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The New EU Financial Conglomerates Directive

By

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Introduction


The Directive introduces and requires (from financial years beginning in 2005) a supplementary prudential supervision of financial conglomerates on a group wide basis and enables the assessment of the overall solvency on a group wide basis by addressing certain issues in EU financial legislation. The rationale of the Directive in introducing prudential legislation is to ensure both the soundness of the groups in the banking, investment and insurance sectors, and minimum harmonisation of the prudential legislation applicable to homogenous financial groups active in a single sector. Therefore, it will promote convergence in national supervisory approaches and enhance financial stability.\(^2\) The Directive will have impact on both the EU and third country banking and investment firm groups.

Necessity for a new Directive

Financial groups have become of increasing interest as concentrations in the banking, investment and insurance sectors grew in Europe in the 1980s and 1990s. Appropriate supervision of financial groups carries importance because they operate either in a particular Member State of the EU or in the EU as a whole. Due to certain changes, such as the increasing complexity of financial products and the need of expertise in their supervision, a group wide supervision directive was necessary. Whilst the current Community legislation provides a set of rules on the prudential supervision of credit institutions, insurance undertakings and investment firms on a

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\(^1\) Lecturer in Law, The Robert Gordon University Department of Law, Aberdeen.

\(^2\) 2002/87/EC
stand-alone basis, until the publication of the EU Directive there was no form of prudential supervision on a group wide basis that brings together groups that cover both insurance and banking industries. Whilst the supervision rules in the banking industry were limited to credit institutions, investment firms and financial institutions that were part of a group, these rules did not contain rules of supervision of insurance undertakings. There are differences in the nature of the rules that apply to the solvency of banking and insurance industries (while banks try to ensure adequate coverage of credit and market risks, insurance industry protects policy holders against the risk of individual bankruptcy, with a focus on the liabilities assumed by insurance undertakings)\(^3\) and the Directive will provide a long term harmonisation in this area. The supplementary supervision of financial groups is a stage in the completion of Single Market in Financial Services and was identified in the Action Plan for Financial Services\(^4\) as one of the areas to be developed which would address loopholes in the present sectoral legislation.

The EU Commission triggered the preparation of a Directive that would fill the gaps in the current prudential legislation and ensure the stable functioning and control of financial groups by introducing a supplementary supervision of financial conglomerates on a group wide basis. These gaps are lack of coverage of some types of financial groups by current directives; lack of regulation of prudential issues that are regulated in banking, investment and insurance sectors directives at the level of financial conglomerate and the possibility that the same financial group can be covered by different sectoral directives. Therefore the new Directive ensures that there is a prudential legislation applicable to homogeneous financial groups active in a single sector. The solvency of these financial groups is important because if they experience financial difficulties, these could destabilise the financial system and affect individual depositors, insurance policy holders and investors.\(^5\) In this connection, the Directive both protects consumers, depositors and investors and increases the dynamism of the European financial market.\(^6\)

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The aim of the Directive

The Directive’s aim is to restrict the use of one and the same regulatory capital in two or more entities of the group within financial conglomerates (namely “multiple gearing”) and the use of regulatory capital funds raised by a parent company as debt and downstreamed to a regulated subsidiary as equity (namely “excessive leveraging”). The rationale of this restriction is that when there is multiple gearing of the same regulatory capital, this allows the group to use the same funds for both the parent and subsidiary company. In this case there is the risk of shortage of capital in the group wide basis, even though individual companies seem to have adequate capital to cover their own risk.

“Group” and “Financial Conglomerate” defined

EU Directive 2002/87/EC, Art. 2 defines a number of specific terms related to the banking, insurance and investment industry. One of them is the definition of a “group.” According to Art. 2(12) a “group” was 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, as well as undertakings linked to each other by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC.” Accordingly, even if “a group taken as a whole does not constitute a financial conglomerate, but one of its subgroups does, the Financial Groups Directive will apply to that subgroup.”

The other definition that carries particular importance for the Directive is “financial conglomerate.” Article 2(14) defines “financial conglomerate” subject to Art. 3. Accordingly, in order to be a financial conglomerate a group must contain a European Economic Area (EEA) regulated entity which has its head office in the EEA or includes at least one EU regulated financial entity (a credit institution, investment firm or insurance company). The group must be a financial group which is either headed by an EEA regulated firm or whose combined banking-investment and insurance sectors account for more than 40 per cent of its balance sheet, as mentioned in Art. 3(1). At least one of the entities in the group is within the insurance sector and at least one is within the banking or investment sectors (i.e. the group must be

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7 See Meyers and Ballegeer, supra note 3.

8 See Meyers and Ballegeer, n. 3 above.
significantly cross-sectoral by virtue of Arts 2(14)(e) and 3(2)). In order to meet cross-sectoral requirement the group has to meet thresholds set out in Art. 3 and the group is treated as having two financial sectors (i.e. insurance and banking/investment). According to Art. 3(2), a group will be regarded as cross-sectoral if the average of both the ratio of the balance sheet total of a particular financial sector in the group to the balance sheet total of group’s entire financial sector, and the ratio of the solvency requirements of the same financial sector in the group to the total solvency requirements of the group’s entire financial sector, exceeds 10 per cent. Alternatively, a group will be regarded as cross-sectoral if, by virtue of Art. 3(3), the balance sheet total of the group’s smaller financial sector exceeds €6 billion and the relevant competent EU authorities, by common agreement, decide not to apply the €6 billion test. In brief, a group will be a financial conglomerate if at least 40 per cent of its business is financial and at least 10 per cent or €6 billion of its financial business is in each of the insurance and the combined banking/investment sectors.

Financial Position of Groups

The Directive ensures that the financial groups have adequate capital of their own and abolishes the multiple gearing of own funds. Art. 6(2) of the Directive stipulates that the Member States shall require regulated entities in a financial conglomerate to ensure that own funds are available at the level of the financial conglomerate and that regulated entities have in place adequate capital adequacy policies at the level of financial conglomerate. In this connection, “the parent firm will not be able to issue loans to finance its regulated subsidiaries.”

The Directive also introduces rules for risk concentration (Art. 7) and intra-group transactions (Art. 8) at group level. “Groups carry out their risk assessment and capital planning at a group level or along business lines rather than legal entity lines.” According to Art. 7(2) the Member States shall require regulated entities or mixed financial holding companies to report on a regular basis, and at least annually, to the coordinator any significant risk concentration at the level of financial conglomerate. This supplementary supervision of the risk concentration of regulated

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9 Art. 6.
entities in a financial conglomerate will be exercised in accordance with the rules laid down in Arts 9(2) to 9(4). In this context, the risk management processes include: sound governance and management with the approval and periodical review of the strategies and policies by governing bodies at the level of financial conglomerate; adequate capital adequacy policies in order to anticipate the impact of their business strategy on risk profile and capital requirements; and adequate procedures to ensure that their risk monitoring systems are well integrated into their organisation. These internal control mechanisms include: adequate mechanisms as regards capital adequacy to identify all material risks; and sound reporting and accounting procedures to identify, measure, monitor and control the intra-group transactions.

**Some Implications of the Directive**

The Directive will have impact on both the EU and third country banking and investment firm groups. The main impact of the Directive will be the introduction of “mandatory requirements for the treatment, by banks and investment firms, of their investments in insurance companies, reinsurance companies and insurance holding companies.”\(^\text{12}\) Accordingly, “significant investments in the capital instruments of insurance firms are deducted from capital.”\(^\text{13}\)

The implications of the Directive upon the financial conglomerate whose parent undertaking is in the EEA will be as follows. According to Art. 10(1), a single coordinator will be appointed from among competent authorities of the Member States for each financial conglomerate. Other relevant competent authorities are identified for each group and that they are consulted about specified aspects of the supervision. The coordinator and relevant competent authorities have a specific and defined role in exercising discretion over the definition and identification of a financial conglomerate. The co-ordinator will be the regulator of the parent undertaking heading a financial conglomerate. If the financial conglomerate is not headed by a regulated entity the task of co-ordinator will be exercised by the competent authority. Accordingly, this co-ordinator will exercise the supplementary supervision over the financial conglomerate. The tasks of the co-ordinator are given


in Art. 11. Pursuant to Art. 11 the co-ordinator shall co-ordinate the gathering and dissemination of relevant or essential information in going concern and emergency situations, supervise and assess the financial situation of a financial conglomerate, assess the compliance of financial conglomerates with the rules on capital adequacy and of risk concentration, and finally, plan and co-ordinate supervisory activities along with assessment of the financial conglomerate’s structure.

With respect to third country banking and investment groups and conglomerate groups, the Directive amends the existing regime for banking and investment groups. With this amendment a European regulator will apply appropriate supervisory techniques in order to harmonise the objectives of supervision on a consolidated basis for a worldwide group where there is not equivalent consolidated supervision by a non-EEA third country supervisor. According to Art. 5(3), third country banking and investment firm groups whose head offices are outside the EEA will be subject to supplementary supervisions at the level of financial conglomerate. The impact of the Directive on the third country groups will depend on the supervision of the EU and Member States’ supervisory agencies if they decide that these groups are not subject to consolidated supervision by their home country supervisor, equivalent to that required under the Directive.

The procedure for determining the equivalence of supervision is established in Art. 18. According to Art. 18, competent authorities shall verify whether the regulated entities whose parent undertakings have head offices outside the EU are subject to supervision by a third country competent authority which is equivalent to that provided for by the Directive. This verification will be carried out by the competent authority, which would be the co-ordinator. The EU co-ordinator will consult the other relevant EU competent authorities for the group and the relevant EU Committee for the purpose of taking into account any applicable guidance, and reach agreement with the third country supervisory authority for the group to co-operate concerning supervision of the group. The Co-ordinator will apply the process and procedures set out in Art. 10 of the Directive. The relevant EU Committees are set out in Art. 19(2). Accordingly, these committees are: Financial Conglomerates Committee for a financial conglomerate, and Banking Advisory Committee for banking and investment groups which are not financial conglomerates. According to Art. 21(5), the Financial Conglomerates Committee may give general guidance as to whether the supplementary supervision arrangements of competent authorities are likely to
achieve the objectives defined in the Directive. It also states that the committee must review and take into account any changes in supervision by particular third country competent authorities.

If the supervision within the EU results with the decision that the home country supervision is not equal to that of the EU, then additional regulatory requirements will be imposed upon the third country groups. In the case of non-equivalence the Directive requires one of the two approaches must be taken. These are: world-wide group supervision by the EU co-ordinator, applying the requirements for an EU group or sub-group by analogy to the wider group; or the EU co-ordinator may apply other methods to the group which achieve the objectives of the relevant directive.\textsuperscript{14} With respect to other methods, in the UK, the Financial Services Authority (“FSA”) states that they may require that the group has a holding company in the EU to cover all its European financial firms, or that the regulated firms within the ring-fence (which is a method used to restrict exposures of firms within the ring-fence to other group companies outside the ring-fence) to hold additional capital.\textsuperscript{15}

Finally, the Directive will also have implications on the insurance groups. Insurance undertakings must hold some own capital (solvency margin) as a protection of their solvency. This solvency margin is a guarantee of security for policy holders. According to Insurance Group Directive of 98/78/EC, insurance groups must report a worldwide calculation of their consolidated solvency position even their parent undertaking is a non-EEA entity. In the past, borrowing at the group level and downstreaming of funds as equity to insurance subsidiaries created capital shortfalls at the group level. Therefore the new Directive ensured that insurance groups will have to meet consolidated solvency requirements. In this connection, the Directive ensures that insurance and banking groups will have identical consolidated capital adequacy requirements.\textsuperscript{16} Insurance groups, in this regard, will have to raise more capital in order to meet the capital adequacy requirement.

The capital adequacy will be measured by three methods. These are set out in Annex 1 of the Directive.\textsuperscript{17} These methods are: the accounting consolidation method, the deduction and aggregation method, and the book value/requirement deduction

\textsuperscript{14} ibid., p. 45.
\textsuperscript{15} ibid., p. 46.
\textsuperscript{16} See Arts 6 and especially 6(3) of the Directive, and see also Arts 28 et seq.
method. The Annex also indicates the possibility of combination of these three or any
given two methods. These methods have been developed by the Joint Forum on
Financial Conglomerates which combines the Basel Committee on Banking
Supervision, the International Organization of Securities Commissions and the
International Association of Insurance Supervisors.

Conclusion

In conclusion, one can argue that the Directive is a step forward within the
framework of Single Market in Financial Services and harmonisation. It requires a
supplementary supervision on a group wide basis where banking, investment and
insurance sectors are gathered under one financial conglomerate, and the appointment
of a co-ordinator who will oversee the process. Third country banking and investment
firm groups are also included in the supervision process; therefore their prudential
(and harmonised with that of EU firm groups) supervision will be ensured through
this Directive.

18 www.bis.org/publ/bcbsc323.pdf (Last visited August 2004);
www.iosco.org/news/pdf/IOSCONWS49.pdf (last visited August 2004);
19 www.bis.org/bcbs (Last visited August 2004).
21 www.iaisweb.org (Last visited August 2004).