

**CONSULTATION ON THE
REVIEW OF DIRECTIVE 2002/87/EC ON THE SUPPLEMENTARY SUPERVISION OF CREDIT
INSTITUTIONS, INSURANCE UNDERTAKINGS AND INVESTMENT FIRMS IN A FINANCIAL
CONGLOMERATE (FCD)**

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Please note that the views expressed in these comments are those of the IMF's staff, and not necessarily of its management or Board.

General

The review addresses a number of legal and technical issues, such as the correction of certain inadvertent consequences of the current FCD (see Section 3). However, we would like to emphasize that the regulation and supervision of conglomerates needs to be kept under review in light of broader regulatory changes and innovations in the European supervisory architecture. Certain issues are especially germane:

- How to identify conglomerates that are of systemic importance, including whose constituent parts may not be of systemic importance;¹
- How in practice financial conglomerates will be covered by the European System of Financial Supervisors (ESFS), with a view to achieving effective integrated supervision as well as harmonized rules and supervisory practices. Once the Joint Committee and its Financial Conglomerates Sub-Committee become operational, regulatory gaps or impediments may become apparent. A particular issue is how the ESRB will be provided with the necessary means, notably data access, to allow it to monitor systemic risks stemming from financial conglomerates;
- What will be the implications of changes in regulatory standards, such as requirements for better capital and more liquid assets, and extending the “regulatory perimeter,” being envisaged by the Basel Committee, the FSB, etc. On the one hand, current and prospective regulatory changes may create new incentives for the shifting of activities between banks and nonbanks, and even regulatory arbitrage, through

¹ The joint IMF-BIS-FSB paper “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” (released November 2009) provides some relevant criteria.

conglomerate structures. On the other, an expanded regulatory perimeter may imply that more conglomerates, and a larger share of conglomerates' activities, are subject to regulation; and

- Whether conglomerates pose special problems for resolution and the formulation of “livings wills” and similar mechanisms.

Question 1

For which of the following a review with respect to the transparency of group structures would be justified?

Yes, for all groups, banks or insurers or conglomerates.

This would be in line with the Recommendation 5 put forward in the report of the Basel Committee's Cross-border Bank Resolution Group, which says that supervisors should understand group structures with a view to how they would be resolved in a crisis and that incentives should be provided to encourage simplification of group structures.

Question 2

Do you think that a more in-depth investigation is justified with respect to the supervisory scope of supplementary supervision, especially in relation to the non-regulated parts of financial conglomerates?

Yes. The crisis has demonstrated the risks of regulatory arbitrage and those related to formal or non-formal exposures to off-balance sheet entities. Hence, supervisors should have the possibility not only to extend the scope of supplementary supervision to non-regulated entities of conglomerates, but also to redefine the perimeter of the conglomerate when warranted. Supplementary supervision may also be important for non-prudential supervision, related for example to anti-money laundering and consumer protection issues.

Question 3

In your opinion, would the debates on the definition of capital in the banking and insurance sector respectively, justify a more in-depth investigation of the cross-sectoral perspective?

The need for a more in-depth discussion of the definition of capital is warranted and should take a forward-looking approach. Since the outbreak of the crisis, discussions have been generally oriented to defining stronger, more substantial criteria for regulatory capital. However, recent innovations proposed by banks for hybrid capital, such as Lloyds' contingent capital exchange (CoCo), are moving the discussion to a use of capital that is possibly less well-defined, and more difficult to evaluate and price. Other aspects worth considering include capital and liquidity fungibility within financial conglomerates—which can be critical in times of stress—and the efficient allocation of capital and liquidity resources

across subsidiaries and business lines of multinational conglomerates. As capital and solvency regulations and instruments evolve, it will be necessary to check for possibilities of double counting, and to ensure that useful measures of group-wide strength remain available to investors and others.

In this connection, we suggest that liquidity regulation be treated explicitly, perhaps alongside Articles 6 and 8 of the FCD. The coordinator would have a special role in determining whether supplementary supervision and requirements are needed, depending, for example, on whether there are legal barriers to the pooling of liquidity across the conglomerate and whether sectoral regulations impose certain liquidity requirements on entities (such as banks) in the conglomerate.

Question 4

With respect to the group wide remuneration policies in financial conglomerates, would you regard it as useful to consider the compatibility of these policies across the banking and insurance sectors within the conglomerate?

An examination of the compatibility of remuneration policies across the banking and insurance sectors within conglomerates should be conducted. The FSB principles on compensation have been incorporated in guidance issued by standard setters for banks and their supervisors. Integrated supervisory agencies have indicated these will also apply to the insurance sector. Consequently, we would support the extension of equivalent principles to other regulated financial institutions—with the necessary adjustments to reflect the differences in the nature of their respective financial activities—in order to prevent regulatory arbitrage and talent drain, particularly from the banking sector.

Question 17

Which of the following indicators could be used in addition to or instead of 10% of solvency and of total assets in the other sector to make the identification process of a financial conglomerate more risk-based? Select all that apply:

- (a) income structure: in addition / instead / not**
- (b) off balance sheet activities: in addition / instead / not**
- (c) relative size of respective businesses in their respective markets: in addition / instead / not**
- (d) business structure, i.e., relations between the respective sectors within the conglomerate: in addition / instead / not**
- (e) other, please specify.**

All the additional indicators could provide relevant information as to the risk exposures of financial conglomerates and could be used in the identification process. In some ways a conglomerate can be thought of like the financial system in miniature, where the “conglomerateness” depends on the degree of systemic interconnectedness. This

interconnectedness is a matter of function more than balance sheet entries. You may wish to refer to the joint IMF-BIS-FSB paper “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” (released November 2009), where it is argued that absolute size is not a universal guide to systemic importance, and which contains suggestions on which other factors are worth considering.

Under (e), there may be cases where operational linkages give disproportionate importance to a financially small component of a group. For example, a data processing or internal control subsidiary—perhaps sited in a different jurisdiction—may be essential to the functioning of a large group, even though it has an insignificant balance sheet and operational costs. Moreover, the extent of influence of the group’s management on the decision-making processes of its financial subsidiaries may need to be considered.

In this connection, we are concerned that a conglomerate might be constructed where financial entities constitute a relatively small share of the balance sheet, but which still poses risks of regulatory arbitrage or creates systemic vulnerabilities. We therefore suggest that supervisors be given the power, by common agreement and on an exceptional basis, to designate a conglomerate as a (mixed) financial conglomerate even if it does not meet the 40 percent criterion mentioned in FCD Art. 3(1) and the supplementary criteria mentioned in FCD Art. 3(5). Alternatively, the trigger point might be reduced from 40 percent to some lower level.

January 2010