisions, when the conglomerate has no control over an entity, as in the case of participations, it may not be able to obtain (or have access to) the necessary information from such firms even though this information may be relevant from a supervisory perspective. In the case of IGT, access to all relevant information stemming from participations could even be more pertinent, as in some cases it could be useful that the transactions between two participations are also assessed.

140. Industry respondents have confirmed that it is hardly feasible to comply with the information requirements, particularly in the area of risk concentrations, since minor participations have no right to ask for disclosure of relevant data, and minority participations cannot be legally forced to deliver information.

141. The matter of participations is also relevant when such firms are unregulated entities which could cause further difficulties in the application of the FCD’s RC and IGT provisions. In fact, there is some preliminary evidence of different treatment of such entities when no information regarding RC and IGT is available.

142. Another issue connected with the treatment of participations, but going beyond the mere availability of (access to) relevant data, relates to how exposures arising from entities qualified as participations should be considered for RC and IGT supervision and reporting. Particularly, there could be some doubts if such exposures should be considered in the same percentage used for the computation of capital adequacy at the conglomerate level (on the one hand, this issue seems to be more relevant when limits on RC are in place and when such participations are included in the computation of the capital adequacy of the financial conglomerate; on the other hand, it could be considered to be further mitigated when assessing/supervising RC from a qualitative perspective, namely when there are no hard limits which have to be met).

143. The aforesaid issues arising from “participations” in the context of RC and IGT have been mainly highlighted by supervisory authorities, largely reflecting

difficulties in the application of the relevant provisions of the FCD, although they have tried to overcome them.

144. Nonetheless, in the context of RC and IGT, some other aspects were advocated by the industry:

a. the deletion of Articles 7 (3) and 8 (3) FCD which concern the possibility given to supervisory authorities to set quantitative limits, on the basis that such strict and generally applied quantitative limits do not take into account the developments on internal risk management systems and/or are not risk-based and/or do not differentiate types of RC and IGT. In the same vein, and specifically on IGT, it is proposed that the default definition of materiality (e.g. 5% of capital adequacy requirements) should be increased to remove the need to report routine transactions;

b. clarification on whether the concept of IGT under the FCD covers inter-sectoral transactions (between entities belonging to different sectors) as well as intra-sectoral transactions (between entities belonging to the same sector), mentioning that, in order to avoid duplication and additional burden to financial conglomerates, only the former should be relevant.

C. Issues assessment in relation to the objectives of the FCD

145. The development of supplementary prudential legislation for financial conglomerates is aimed to address loopholes in the existing sectoral legislation and at the same time to ensure sound supervisory arrangements with regard to financial groups with cross-sectoral financial activities. To this end consistent application of the principles envisaged by the FCD is of major relevance.

146. In general, the provisions of Articles 7 (RC) and 8 (IGT) of the FCD could be considered as delivering the objectives of the FCD. In this context, the issues identified in paragraphs 136 to 139 above essentially reflect difficulties arising from the practical implementation of such provisions in certain circumstances and, as such, the objectives of the FCD would only be hampered to the extent the solutions to overcome them substantially diverge.

Part 2 - The treatment of Participations in respect of internal control mechanisms and risk management processes

Overview

147. Problems might arise with regard to the implementation of risk management and internal controls in participations, because the participations are not controlled. These issues could be further complicated if an entity is to be included in the risk management of several conglomerates.

148. It is recommended that extra guidance should be developed to clarify how the Directive should be applied to address these issues.

A. Relevant provisions of the Financial Conglomerates Directive

149. The FCD requires that regulated entities should have in place adequate risk management processes and internal control mechanisms at the level of the financial conglomerate, including sound administrative and accounting procedures (Article 9 (1) FCD).

150. On the one hand, risk management processes shall include (i) sound governance and management and periodical approval/review of the strategies and policies in respect of all the risks the financial conglomerate assumes, (ii) adequate capital adequacy policies and (iii) adequate procedures to ensure that risk monitoring systems are well integrated into the organisation and implemented in all the undertakings included in the scope of supplementary supervision (Article 9 (2) FCD).

151. On the other hand, the internal control mechanisms shall include (i) adequate mechanisms as regards capital adequacy to identify and measure all material risks incurred and (ii) sound reporting and accounting procedures to identify, measure, monitor and control RC and IGT (Article 9 (3) of the FCD).

B. Issues identified and consequences of FCD provisions in relation to the objectives of the FCD

152. The treatment of participations is also relevant in the context of Article 9 FCD, namely as regards enforcement for the implementation of adequate internal control mechanism in entities within the scope of a financial conglomerate but which are not controlled.

153. Article 9 FCD envisages that regulated entities within the financial conglomerate should have in place adequate risk management processes and internal control mechanisms at the level of the financial conglomerate, including sound reporting and accounting procedures to identify, measure, monitor and control RC and IGT.

154. Regarding the application of the FCD, the issue here concerns problems that might arise with regard to the enforcement of such requirements in relation to an entity which is not controlled (a participation), or even when there is co-ownership (including the situation when one entity is part of more than one financial conglomerate). This is a topic highlighted by supervisors who would need to assess the specific circumstances of the financial conglomerate and its participations to determine how to implement such requirements and who has the ability (i.e. control) to implement them.

155. In the context of verifying the practical implementation of Article 9 FCD, some supervisors note that the issues identified do not significantly diverge from those issues arising in sectoral groups and that the more sectoral legislation converges, the less problematic the qualitative assessment of risk management processes at the level of financial conglomerates will be (e.g., amongst the issues noted is the need for groups to move towards a more comprehensive and integrated risk management approach).

156. The inclusion of participations in the supplementary supervision also leads to the problem that an entity might be included in the risk management of several financial conglomerates. This issue may arise in the situation illustrated by the example in Part 2 of chapter 4, where Bank B holds 80% of the capital in Insurer C and the Bank C 20% of the capital. It may be difficult to include an entity into two different risk management systems.

C. Issues assessment in relation to the objectives of the FCD

157. The existence of adequate risk management processes and internal control mechanisms, consistently implemented throughout a group, is essential both for sectoral / homogeneous groups as well as for financial conglomerates. Therefore, the issues noted above primarily reflect an effective practical

difficulty in applying a requirement of the FCD, as parent companies would be unable to enforce it with respect to a non-controlled undertaking.

D. Possible solutions to the issues in Part 1 and 2

Description	Pros	Cons
1. no legislative change but Extra Level 3 guidance to clarify how the Directive should be applied to address the issues relating to supervising participations in the context of supervising RC&IGT&IC	• Prescribe a methodology for weighting participations in the context of supervising RC&IGT • Member States would have the flexibility to implement a risk-based approach to the supervision of participations in the context of RC&IGT&IG • The supervision of participations in the context of RC&IGT&IC would be more transparent than currently • The issues relating to the supervision of RC&IGT would be addressed within the supervisory community • The guidance could be more easily amended to take account of future sectoral developments than the FCD itself • The guidance could provide a basis for dealing with co-ownership	• Not legally binding, so would not force supervisory convergence in the same way as legislative amendments to the FCD however the comply or explain principle will be applicable
2. Legislative change - **Specific provision** to allow participations to be excluded from IGT/RC/IG following Article 6 (5).	• Flexible	• Un-level playing field • Lack of convergence • Disproportionate • Does not address the issue

E. JCFC advice to address the issues in Part 1 and 2

158. It is recommended that a more transparent and risk-based approach to the supervision of participations in the context of RC, IGT and IC should be promoted.

159. This approach should lead to a common understanding both in terms of a common methodology for weighting participations regarding RC and IGT and a common basis for dealing with co-ownership.

160. Besides, to take into account future sectoral developments on these issues, some Level 3 guidance rather than legislative changes in the FCD should be favoured. For instance, a legislative change would not necessarily solve the rather practical problem of obtaining information from or implementing group-wide governance arrangements in non controlled participations. Article 14 FCD already intends to create a legal basis for obtaining information from such entities. Therefore, Option 1 in the table above is recommended.

F. Consultation questions

Q15	**Do you agree with the above analysis?**
Q16	**Do you agree to the proposed recommendations? (Yes / No)** **If No, please elaborate on your alternative proposal.**
Q17	**Could you suggest what issues the Level 3 guidance should address and provide evidence to support your suggestion?**

Annex I DEFINITIONS

Definitions	Financial Conglomerates Directive (2002/87/EC) – FCD	Capital Requirements Directive 14th June 2006 (2006/48/EC) - CRD	Directive 98/78/EC on the supplementation supervision of Insurance undertakings in an insurance group	Seventh Council Directive of 13 June 1983 on consolidated accounts (83/349/EEC) – 7th Consolidated Accounts Directive	Fourth Council Directive of 25 July 1978 on the annual accounts of certain types of companies	Solvency 2 Directive (as approved by Parliament and ECOFIN – wait for formal publication including numbering)
"control"	**Article 2 (13)** (within the definition of "close links") (b) "control", which shall mean the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 1(1) and (2) of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking; any subsidiary undertaking of a subsidiary undertaking shall also be considered a subsidiary of the parent undertaking which is at the head of those undertakings.	**Article 4 (9)** "control" means the relationship between a parent undertaking and a subsidiary, as defined in Article 1 of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking;				**Article 13 (15)** "control" means the relationship between a parent undertaking and a subsidiary undertaking, as set out in Article 1 of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking;
"participation"	**Article 2 (11)** "participation" shall mean a participation within the meaning of 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, or	**Article 4(10)** "participation" for the purposes of points (o) and (p) of Article 57, Articles 71 to 73 and Title V, Chapter 4 means participation within the meaning of the first sentence of Article 17 of Fourth Council Directive 78/660/EEC of 25 July	**Article 1 (f)** "participation" means participation within the meaning of Article 17, first sentence, of Directive 78/660/EEC (9) or the holding, directly or indirectly, of 20 % or more of the voting rights or capital of an undertaking;		**Article 17** "participating interest" in - For the purposes of this Directive, "participating interest" shall mean rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link	**Article 13(16)** Participation means the ownership, direct or by the way of control, of 20% or more of the voting rights or capital of an undertaking. **Article 210(2)** For the purpose of [group supervision...supervisors] shall consider as participation

	the direct or indirect ownership of 20 % or more of the voting rights or capital of an undertaking;	1978 on the annual accounts of certain types of companies, or the ownership, direct or indirect, of 20 % or more of the voting rights or capital of an undertaking;	**Article 1 (g)** "participating undertaking" means an undertaking which is either a parent undertaking or another undertaking which holds a participation.		with those undertakings, are intended to contribute to the company's activities. The holding of part of the capital of another company shall be presumed to constitute a participating interest where it exceeds a percentage fixed by the Member States which may not exceed 20 %.	the holding directly or indirectly of voting rights or capital in an undertaking over which, in the opinion of supervisory authorities, a significant influence is effectively exercised.
"parent undertaking"	**Article 2 (9).** "parent undertaking" shall mean a parent undertaking within the meaning of Article 1 of Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts and any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking;	**Article 4 (12)** a parent undertaking as defined in Articles 1 and 2 of Directive 83/349/EEC; or for the purposes of Articles 71 to 73, Title V, Chapter 2, Section 5 and Chapter 4, a parent undertaking within the meaning of Article 1(1) of Directive 83/349/EEC and any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking;	**Article 1(d)** "parent undertaking" means a parent undertaking within the meaning of Article 1 of Directive 83/349/EEC (8) and any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking;	**Article 1 (1)** A Member State shall require any undertaking governed by its national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking):		
"subsidiary"	**Article 2 (10).** "subsidiary undertaking" shall mean a subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC and any undertaking over which, in the opinion of the competent authorities, a parent undertaking effectively exercises a dominant influence; all subsidiary undertakings	**Article 4 (13)** A "subsidiary" means a subsidiary undertaking as defined in Articles 1 and 2 of Directive 83/349/EEC; or for the purposes of Articles 71 to 73, Title V, Chapter 2, Section 5, and Chapter 4 a subsidiary undertaking within the meaning of Article 1(1) of Directive 83/349/EEC and any undertaking over which, in the opinion of	**Article 1 (e)** "subsidiary undertaking" means a subsidiary undertaking within the meaning of Article 1 of Directive 83/349/EEC and any undertaking over which, in the opinion of the competent authorities, a parent undertaking effectively exercises a dominant influence. All subsidiaries of subsidiary undertakings shall also	**Article 1 (1)** (a) has a majority of the shareholders" or members" voting rights in another undertaking (a subsidiary undertaking); or (b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking)		

	of subsidiary undertakings shall also be considered as subsidiary undertakings of the parent undertaking;	the competent authorities, a parent undertaking effectively exercises a dominant influence. All subsidiaries of subsidiary undertakings shall also be considered subsidiaries of the undertaking that is their original parent;	be considered subsidiaries of the parent undertaking which is at the head of those undertakings;	and is at the same time a shareholder in or member of that undertaking; or (c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or Articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for such contracts or clauses shall not be required to apply this provision; or (d) is a shareholder in or member of an undertaking, and: (aa) a majority of the members of the administrative, management or supervisory bodies of that undertaking (a subsidiary undertaking) who have held office during the financial year, during the preceding financial		

				year and up to the time when the consolidated accounts are drawn up, have been appointed solely as a result of the exercise of its voting rights; or (bb) controls alone, pursuant to an agreement with other shareholders in or members of that undertaking (a subsidiary undertaking), a majority of shareholders' or members' voting rights in that undertaking. The Member States may introduce more detailed provisions concerning the form and contents of such agreements. The Member States shall prescribe at least the arrangements referred to in (bb) above. They may make the application of (aa) above dependent upon the holding's representing 20 % or more of the shareholders' or members' voting rights. However, (aa) above shall not apply where another undertaking has the rights referred to in subparagraphs (a), (b) or (c) above with regard to that subsidiary		

				undertaking. 2. Apart from the cases mentioned in paragraph 1 above and pending subsequent coordination, the Member States may require any undertaking governed by their national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking) holds a participating interest as defined in Article 17 of Directive 78/660/EEC in another undertaking (a subsidiary undertaking), and: (a) it actually exercises a dominant influence over it; or (b) it and the subsidiary undertaking are managed on a unified basis by the parent undertaking. Article 2 1. For the purposes of Article 1 (1) (a), (b) and (d), the voting rights and the rights of appointment and removal of any other subsidiary undertaking as well as those of any person acting in his own name but on behalf of the parent undertaking or of another subsidiary undertaking must be added to those of the parent undertaking. 2. For the		

				purposes of Article 1 (1) (a), (b) and (d), the rights mentioned in paragraph 1 above must be reduced by the rights: (a) attaching to shares held on behalf of a person who is neither the parent undertaking nor a subsidiary thereof; or (b) attaching to shares held by way of security, provided that the rights in question are exercised in accordance with the instructions received, or held in connection with the granting of loans as part of normal business activities, provided that the voting rights are exercised in the interests of the person providing the security. 3. For the purposes of Article 1 (1) (a) and (c), the total of the shareholders' or members' voting rights in the subsidiary undertaking must be reduced by the voting rights attaching to the shares held by that undertaking itself by a subsidiary undertaking of that undertaking or by a person acting in his own name but on behalf of those undertakings.		

"financial holding company" / insurance holding company		**<u>Article 4 (19)</u>** "financial holding company" means a financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, at least one of such subsidiaries being a credit institution, and which is not a mixed financial holding company within the meaning of Article 2(15) of Directive 2002/87/EC;	**<u>Article 1 (i)</u>** "insurance holding company" means a parent undertaking, the main business of which is to acquire and hold participations in subsidiary undertakings, where those subsidiary undertakings are exclusively or mainly insurance undertakings, reinsurance undertakings or non-member country insurance undertakings or non-member country reinsurance undertakings, at least one of such subsidiary undertakings being an insurance undertaking, or a reinsurance undertaking and which is not a mixed financial holding company within the meaning of 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			

"mixed holding company"	**Article 2 (15)** "mixed financial holding company" shall mean 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.	**Article 4 (20)** "mixed-activity holding company" means a parent undertaking, other than a financial holding company or a credit institution or a mixed financial holding company within the meaning of Article 2(15) of Directive 2002/87/EC, the subsidiaries of which include at least one credit institution;	**Article 1 (j)** "mixed-activity insurance holding company" means a parent undertaking, other than an insurance undertaking, a non-member country insurance undertaking, a reinsurance undertaking, a non-member country reinsurance undertaking, an insurance holding company or a mixed financial holding company within the meaning of Directive 2002/87/EC, which includes at least one insurance undertaking or a reinsurance undertaking among its subsidiary undertakings.			
"close links"	**Article 2 (13)** "close links" shall mean a situation in which two or more natural or legal persons are linked by: (a) "participation", which shall mean the ownership, direct or by way of control, of 20 % or more of the voting rights or capital of an undertaking; or (b) "control", which shall mean the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 1(1) and (2) of Directive 83/349/EEC, or a similar relationship between any natural	**Article 4 (46)** "close links" means a situation in which two or more natural or legal persons are linked in any of the following ways: participation in the form of ownership, direct or by way of control, of 20 % or more of the voting rights or capital of an undertaking; control; or the fact that both or all are permanently linked to one and the same third person by a control relationship;				**Article 13 (14)** "close links" shall mean a situation in which two or more natural or legal persons are linked by control or participation, or a situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship.

	or legal person and an undertaking; any subsidiary undertaking of a subsidiary undertaking shall also be considered a subsidiary of the parent undertaking which is at the head of those undertakings. A situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship shall also be regarded as constituting a close link between such persons;					
Deduction method		**Article 59** As an alternative to the deduction of the items referred to in points (o) and (p) of Article 57, Member States may allow their credit institutions to apply mutatis mutandis methods 1, 2 or 3 of Annex I to Directive 2002/87/EC. Method 1 (accounting consolidation) may be applied only if the competent authority is confident about the level of integrated management and internal control regarding the entities which would be included in the scope of consolidation. The method chosen shall be applied in a consistent manner over time.	**Article 16 of Life (2002/87) and Non Life Directives (73/239) as amended by Article 22.2 and Article 23.2 FCD** As an alternative to the deduction of the items referred to in (a) and (b) of the fourth subparagraph which the insurance undertaking holds in credit institutions, investment firms and financial institutions, Member States may allow their insurance undertakings to apply mutatis mutandis methods 1, 2, or 3 of Annex I to 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. Method 1 (Accounting consolidation) shall only be applied if the competent authority is confident about the level of integrated management and internal control regarding the entities which would be included in the scope of consolidation. The method chosen shall be applied in a consistent manner overtime.			
"group"	**Article 2 (12)** "group" shall mean a group of undertakings, which consists of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a participation, as well as undertakings linked to each other by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC;					**Article 210** "group" means a group of undertakings: i) which consists of a participating undertaking, its subsidiaries and the entities in which the participating undertaking or its subsidiaries hold a participation, as well as undertakings linked to each other by a relationship as set out in Article 12(1) of Directive 83/349/EEC; ***or*** *(ii) that is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those undertakings, and that may include mutual or mutual-type associations, provided that:* *-one of those undertakings effectively exercises, through centralised coordination, a dominant influence over the decisions, including financial decisions,*

						of the other undertakings that are part of the group; and - *the establishment and dissolution of such relationships for the purposes of this Title are subject to prior approval by the group supervisor.* - *The undertaking exercising the centralised coordination shall be considered as the parent undertaking, and the other undertakings shall be considered as subsidiaries;*
"Intra-group transactions"	**<u>Article 2 (18)</u>** "Intra-group transactions" shall mean all transactions by which regulated entities within a financial conglomerate rely either directly or indirectly upon other undertakings within the same group or upon any natural or legal person linked to the undertakings within that group by "close links", for the fulfilment of an obligation, whether or not contractual, and whether or not for payment.		**<u>Article 8</u>** 1. Member States shall provide that the competent authorities exercise general supervision over transactions between: (a) an insurance undertaking or a reinsurance undertaking and: (i) a related undertaking of the insurance undertaking or of the reinsurance undertaking; (ii) a participating undertaking in the insurance undertaking or in the reinsurance undertaking; (iii) a related undertaking of a participating undertaking in the insurance undertaking or in the reinsurance undertaking; (b) an insurance undertaking or a			

			reinsurance undertaking and a natural person who holds a participation in: (i) the insurance undertaking, the reinsurance undertaking or any of its related undertakings; (ii) a participating undertaking in the insurance undertaking or in the reinsurance undertaking; (iii) a related undertaking of a participating undertaking in the insurance undertaking or in the reinsurance undertaking.			
"risk concentration"	**<u>Article 2 (19)</u>** "risk concentration" shall mean all exposures with a loss potential borne by entities within a financial conglomerate, which are large enough to threaten the solvency or the financial position in general of the regulated entities in the financial conglomerate; such exposures may be caused by counterparty risk/credit risk, investment risk, insurance risk, market risk, other risks, or a combination or interaction of these risks.					
scope of supplementary	**<u>Article 6 (3)</u>**		ANNEX I			

supervision – capital adequacy	For the purposes of calculating the capital adequacy requirements the following entities shall be included in the scope of supplementary supervision: (a) a credit institution, a financial institution or an ancillary banking services undertaking within the meaning of Article 1(5) and (23) of Directive 2000/12/EC (reference to Codified CRD); (b) an insurance undertaking, a reinsurance undertaking or an insurance holding company within the meaning of Article 1(i) of Directive 98/78/EC; (c) an investment firm or a financial institution within the meaning of Article 2(7) of Directive 93/6/EEC (reference to MiFID); (d) mixed financial holding companies. In the case of a non-regulated financial sector entity, the notional solvency requirement means the capital requirement with which such an entity would have to comply under the relevant sectoral rules as if it were a regulated entity of that particular financial sector; in the case of asset management companies, solvency		CALCULATION OF THE ADJUSTED SOLVENCY OF INSURANCE UNDERTAKINGS AND REINSURANCE UNDERTAKINGS 2. APPLICATION OF THE CALCULATION METHODS 2.1. Related insurance undertakings and related reinsurance undertakings. 2.2. Intermediate insurance holding companies 2.3. Related non-member country insurance undertakings and related non-member country reinsurance undertakings 2.4. Related credit institutions, investment firms and financial institutions			

	requirement means the capital requirement set out in Article 5a(1)(a) of Directive 85/611/EEC; the notional solvency requirement of a mixed financial holding company shall be calculated according to the sectoral rules of the most important financial sector in the financial conglomerate.					
Scope of Consolidation /Scope of supplementary supervision	**Articles 5 (1) and 5 (2) and 5 (4)** Without prejudice to the provisions on supervision contained in the sectoral rules, Member States shall provide for the supplementary supervision of the regulated entities referred to in Article 1, to the extent and in the manner prescribed in this Directive. 2. The following regulated entities shall be subject to supplementary supervision at the level of the financial conglomerate in accordance with Articles 6 to 17: (a) every regulated entity which is at the head of a financial conglomerate; (b) every regulated entity, the parent undertaking of which is a mixed financial holding company which has its	**Article 133** 1. The competent authorities responsible for supervision on a consolidated basis shall, for the purposes of supervision, require full consolidation of all the credit institutions and financial institutions which are subsidiaries of a parent undertaking. However, the competent authorities may require only proportional consolidation where, in their opinion, the liability of a parent undertaking holding a share of the capital is limited to that share of the capital in view of the liability of the other shareholders or members whose solvency is satisfactory. The liability of the other shareholders and members shall be clearly established, if necessary by means of formal signed commitments. In the case where undertakings are linked by a relationship within the meaning of Article	**Article 3.2** The supplementary supervision shall take into account the following undertakings referred to in Articles 5, 6, 8, 9 and 10: - related undertakings of the insurance undertaking or of the reinsurance undertaking, - participating undertakings in the insurance undertaking or in the reinsurance undertaking, - related undertakings of a participating undertaking in the insurance undertaking or in the reinsurance undertaking. **Article 1.h** (h) related undertaking shall mean either a subsidiary or other undertaking in which a participation is held, or an undertaking linked with another			

	head office in the Community; (c) every regulated entity linked with another financial sector entity by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC. 4. Where persons hold participations or capital ties in one or more regulated entities or exercise significant influence over such entities without holding a participation or capital ties, other than the cases referred to in paragraphs 2 and 3, the relevant competent authorities shall, by common agreement and in conformity with national law, determine whether and to what extent supplementary supervision of the regulated entities is to be carried out, as if they constitute a financial conglomerate. *(on ASSET MANAGEMENT COMPANIES)* Article 30 Asset management companies Pending further coordination of sectoral	12(1) of Directive 83/349/EEC, the competent authorities shall determine how consolidation is to be carried out. 2. The competent authorities responsible for supervision on a consolidated basis shall require the proportional consolidation of participations in credit institutions and financial institutions managed by an undertaking included in the consolidation together with one or more undertakings not included in the consolidation, where those undertakings' liability is limited to the share of the capital they hold. 3. In the case of participations or capital ties other than those referred to in paragraphs 1 and 2, the competent authorities shall determine whether and how consolidation is to be carried out. In particular, they may permit or require use of the equity method. That method shall not, however, constitute inclusion of the undertakings concerned in supervision on a consolidated basis. **Article 134** 1. Without prejudice to Article 133, the competent authorities	undertaking by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC ANNEX 1.1B The calculation of the adjusted solvency of an insurance undertaking shall take account of the proportional share held by the participating undertaking in its related undertakings. ‘Proportional share’ means either, where method 1 or method 2 described in point 3 is used, the proportion of the subscribed capital that is held, directly or indirectly, by the participating undertaking or, where method 3 described in point 3 is used, the percentages used for the establishment of the consolidated accounts. However, whichever method is used, when the related undertaking is a subsidiary undertaking and has a solvency deficit, the total solvency deficit of the subsidiary has to be taken into account. However, where, in the opinion of the competent authorities, the responsibility of the parent undertaking owning a share of the capital is limited strictly and unambiguously to that share of the capital, such competent authorities may give			

	rules, Member States shall provide for the inclusion of asset management companies: (a) in the scope of consolidated supervision of credit institutions and investment firms, and/or in the scope of supplementary supervision of insurance undertakings in an insurance group; and (b) where the group is a financial conglomerate, in the scope of supplementary supervision within the meaning of this Directive. For the application of the first paragraph, Member States shall provide, or give their competent authorities the power to decide, according to which sectoral rules (banking sector, insurance sector or investment services sector) asset management companies shall be included in the consolidated and/or supplementary supervision referred to in (a) of the first paragraph. For the purposes of this provision, the relevant sectoral rules regarding the form and extent of the inclusion of financial institutions (where asset management	shall determine whether and how consolidation is to be carried out in the following cases: (a) where, in the opinion of the competent authorities, a credit institution exercises a significant influence over one or more credit institutions or financial institutions, but without holding a participation or other capital ties in these institutions; and (b) where two or more credit institutions or financial institutions are placed under single management other than pursuant to a contract or clauses of their memoranda or Articles of association. In particular, the competent authorities may permit, or require use of, the method provided for in Article 12 of Directive 83/349/EEC. That method shall not, however, constitute inclusion of the undertakings concerned in consolidated supervision. 2. Where consolidated supervision is required pursuant to Articles 125 and 126, ancillary services undertakings and asset management companies as defined in Directive 2002/87/EC shall be included in consolidations in the cases, and in	permission for the solvency deficit of the subsidiary undertaking to be taken into account on a proportional basis.			

	companies are included in the scope of consolidated supervision of credit institutions and investment firms) and of reinsurance undertakings (where asset management companies are included in the scope of supplementary supervision of insurance undertakings) shall apply mutatis mutandis to asset management companies. For the purposes of supplementary supervision referred to in (b) of the first paragraph, the asset management company shall be treated as part of whichever sector it is included in by virtue of (a) of the first paragraph. Where an asset management company is part of a financial conglomerate, any reference to the notion of regulated entity and any reference to the notion of competent authorities and relevant competent authorities shall therefore, for the purposes of this Directive, be understood as including, respectively, asset management companies and the competent authorities responsible for the supervision of asset management	accordance with the methods, laid down in Article 133 and paragraph 1 of this Article.				

	companies. This applies mutatis mutandis as regards groups referred to in (a) of the first paragraph.					

Annex II Provisions in the FCD, CRD, IGD and Solvency II that are relevant to specific areas

Areas	Cross sector	Banking	Insurance		Forthcoming regulation	
			Life	Group	Banking	Insurance
	Financial Conglomerates Directive (2002/87/EC) – FCD	Capital Requirements Directive 14th June 2006 (2006/48/EC) - CRD	Directive 2002/83/EC concerning life insurance (the same provisions are also in place for non-life insurance: Third NON LIFE directive 92/49 Article 20-22)	Directive 98/78/EC on the supplementary supervision of Insurance undertakings in an insurance group	Revised Capital Requirements Directive (draft)	Solvency 2 Directive (as approved by Parliament and ECOFIN – wait for formal publication including numbering)
Risk Concentration	Article 2(19) Article 7, Risk concentration Annex II, Technical application of the provisions on intra-group transactions and risk concentration	Article 4(45) Article 71 (Scope of application on a consolidated basis) Article 105 Section 5, Article 106 to 118, Large Exposures Article 133 Annex V subsection II (Treatment of risks), and subsection V (Concentration risk)	Article 22, Assets covering technical provisions Article 23, Categories of authorised assets Article 24, Rules for investment diversifications [The supervision of risk concentration is exercised on a solo basis]		Article 4(45) Article 71 (Scope of application on a consolidated basis) Article 105 Section 5, Article 106 to 118, Large Exposures Article 133 Annex V subsection II (Treatment of risks), and subsection V (Concentration risk)	Article 248, Supervision of risk concentration Article 250(2) Supervision of the system of governance
Intra Group Transactions	Article 2(18) Article 8, Intra-group transactions Annex II, Technical application of the provisions on intra-group transactions and risk concentration	Article 68(1) (Scope of application on a solo basis) Article 105 Section 5, Article 106 to 118, Large Exposures Article 138		Article 8, Intra Group Transactions	Article 68(1) (Scope of application on a solo basis) Article 105 Section 5, Article 106 to 118, Large Exposures Article 138	Article 249, Supervision of intra-group transactions Article 267 Intra-group transactions
Pillar II	Article 6 (2), subparagraph 2 Article 9 (1)	Article 22 Article 123 Article 124 Article 136 Annex V Annex XI			Article 4(48) Article 22 Article 123 Article 124 Article 129 Article 136 Annex V	Article44, Own risk and solvency assessment Article 41-48 and 250, Supervision of the system of governance
On-site	Article 14 Access to information	Article 137 (1) and (2)	Article 11 (on site inspection of branches	Article 6 (2) and (3), Access to		Article 259 Verification of

inspecti ons	**Article 15, Verification**	**Article 139(1)** **Article 141**	**by the home state authority)** **Article 13 (1) a) (general power of supervisors to perform on site inspections)**	**information**		**information**

Annex III – Provisions in accounting standards and financial services directives that are related to the definition of participation relevant to Chapter 4 part 1.

IAS 24 (9)

The following terms are used in this standard with the meanings specified:

Related party A party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

(ii) has an interest in the entity that gives it significant influence over the entity; or

(iii) has joint control over the entity;

(b) the party is an associate (as defined in IAS 28 Investments in associates) of the entity;

(c) the party is a joint venture in which the entity is a venturer (see IAS 31 Interests in joint ventures);

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significance influence may be gained by share ownership, statute or agreement.

IAS 28:

2 The following terms are used in this standard with the meanings specified:

An associate is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

Significant influence

6 If an investor holds, directly or indirectly (e.g. through subsidiaries), **20 per cent** or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (e.g. through subsidiaries), **less than 20 per cent** of the voting power of the investee, it is presumed that the investor does not have **significant influence**, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

7 The existence of significant influence by an investor is usually evidenced in one or more of the following ways:
(a) representation on the board of directors or equivalent governing body of the investee;
(b) participation in policy-making processes, including participation in decisions about dividends or other distributions;
(c) material transactions between the investor and the investee;
(d) interchange of managerial personnel; or
(e) provision of essential technical information.

10 An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual agreement.

IAS 31.3

Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).
A **joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Significant influence is the power to participate in the financial and operating policy decisions of an economic activity but is not control or joint control over those policies.

Annex IV – Questions asked throughout the consultation document

Chapter 2 **Definitions of different types of holding companies and their impact on the application of sectoral group supervision**	
Q1	Do you agree with the above analysis?
Q2	Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal
Chapter 3 **The definition of "financial sector" and the application of the threshold conditions in Article 3 of the FCD**	
Part 1	
Q3	Do you agree with the above analysis?
Q4	Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal
Part 2	
Q5	Do you agree with the above analysis?
Q6	Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal
Q7	Could you suggest what issues the guidance should address and provide evidence to support your suggestion?
Q8	For the purposes of potential guidance, what are the features of the activities of an AMC that you consider are relevant for determining the appropriate sector of that company?
Part 3	
Q9	Do you agree with the above analysis?
Q10	Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal
Q11	Could you suggest what issues the guidance should address and provide evidence to support your suggestion?
Chapter 4 **Implications of different treatments of participations for the identification and scope of supplementary supervision of financial conglomerates**	
Q12	Do you agree with the above analysis?
Q13	Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal
Q14	Could you suggest what issues the guidance should address and provide evidence to support your suggestion?
Chapter 5 **The treatment of "participations" in respect of risk concentrations (RC) and intra-group transactions (IGT) supervision and internal control mechanisms**	

Q15	Do you agree with the above analysis?
Q16	Do you agree to the proposed recommendations? (Yes / No) If No, please elaborate on your alternative proposal.
Q17	Could you suggest what issues the Level 3 guidance should address and provide evidence to support your suggestion?