"Financial conglomerates, supervisory dynamics"
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Written version

IWCFC's chairman Arnold Schilder gratefully accepted the invitation to speak at the annual Brussels 3L3 conference. These Brussels conferences are an important opportunity to raise and discuss issues of deep interest to all three Lamfalussy committees.

Arnold Schilder mainly spoke about the work the supervisory community has been doing in the EU on conglomerates, and explained the details of the work of the Interim Working Committee on Financial Conglomerates (IWCFC).

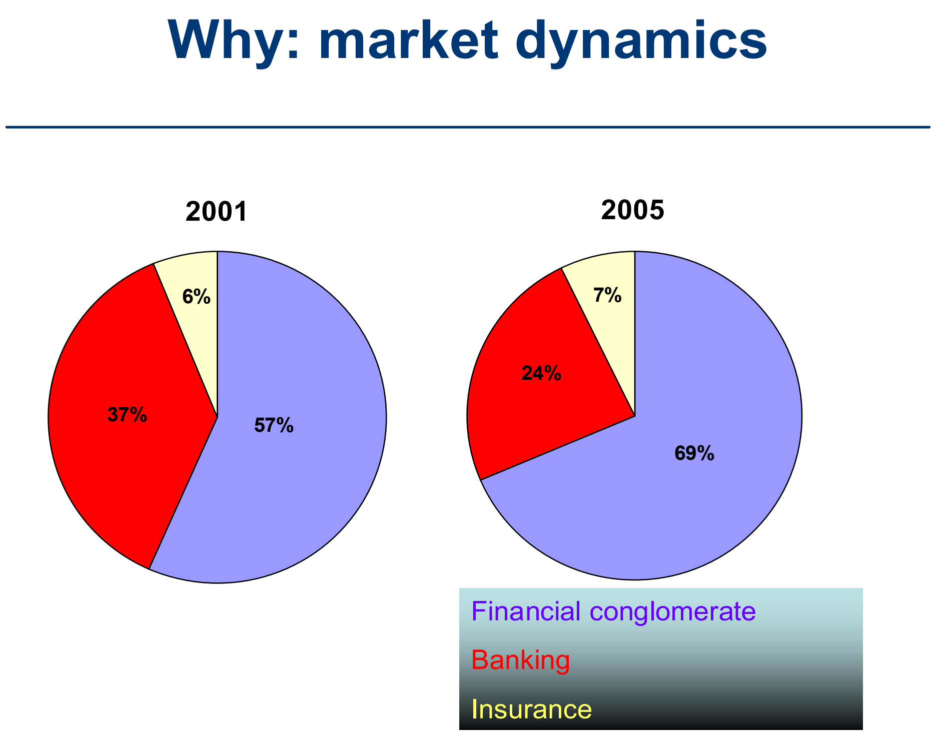
The structure of the Committee itself tells a lot about the joint effort that is needed to address the issue of conglomerates. The Committee was established after discussions with pretty much all the key national supervisors and EU authorities.

The set-up involved the European Commission, EU supervisors in banking and insurance, and the three sectoral committees CEBS, CEIOPS, and also CESR. It was also clear that the finance ministries and Commission - in the Economic Financial Conglomerates Committee (EFCC) at what we call level 2 - needed technical experts to feed its discussions.

It was agreed that the organizational structure of the Committee would need to be explicitly balanced. First, its members are from all sectors, the chair and vice chair are from two of the sectoral committees (Banking and Insurance). Second, the Secretariat is a co-production of the CEBS and CEIOPS secretariats. This means that the output is not only fed by cross sectoral input, but also supported by banking and insurance.

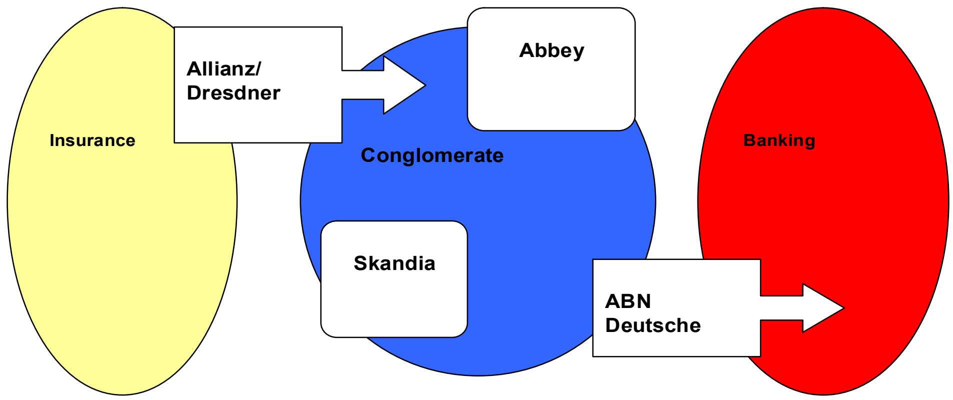
Market dynamics

The diagrams below illustrate what happened in recent years in the financial sector, and how these developments made everyone think about conglomerates' supervision.



These two diagrams illustrate the growth of conglomerates between 2001 and 2005 in the European Union. The blue sections represent conglomerates, yellow represents insurance firms and the red represents banking, in terms of relative balance sheet totals of the largest 25 banks, insurers, and conglomerates. It is obvious that the conglomerates-part has grown in the last 5 years.

Why: market dynamics



Not only is the conglomerates part growing and dominating the picture, it is also a dynamic picture.

For example ABN AMRO transferred its insurance activities to Delta Lloyd, and 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 their insurance-participations in, among others, Gerling.

On the other side, the insurance group Allianz moved from insurance towards conglomeration, through its acquisition of Dresdner in 2001 for about 21 billion euro.

There have been many more acquisitions, including significant acquisitions between existing financial conglomerates. For example Skandia was acquired by Old Mutual last year. Another example is the acquisition of Abbey by Santander in 2004, an acquisition of 15 billion euro.

Market dynamics matter

Supervisors need to bear in mind the financial stability effects of these market dynamics. The President of the European Central Bank, Mr Trichet, explained to CEIOPS conference in 2005 that focussing on modernizing prudential supervision was a good thing, but the market would go on sharing and hedging risks and developing instruments for that. New problems could arise as risk sharing could induce potential contagion. Supervisors want to be ahead of that evolution, not by limiting the market in sharing and hedging risks, but by knowing what happens and making sure their processes are adequate to protect clients´ claims.

In his speech, Arnold Schilder demonstrated how supervisors think about addressing these developments, including the first results of those joint supervisory efforts, and what results may be expected in due course.

Regulatory dynamics

Regulators and supervisors have been observing the evolution towards more cross border and cross sector consolidation for some years now. This is reflected in the Financial Conglomerates Directive (FCD) itself.

The FCD is a key directive in requiring cross border cooperation between supervisors, on an operational basis. It requires competent authorities to agree on a coordinating supervisor. This coordinator has responsibility for monitoring and aggregating all the key risks faced by the conglomerate, in both its banking, securities and insurance business.

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 it also gives the consolidating supervisor a key role across banking groups, in terms of model validation for advanced approaches.

The European Commission is currently working on the first drafts for the framework directive for Solvency II. The Commission's draft for the Framework Directive for Solvency II might be developed in an innovative way reflecting the economic reality of insurance group structures.

Of course, financial conglomerates are not licensed themselves. Instead, insurers, banks, investment firms, and many other types of financial service providers are licensed. This makes the enforcement of supervisory requirements for financial conglomerates quite difficult.

However, the FCD has answers to this problem. It requires supervisors to monitor the key risks faced by conglomerates: concentration risk, intra group transactions and the capital at the top level. Moreover, the FCD calls also for the monitoring of group processes such as internal control and risk management.

Supervisors also need to complement their sectoral, or national view, with a wider view of the whole institution. And finally they need to share their view of the conglomerate's risk with the management of those conglomerates. Essentially the FCD addresses the collective concern that conglomerates matter, and that contagion risks and other risks may arise in a conglomerate.

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. The European Commission and the European Parliament support their plea. The members of the IWCFC are trying to make sure conglomerates supervision is done efficiently keeping in mind that conglomerates need to be able to operate under both the CRD and Solvency II, but do not want to complicate supervisory matters for the groups. So they aim for greater convergence, to make both risk management and supervision more efficient, coherent and less burdensome for conglomerates.

EC and EFCC need practical advice

An important impulse to set up the IWCFC came from the European Commission and the EFCC. Driven by their observation of the market dynamics, and other regulatory developments, they recognised that they would need very practical advice from supervisory experts on the implementation of the FCD and any reviews of the legislation that may be needed in the next few years.

Level 3 committees' agendas loaded

Secondly, CEIOPS, CEBS and CESR, as supervisory committees, have been working on cross sectoral issues in their daily work. But besides all the cross sectoral work, there is also a need to work on issues that are specific to conglomerates. And it is hard to fit this perspective into the already heavily loaded work programmes of the sectoral committees.

Timing: FCD implementation

The timing of the IWCFC is just right. The FCD is just being implemented by all member states, and supervisors will profit from each others' experience and ideas. In the IWCFC there is a strong sense of this from the enthusiastic participation in the expert groups, i.e. cooperation not as an end, but as a means to better supervision.

Coherent view is not extra view, nor equal

Arnold Schilder underlined that the IWCFC is not seeking a parallel view on supervising conglomerates. Instead, as the Directive requires, the aim is to have a *coherent* view that enables more and better convergence for the supplementary supervision of conglomerates in Europe. This mission is implicit in the way the Committee works, with joint task forces and expert teams, often drawn from the sectoral committees.

Schilder explained that coherence is not the same as full sectoral uniformity. There are a lot of 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.

The European Commission confirmed this mission in a letter to the IWCFC last November. The European Commission is asking supervisors to synthesize views from banking, insurance and securities supervisors, to provide an output that addresses the unique challenges posed by conglomerates.

The IWCFC's action plan

Mapping and co-operation arrangements

First, the IWCFC started by investigating which institutions are the financial conglomerates in Europe and who are their supervisors. This "mapping" exercise immediately tackled the issue of the identification of a conglomerate. The FCD sets out basic rules and criteria that must be met before the supplementary supervision of the institution kicks in, as indeed imposing this burden on those institutions that genuinely are conglomerates, as it is not without costs.

Also, there is a need to know who is involved in the supervision of large groups, which are the Relevant Competent Authorities (RCAs) and how to make sure supervisors cooperate and share information but keep operations effective. This work is still ongoing in 2007 and links to the question of co-operation arrangements.

Implementation stocktake

Second, the IWCFC held a stocktake on the implementation of the FCD in the member states, where and how the different implementation of rules could have a high impact on international groups. An implicit side-effect of this stocktake was that those member states that have not yet fully implemented every single detail of the FCD can draw on the good practice of the other member states, and can be assured that they have a high degree of convergence from the start.

The Committee has started work to look in detail at the key risks for conglomerates - concentration risk and intra group transactions. It is not envisaged that the Committee will want to, or be able to, come up with level 3 guidelines in these areas. But the hope is that by sharing information and experiences in these areas there will come to a much better and common understanding of the issues.

EFCC Calls for Advice: Capital and Equivalence

Third, they have been working on two draft Calls for Advice, from the European Commission and the level 2 financial conglomerates committee, the EFCC. These cover an investigation of the eligibility of capital in the different sectors, and a joint exercise on the equivalence of group supervision in the USA and Switzerland.

Tour de table and case studies

Last but definitely not least, day to day supervision is a structural item on the Committee's agenda. In the tour de table any problem or practical case can be put on the table in a confidential session with supervisors. There already several cases encountered where the directive does not provide for straightforward solutions, such as how to define risk concentration exactly and the treatment of minority participation in reporting.

In the same line of thinking about current supervisory practices, financial conglomerates themselves are invited to talk to the Committee in lunchtime sessions. This is proving very interesting and effective, as this gives the chance as practitioners to discuss real life cases with the senior management of an institution.

The Capital report

The Committee started in May 2006, and has been hard at work ever since. Most of this work has been internal. But already a major piece of work has been published in January this year: a report on the eligibility of capital instruments. This result is in large part due to the very effective cooperation of a special Joint Task Force (chaired by Sylvie Matherat and Paul Sharma), the active contribution of IWCFC members, a very productive secretariat, and above all a true spirit of cooperation between sectoral supervisors.

Experts from insurance and banking, and from a representative set of member states, intensively studied the sectoral rules on the eligibility of capital. The main similarities and differences of the characteristics of regulatory capital for a bank, an investment firm and an insurance entity were analysed. It was 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 business of each sector, or by differences in the calculation of eligible capital elements and the way they are taken into account at group level.

For 2007 the Committee will analyse the impact and consequences of the comparison exercise. Experts will analyse the impact of the differences in the sectoral rules on eligible capital elements on the supervision of financial conglomerates. They expect to deliver some recommendations by end-2007.

Equivalence exercise

Working with CEBS, in 2007 the IWCFC will provide the European Commission with some technical analysis of the equivalence of the supervision of financial conglomerates and banking in the United States and in Switzerland. The supervisors in Switzerland and the United States have been asked on their approaches, the developments in their domestic regulation, and their supervisory practice. Also the Committee's Members have been asked to report on their experiences. That will provide the basis for the technical analysis.

Market dynamics remain challenging

This list of work shows the efforts that are needed at the EU level. However, the large conglomerates do not operate solely - and some not even mainly - within Europe. In this regard the dialogue on the equivalence work with the Swiss and the American supervisors is just a start. Supervisors will learn from this and see the added value of supervisory cooperation across more regions. Market dynamics will keep on challenging supervisory dynamics. And also the finance ministry colleagues in the EFCC are likely to keep the IWCFC busy with requests to review the FCD and advise them on whether amendments are needed.

Future prospect

And looking into the medium term, by 2010 Arnold Schilder hopes the IWCFC will have finished a lot of cross sectoral and cross border work in the field of conglomerates' supervision:

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