CEBS Committee of European Banking Supervisors

CEIOPS Committee of European Insurance and Occupational Pensions Supervisors

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Pragmatic regulation for financial conglomerates
A European supervisory perspective

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1. Introduction

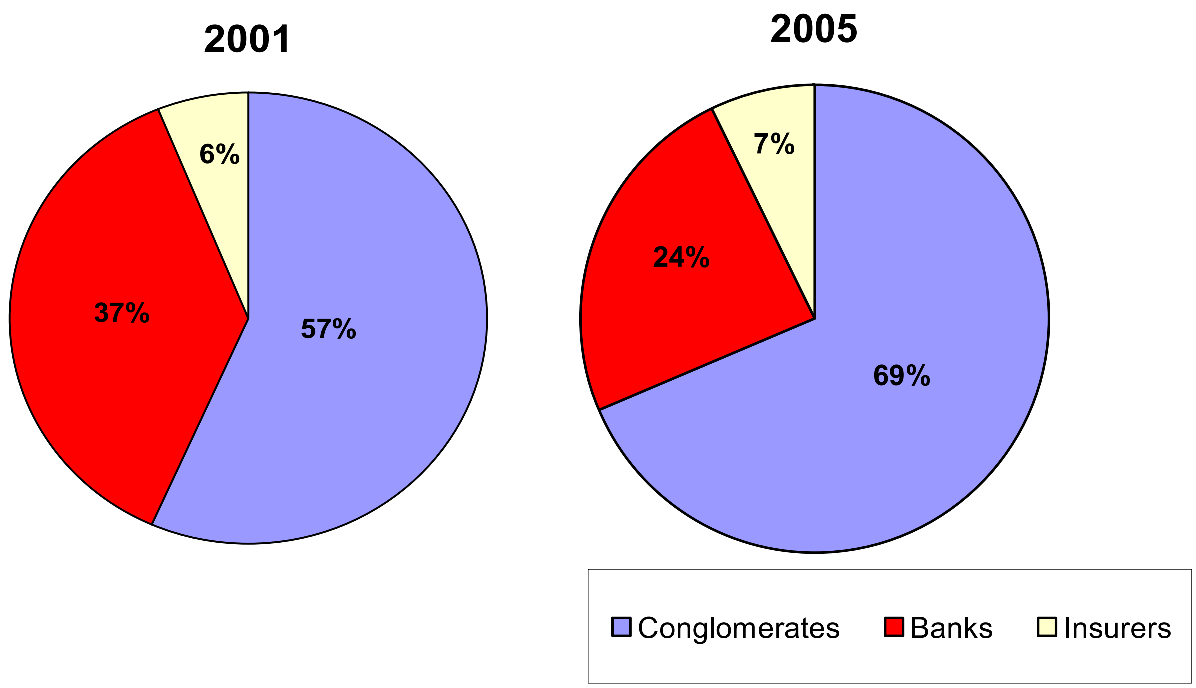
Good afternoon, ladies and gentlemen. This conference obviously attaches great importance to smoothly working capital markets, within an efficient framework of prudential rules. This pragmatic approach to the regulation of financial markets appeals to me, both as a supervisor and as the chairman of the European Interim Working Committee on Financial Conglomerates (IWCFC). Supervisors are as much committed as you are to the smooth working of the capital market in general, and the soundness of the financial groups operating there in particular. We heard Commissioner McCreevy insisting on supervisory cooperation in the transatlantic market, which is so crucial to a dynamic market environment. Both Mr. McCreevy and Andrew Crockett insisted on building mutual trust, by cooperative mechanisms. That is exactly what we are doing in the IWCFC.

2. Outline

- Market dynamics Europe
- Pragmatic regulation of financial conglomerates
- Response: IWCFC
- IWCFC: objectives
- Regulatory interaction
- Pragmatism in group supervision
- Supervision of risks
- Supervisory coordination
- Prospects by 2010
- Transatlantic dialogue

I will give you a brief overview of the dynamics in the supervision of financial conglomerates in Europe. It will cover three main areas:

- First, what driving forces made supervisors in Europe strive for joint efforts at level 3 regarding conglomerates? Market developments were the first.
- Second, what is objective of the IWCFC and which regulation governs our work?
- Third, what challenges do we face in the transatlantic market?

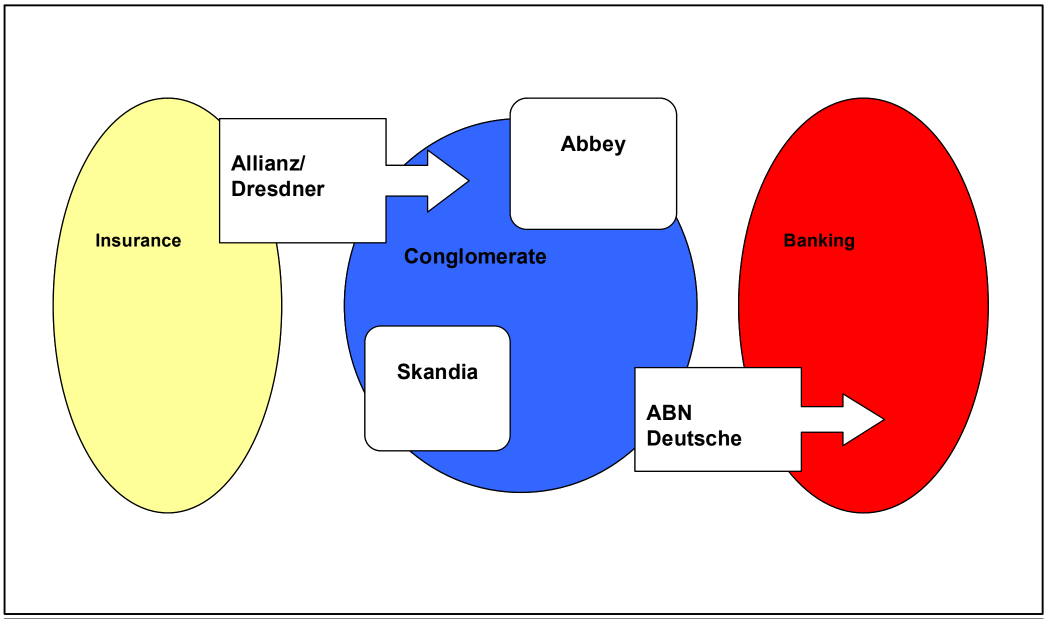


3. Market dynamics

The two diagrams illustrate the growth of conglomerates between 2001 and 2005 in the European Union, drawn from the balance sheet totals of the largest 25 banks, insurers, and conglomerates in the market. The blue sections represent conglomerates, yellow represents insurance firms and red represents banks, in terms of relative balance sheet totals of the largest 25 banks, insurers, and conglomerates.
The share of conglomerates has clearly grown during the last 5 years.

- European Union
  - not yet a single market without borders
  - a common base with 27 jurisdictions
  - but financial conglomerates evolving across jurisdictions

The diagrams illustrate the European market, but it is not a "borderless market". In the internal market of the European Union, we are dealing with 27 jurisdictions. It is in this legally fragmented framework that institutions and regulators have to operate. However, institutions grow and evolve dynamically, across sectors and across borders. A rigid regulatory system would not just hinder economically sound developments, it would also be ineffective.



This picture, showing mergers and acquisitions across sectors in Europe, is by definition outdated. It illustrates some market dynamics, in terms of the movements of some very large institutions, from banking and insurance, to conglomerates, and vice versa.

Having transferred its insurance activities to Delta Lloyd a few years ago, ABM AMRO went from being a conglomerate to a bank-dominated institution.

Deutsche Bank also went from being a conglomerate to a bank-dominated institution, by selling its insurance participations in, among others, Gerling.

The Allianz insurance group, on the other hand, moved from insurance towards conglomeration through its acquisition of Dresdner in 2001.

There have been many more acquisitions, including significant acquisitions between existing financial conglomerates. Last year, for example, Skandia was acquired by Old Mutual. And another example is the acquisition of Abbey by Santander in 2004.

4. Pragmatic regulation of financial conglomerates

The regulatory institutions in the European Union reveal a common base, a common goal when it comes to regulation of financial markets: the stability of the system and the soundness of the institutions making up that system. Supervisors acknowledge the necessity to join forces when it comes to supervising international financial groups. It is not just about recognising different jurisdictions, but also about recognising groups consisting of large pools of licences.

- European Commission (November 2006)
  - "Supervision must ensure an efficient and effective prudential framework for these groups in the EU"
  - "A single view reflecting the group-wide perspective that conglomerate supervision requires, rather than a composite view reflecting differing sectoral perspectives"

This common goal was also acknowledged by the European Commission. The Commission asked the IWCFC to synthesize views from banking, insurance and securities supervisors into an output addressing the unique challenges posed by conglomerates.

<u>5. Response: IWCFC</u>

On the basis of their day-to-day experience, supervisors, too, were seeking maximum pragmatism in this European market of 27 jurisdictions. Joining forces in the IWCFC, prudential supervisors decided to aim for a coherent view, with the support of CESR and the ECB as permanent observers.

- IWCFC
  - Set up jointly in 2006 and facilitated by 27 banking supervisors (CEBS) and 27 insurance supervisors (CEIOPS)
  - Driven by daily experience of supervising insurance groups, banking groups and financial conglomerates
  - Aiming for a *coherent* view on group supervision

I should point out that coherence is not the same as full sectoral uniformity! There are many reasons and circumstances that justify specific applications and sectoral differences in supervision. A coherent view enables group supervision that is effective throughout the group, both across sectors and across countries. It is effective, combines the best of both sectoral views, and avoids unnecessary differences.

<u>6. IWCFC: objectives</u>

So pragmatism and a coherent view are key, and IWCFC agreed to the European Commission's request.

- Joint efforts by supervisors
  - IWCFC (level 3) aiming for a pragmatic approach to groups of banks and insurers

- IWCFC (November 2006)
  - "… agreed to deliver practical results and convergent implementation under the Financial Conglomerates Directive..."

<u>7. Regulatory interaction</u>

This market of 27 insurance supervisors and 27 banking supervisors is not as fragmented as you might think. The directives of the European Union do, of course, provide guidelines with respect to the regulatory framework of the internal market. Three of them are relevant for financial conglomerates.

Financial Conglomerates Directive (FCD)

- Group level monitoring and aggregation of risk concentration, intra-group transactions, capital at group level
- Coordinator for cross-border cooperation and coordination

Basel II & Capital Requirements Directive (CRD)

- Risk sensitivity in requirements & Risk-based supervision
- Consolidating supervisor leads model validations
- CRD Art 129 requires cross-border coordination

Insurance Groups Directive (IGD), IAIS Solvency & EU Solvency II

- Assessing group risks
- Risk sensitivity in requirements
- Group supervisor's responsibilities defined

1. The market evolution towards more cross-border and cross-sector consolidation is reflected in the Financial Conglomerates Directive (FCD). It requires supervisors, first, to monitor the key risks faced by conglomerates: risk concentration, intra-group transactions and capital at the top level of a group. Second, it requires supervisors to coordinate their activities.

2. The Basel 2 Directive - the Capital Requirements Directive (CRD) – is essentially about embedding sensitive risk management techniques and making supervision risk-based. Following the FCD, the CRD also gives the consolidating supervisor a coordinating role in art 129. A new element is the key role of the consolidating supervisor in the assessment of risk models.

3. For insurance groups, regulatory developments are in line with those for the other two categories. The European Commission is currently working on the first draft framework directive for Solvency II. The Commission's draft of the Framework Directive for Solvency II might be developed in an innovative way, reflecting the economic reality of insurance group structures. It will be published in July 2007.

8. Pragmatism in group supervision

Of course, we do not license financial conglomerates. Instead we license insurers, banks, investment firms, and many other types of financial service providers. This makes it fairly difficult to enforce supervisory requirements for financial conglomerates.

Not surprisingly, the sector has been repeating its plea for efficiency and a reduction of the supervisory burden in this evolving field for some time now. And the European Commission and the European Parliament support their plea. We are trying to make sure conglomerates supervision is exercised efficiently.

- **European politicians and industry** call for regulatory and supervisory efficiency, a "group-wide perspective".

European Directives require

- Risk sensitivity in supervisory assessments
- Supervisory coordination for groups

How does IWCFC address this need for pragmatism?

- IWCFC strives for common interpretations and applications of regulatory concepts in the real world
- IWCFC strives for cross-border and cross-sector coordination that enhances effective and efficient day-to-day supervision

The three directives have split supervisory work into two main areas: supervision of key risks across the sectoral parts of a group, and coordination across sectors and across countries.
Striving for pragmatism, we are seeking common interpretations in the area of risk assessments, and an efficient mechanism for coordinating the different parts in conglomerates supervision.

9. Supervision of risks

As common interpretations are preceded by mutual understanding, a stocktake on the implementation of the FCD in the European Member States was the start of an analysis of the potential impact of differences in how the rules for assessing the risks in financial conglomerates have been implemented.
Risk concentration and intra-group transactions are the first supervisory issues which need to be tackled. Real-life cases, discussions on possible interpretations and common views on supervisory tools are feeding the debate in the IWCFC plenary and its expert groups. Of course they closely follow what is being done at a global level in the Joint Forum.

Risk concentrations & intra-group transactions:

- stocktake of implementation in 27 member states
- common understanding, also in Joint Forum
- common interpretation, also using Joint Forum expertise
- real-life cases

Capital adequacy at top level:

- Report on the comparison of capital instruments
  - ➢ highlights many similarities
  - ➢ shows differences in sector-specifics
  - ➢ sector-specific instruments
  - ➢ calculations at consolidated level
  - ➢ hybrids
- Impact of sectoral differences and how to address them

Not surprisingly a study on capital was a major challenge. I strongly recommend the report published last January 2007 on the comparison of capital instruments. See http://www.c-ebs.org/Advice or http://www.ceiops.org/media/files/publications/submissionstotheec/Comparisonofsectoralrulescapitalinstruments.pdf

We analysed the main similarities and differences of the characteristics of regulatory capital for a bank, an investment firm and an insurance entity. We found that most eligible capital instruments - although named differently - are in fact common in the two sectors and share the same core characteristics.
However there are important differences as well. These can be explained by the differences in the nature of each sector's business, or by differences in the calculation of eligible capital elements and the way they are taken into account at group level. We aim to finalise the impact study by September 2007.

10. Supervisory coordination

The different directives all require supervisors to coordinate their activities. However, the names used for the coordinating supervisor differ across the three frameworks:

- the FCD requires a coordinator;
- the IGD calls it a lead supervisor and the draft Solvency II Directive calls it a group supervisor;
- and in the CRD we find the "authority responsible for the supervision on a consolidated level", or as we name it, a consolidating supervisor.

As common interpretations and practices call for common understanding and common language, that is where the IWCFC starts.

- EU directives describe a coordinator (FCD)
- A consolidating supervisor (CRD)
- Lead supervisor (IGD)/ Group supervisor (SII draft)

IWCFC seeks common understanding and convergence of practices

Day-to-day supervision on IWCFC agenda
  - Complex real-life supervisory cases
  - Tour de table
  - Combining supervisory practice in banking and insurance

Dialogue with the sector, lunch-time speakers
  - Relevant Competent Authorities
  - Coordination arrangements

As real-life cases from day-to-day supervision illustrate interpretations, they form a structural item on our agenda. In what we call the Tour de Table, any problem or practical case can be put forward in a confidential session with supervisors. In this way we discussed e.g. how to appoint "relevant competent authorities" as a subset to all those supervisors who authorized one or more entities in the conglomerate.
In the same line of thinking about current supervisory practices, we invite financial conglomerates themselves to talk to us in lunch-time sessions. Not all of them have a straightforward group structure of one large parent company and a few smaller subsidiaries, neatly located across a few countries. They have complex structures which require tailored coordination arrangements among the "relevant competent authorities". So we discuss supervisory practices as applied to and/or perceived by BNP Paribas, the

Finnish OP-group, Allianz, Fortis, KBC, Dexia, the Hungarian OTP group, ING, and hopefully others to come.

The interpretations are just as colourful as the market. This understanding enables the IWCFC to arrive at both coherent views and effective implementations in a dynamic market.

11. Prospect 2010

By 2010, I envisage we will have finished much cross-sectoral and cross-border work in the field of conglomerates' supervision:

- We will have reached more convergence in the calculation of capital requirements, the eligibility of instruments, and the treatment of hybrids.
- We will have a clearer idea of the problems in conglomerates supervision and gained experience of what makes coordinated supervision most effective.
- We will have learned by then from the Equivalence exercises and we will have come closer to third-country cooperation.

- **More EU convergence**
  - views on capital requirements and eligibility, including suggestion for the European Commission
  - treatment of hybrids
  - risk concentration & intra-group transactions, liaising with Joint Forum
- **More effective coordinated supervision**
  - reinforcing experience, both within the EU and across continents
- **Better understanding of group supervision in US & Switzerland**
  - lessons for third-country coordination

12. Transatlantic dialogue

The slides on market dynamics showed how groups are evolving across countries and across sectors. These large conglomerates do not operate solely – or even mainly - within Europe. The fact that these groups operate all over the world is one of the reasons for this conference.

I must say that the transatlantic consolidation of financial groups has only just started. That is also revealed by the statistics on these transatlantic groups, which are poor, while data are scarce. There is a lack of reliable global statistics. The trend, however, cannot be neglected. The regulatory framework, aiming at financial stability and preventing contagion in financial markets should keep pace with these developments; that also goes for its supervisory coordination arrangements.

Global dynamics

- conglomerates do not stop at EU borders
- groups are beginning to expand across continents
- machinery for supervisory cooperation has not kept pace with the internationalisation of markets

Main supervisory interests

- Effectiveness: coherent identification and assessment of risks in a rapidly changing financial system
- Efficiency: streamlining the supervisory process, lowering the supervisory burden
- Supervision better aligned to group processes

A coherent view on group supervision across sectors and across countries, the "group-wide perspective", is how IWCFC sees pragmatism in the regulation of financial conglomerates. Supervisors also have an interest in cooperation with third countries. Cooperation will not just make supervision more effective, since it will enable supervisors to see potential contagion more clearly. Cooperation will also make supervision more efficient, prevent double work, and allow supervisors to use each other's expertise etc.

- IWCFC Equivalence exercise: Dialogue with US and Swiss authorities on *applied* group supervision
- Sharing European supervisors' experiences with Swiss and US authorities
- IWCFC in contact with
  - SEC, Fed, NYSBD, OCC, OTS, NAIC
  - EBK, FOPI

I have not yet mentioned one other piece of current work, our equivalence exercise with the United States and Switzerland. This equivalence exercise puts the supervision of groups operating in, or from, third countries in perspective.
We will provide the European Commission with a technical analysis of the supervision of financial conglomerates in the United States and in Switzerland.

The supervisors in the IWCFC started this piece of work by sharing their experiences with supervisors from the US and Switzerland. First impressions are positive in this respect. Second, we have asked our fellow supervisors in Switzerland and the US about their approaches. We would like to know more about developments in their domestic regulation, and their supervisory practices. Mr McCreevy wondered in his speech this morning whether regulators trust each other. Well, this exercise surely reveals a serious attempt to build such trust.

<u>Concluding, pragmatic regulation for financial conglomerates</u>
I regard this dialogue with the Swiss and the American supervisors as just a start. I am sure we will learn from this and see the added value of supervisory cooperation across more regions. Market dynamics will keep on challenging supervisory dynamics.

"We are beginning to discover that on financial market regulation we are condemned to cooperate"

EU Commissioner McCreevy in New York (7 March 2007)

"The best way of making further progress on a genuine and useful common approach is to *work together* on real life examples."

BoE deputy governor FS, Sir John Gieve (13 Nov 2006)

The work of the IWCFC doesn't stand on its own. Support for the work on conglomerates regulation is everywhere. The quotes on the screen speak for themselves; IWCFC is happy to take part in the way forward.

Thank you.