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Rue de Spa/Spastraat, 2
B-1000 Bruxelles/Brussel
Belgium

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Financial Conglomerates Fundamental Review

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on European Commission consultative document on financial conglomerates "Call for Evidence for Fundamental Review".

Please find our remarks on the following pages.

We will remain at your disposal,
Yours sincerely,

Hervé Guider
General Manager

Volker Heegemann
Head of Legal Department

GENERAL REMARKS

EACB welcomes the review of the Financial Conglomerates Directive (FiCoD). The FiCoD is now implemented for more than 10 years. The recent developments in the international and European regulatory frameworks for banking and insurance sectors may have to be reflected on.

However, we strongly believe that the priority of Regulators should be the effective implementation of CRD IV/CRR and Solvency II. We are in the middle of the legislative process for Solvency II and CRD IV/CRR. The provisions of these sectoral legislative acts bring important modifications to the existing standards and also introduce new ratios. However, these provisions are not yet definitely defined. The regulators should not change the Financial Conglomerates Directive before the final versions of the sectoral legislations are adopted, in order to assure cross-sectoral consistency between the different rules.

In addition, we do not share the presumption of the Joint Forum's consultation paper, that the combined risk of banking and insurance activities is greater than the sum of these two activities' standalone risks. To the contrary, there is evidence that the existence of retail insurance activities within banking conglomerates was a key stabilizing factor during the subprime crisis, which should be preserved and even encouraged.

In this context, should regulators decide to apply an additional capital buffer, they would have to clarify the specific circumstances under which, and the criteria according to which supervisors could require group-wide capital to exceed regulatory requirements. In particular, supervisors should take into account the already existing capital buffers at the level of both the banking and insurance activities prior to applying such requirements at the financial conglomerate level.

SPECIFIC REMARKS TO QUESTIONS

A) ***The Structure of the FiCoD***

Question 1:

The question is whether the structure of the Directive, of this set of provisions that must supplement sector-specific provisions, is clear and whether legal certainty is optimal. If not, how could legal clarity and certainty be improved?

EACB is rather satisfied by the legal clarity and certainty provided by the Directive and relevant implementing national acts. Legal clarity and certainty was enhanced by the CEBS and CEIOPS "Recommendations on the supplementary requirements of the Financial Conglomerates Directive for supervisory colleges of financial conglomerates" issued in December 2010. Currently, there are no important complaints as regards the national legislation on the financial conglomerates. Nevertheless, it seems that the FiCoD does not always fit with the relevant national company law respectively sectoral supervisory regulation on solo basis which may partly lead to conflicts between the different rules, particularly between the group-wide/centralized controlling-obligation of the superordinated entity versus the persisting responsibility of the boards of the subordinated entities.

B) The scope of FiCoD - Definition of Group and determination of responsible entities

Question 2:

How could the definition of the relevant "group" and the determination of responsible entities be improved?

We agree with the current definition of group based on the accounting definition. It is important that this rule is kept. Additionally, when identifying groups and their consolidation for the purpose of FiCoD, it is essential to differentiate between regulated and non-regulated entities as well as between financial and non-financial entities. The Directive should not cover non-regulated entities, nor should it cover non financial entities since these are not covered by the sectoral rules. Moreover, the notion of "group" in the FiCoD should be consistent with sectoral rules; so if banking groups are not required to consolidate a SPV for example, the financial conglomerate should not be obliged to consolidate it either.

It should be fully clarified that entities that are not subsidiaries (particularly holdings of 10% - 20%) should not be part of the group. Under the current rules, the handling of these holdings is ambiguous. On the one hand, for solvency purposes they are already deducted (under the sectoral rules). On the other hand, for the purpose of integrated risk management and from the perspective of intra-group transitions these entities are formally part of the group and require specific reporting. As they are minor holdings on which there is no possibility of exercising significant influence, relevant and reliable data are difficult to obtain. Therefore, from a supervisory perspective it brings little added value to include them in the definition of group. Furthermore, we believe that such holdings of 10% - 20% should not trigger financial conglomerate supervision.

Question 3:

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

We believe that the current regulatory framework on financial conglomerates, together with the sectoral rules, generally ensure efficient supervision. Therefore, EACB supports the concept of supplementary supervision as defined by the FiCoD. The supervision of the financial conglomerate should be focused on the supervision of the specific supplementary aspects of financial conglomerates and not lead to a duplication of requirements of the sectoral supervision. We do not support the additional capital charges, since this approach could prove to be risky and could lead to jeopardizing the current principle of a capitalisation by risk type based on confidence levels fixed at sectoral levels.

In order to detect and correct group risks, it is essential to have a global supervisory oversight of financial conglomerates based on a "pillar II" approach – an internal capital adequacy assessment process complemented by a supervisory review process. As regards the group risks, we strongly believe that there are diversification benefits deriving from the different risk profiles of the banking sector and insurance sector which should be recognized by the supervisors. Surveys carried out by the industry have shown that insurance activities have softened the effects of the subprime crisis on the P&L and capital base of the financial conglomerates, supporting the view on the benefits of diversification of risks.

Moreover, in order to deal with the risk concentration and with contagion, Member States have implemented rules at the level of financial conglomerate that are similar to the "large exposure" and "group of connected clients" rules.

Question 4:

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

EACB considers there is no need to change the threshold criteria. These haven't proved to be ineffective. However, it should be fully clarified that entities that are not subsidiaries (particularly holdings of 10% - 20%) should not be part of the group (please see explanation under question 2 on the relevant group)

C) Supervisory powers and responsibilities:

Question 5:

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

As an association representing banks, our concern is that supervision of financial conglomerates is efficient and does not lead to a distortion of competition in the form of lower requirements for financial conglomerates where the head of the group is not a regulated entity. Supervisory authorities should also be able to address the head of a financial conglomerate even if it is not a regulated entity itself if this is necessary to give effect to supervisory measures.

Question 6:

The question is, whether the discretion to apply the rules in the supervisory approach as chosen by the respective authorities is effective in the context of cross-border and cross-sector groups, or whether other enforceable provisions (such as transparency, or obligatory cooperation, see the Joint Forum document for more provisions) are necessary.

EACB acknowledges the usefulness of transparency and cooperation between the different supervisors. Because transparency and co-operation between supervisors is important, the regulators need to define each supervisor's clear responsibilities and aim for a more harmonized supervisory framework. The CEBS and CEIOPS "Recommendations on the supplementary requirements of the Financial Conglomerates

Directive for supervisory colleges of financial conglomerates" have made some progress in this respect but more can be done to achieve a higher effectiveness of supervision.

D) Corporate Governance - Interdependence with Company Law:

Question 7:

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

We believe that the current regulatory framework on financial conglomerates, together with the sectoral rules, generally ensure sound governance of financial conglomerates. The governance rules under CRD IV/CRR will be enhanced and, together with sector specific rules under Solvency II, will be far reaching. Moreover, the governance obligations are developed in the company laws as well.

Taking into account very detailed sector specific rules; the conglomerate specific governance requirements of FiCoD should be the minimum necessary. In our view detailed governance provisions in FiCoD could create possible interpretation problems regarding application of sector-specific and financial conglomerate level provisions. Thus we believe that in general, governance provisions at the level of financial conglomerate should be principle based and flexible, as FiCo-structures vary widely throughout Europe.

Supervisors should not intervene too much in the structure of the financial conglomerates. The governance specific requirements should only be applied to entities that are part of the consolidated group and should exclude the unregulated and non-financial entities.

Question 8:

The question is whether the framework for prudential supervision of financial groups could benefit from this "legal tandem" with company law, or whether the financial supervision framework should be complete and clear in and of itself?

EACB believes that the prudential supervision framework for groups should be constructed in such a way that it can accommodate the different national company laws. It is important to note that even currently the supervisory law does not fit with the company law in different member states. Certain rules under the supervisory framework are impossible to be applied under the national company laws (please see explanation already under question 1).

Moreover we believe that it is important to wait for the final versions of CRD IV/CRR and Solvency II, analyze the conflicts with the company law and make suggestions on how to fit these regulatory frameworks together.

E) <u>Capital and Liquidity:</u>

<u>Question 9:</u>

The question is, whether the European prudential framework should remain confined to enforceable capital- and liquidity-ratio's, and leave discretion to firms to ensure they always meet those minimum ratios, or that additional provisions are necessary, as suggested by the Joint Forum, to ensure that a conglomerate's internal capital and liquidity policy is sufficient to meet the required standards at all times in all of its authorized entities.

Under the current rules the financial groups have to develop an appropriate internal capital adequacy assessment process which is subject to a supervisory review process. These processes ensure the conglomerate's internal capital and liquidity policy is sufficient to meet the required standards at the group level. We support this pillar II approach. We also believe that it is important that unregulated entities that are part of a financial conglomerate are not treated differently than the unregulated entities which are part of other regulated financial groups. The interaction between unregulated entities and regulated entities should be taken into account as "environmental" factors as part of the Pillar II supervisory review and evaluation process.

The sector specific rules under CRD IV/CRR and Solvency II are far reaching and requirements under the sectoral rules will be increased as compared to the previous rules for banking and insurance. EACB believes that this will significantly improve the capital and liquidity positions of the financial conglomerate as well.

As far as capital requirements are concerned, we support the conservation of the current approach of the European legislation. In this respect, a supplementary capital charge should be required only if the consolidated eligible regulatory capital calculated at the financial conglomerate level is lower than the sum of sectorial minimum capital requirements.

Furthermore, the planning of capital management and the liquidity risk management processes are of different nature in the banking and insurance sectors and address the specificities of these two markets. There are different and very specific rules and needs for capital and liquidity as well as different understandings of these concepts in the banking sector on the one hand and in the insurance sector on the other. Subsequently, relevant and efficient liquidity and capital requirements at the level of the conglomerate would be difficult to define and implement. Moreover, liquidity is a banking concept which may become irrelevant in a financial conglomerate context. Insurers are pre-funded by premiums rather than relying on short-term debt to a significant degree or accepting deposits from the public. An insurer would be expected to become insolvent long before it becomes illiquid.

There are significant reasons why there is a separate framework for insurance (Solvency II) and for banking (CRD/CRR). These requirements for the banking and insurance should remain different in order to ensure an efficient and relevant supervision at the sectoral level. The changes in the financial conglomerate rules should only allow alignment with the CRD4/CRR and Solvency II changes while the pillar II rules should ensure there is a proper assessment process for capital and liquidity specific calculations.

F) Risk Management:

Question 10:

Experts are invited to give their views on the European implementation of more specific regulation of group risks (contagion, risk concentration) and introducing relevant requirements at the level of the head of a financial conglomerate.

In principle, we believe that instead of having a more specific regulation for group risks, an alignment of the core principles of supervision for banks and insurance will be beneficial and will lead to a more comprehensive risk management framework for the financial conglomerates. These core principles would have to take into consideration the differences of risks between the two areas of activity and the differences in internal harmonisation in banking and insurance supervision. The core principles should preserve sectoral rules when dealing with capital adequacy and solvency issues.

When talking about contagion and risk concentration we strongly believe that there are diversification benefits deriving from the different risk profiles of the banking sector and insurance sector which should be acknowledged by the supervisors. Surveys carried out by the industry have shown that insurance activities have softened the effects of the subprime crisis on the P&L and capital base of the financial conglomerates, supporting the view on the benefits of diversification of risks. Moreover, in order to deal with risk concentration and with contagion, Member States have implemented rules at the level of financial conglomerate which are similar to the "large exposure" and group of "connected clients" rules. National authorities in different Member States already employ different provisions for risk management applicable to the financial conglomerates which take into consideration capital adequacy, large exposures, groups of connected clients, internal transactions and corporate structure reports.

Question 11:
In view of the objective of this framework, is stress testing at sector-specific level only sufficient to take account of unexpected scenarios in financial conglomerates?

We acknowledge usefulness of stress testing and scenario analyses in providing information to senior management about alignment of the institution's risk profile with the Board's risk appetite under various circumstances. Under the sector specific rules these are an important part of risk management. At the level of financial conglomerate, however, it is not clear what impact should the results of stress testing analysis have on management since it is not always possible, due to company law restrictions, to establish a centralized control and allocation of funds.

Moreover, performing such analysis in the context of financial conglomerates will come across practical limits due to the heterogeneity of the business models and nature of the risks of the different parts of the conglomerate, different techniques of measuring risks and different relevant scenarios. Meaningful scenarios at the level of financial conglomerate would be difficult to define and would require appropriate handling time. The methodology to perform such analysis would have to accommodate the diversity of financial conglomerates' risk profiles and business models since using "one size fits all" approach would be meaningless.

Finally, the diversification benefits from different risk profiles of banking and insurance sectors have been proven to soften the effects of a stressful scenario on the P&L and capital base of the financial conglomerates. Therefore, such an analysis at the level of conglomerate would bring little added value. Thus, we believe that the implementation of the stress testing analysis developed at the level of the individual sector is more efficient.