PARTECIPATIONS AND DEDUCTION

IWCFC Meeting on 19th February 2008

Report

From a financial conglomerates' perspective, the different thresholds for deductions of holdings in banks are only critical if they provide room for regulatory arbitrage. Taking into account that the difference in sectorial rules only encompasses those with holdings in banks between 10-20%, which are not already deducted because of a durable link, the IWCFC currently regards the potential for regulatory arbitrage as low. Therefore the IWCFC would propose neither amendments of the sectorial rules, nor the implementation of a financial conglomerate specific rule. The IWCFC would rather leave it to the supervisory discretion to intervene, if necessary, on a case-by-case basis to avoid arbitrage. What are your views on this conclusion? You are invited to provide evidence of the practical relevance of the sectorial differences from a financial conglomerate point of view. What are the elements you take into account when deciding to allocate a holding/participation in one part of the financial conglomerate rather than another? Do the current thresholds/rules cause any difficulties/prevent you from taking a stake in a bank or insurance company? How many holdings in banks between 10 and 20% does your financial conglomerate actually hold?

1. The foregoing request to provide views and evidence is based on the difference in treatment of holdings/participations in banks under existing regulations, according to whether such holdings/participations are held by a bank or insurer, and consequently on the possibility that such difference in treatment may give rise to incentives for engaging in regulatory arbitrage.

The report also makes clear that the different treatment is based on differences in the operating methods adopted in practice by banks and insurers, and suggests that the existing regime of differentiated treatment might be retained for this reason (cf. point 81 of the Report). The report also summarizes various other possible forms of action aimed at realigning the disparate treatment of holdings/participations in banks.

We would like to stress at the outset that in our view analysis of this issue requires a broader perspective, to ensure that the regulations overall are consistent and to take into account the most significant issues that appear not to have received suitable consideration in the current regulatory and analytical context.

2. In principle, the regime for deducting holdings/participations, inter- and intra-sectorial, serves to help tackle the issue of multiple calculations of net equity for regulated companies belonging to the same group.

However, the current regulatory framework does not appear to take due account of the differences encountered according to whether the holding/participation is owned by (a) a "homogeneous" intermediary, i.e. a shareholding in a bank which is owned by a bank, or (b) a "non-homogeneous" intermediary (e.g. a shareholding in a bank owned by an insurer).

In the second instance, along with the risks of possible multiple gearing there are also a number of advantages: indeed, the risk diversification profiles that characterize financial conglomerates as compared with homogeneous groups have been dealt with in considerable depth, as have the related reduction in volatility of earnings deriving from cost and revenue synergies, and economies of scale in terms of IT and risk, in both the theoretical[1] and technical[2] literature on the subject. Such features enable conglomerates to counter changes in the economic cycle and market shocks more effectively, including from a prudential standpoint, a factor which ought to receive due consideration.

The fact that the creation of inter-sectorial ownership links generates positive as well as negative effects – which, *ceteris paribus*, also mitigates the impact of the multiple gearing issue – should mean that inter-

[1] See, for example, DIERICK, *The Supervision of Mixed Financial Services Groups in Europe*, European Central Bank – *Occasional Paper Series*, no. 20, 2004, p. 14, DE NICOLÒ, BARTHOLOMEW, ZAMAN AND ZEPHIRIN, *Bank Consolidation, Internationalization and Conglomeration, Trends and Implications for Financial Risk*, IMF Working Paper, no. 3/158.

[2] See the opinion given by CES upon the occasion of reviewing proposals for the directive on financial conglomerates, in which the Committee observed that it would have to "*take greater account of the reductions in risks deriving from their diversification and also of the techniques created for this purpose, including the offsetting of opposite positions*" (17 October 2001, published in Official Journal of European Union, no. C 36/1, issued on 8/2/02).

sectorial holdings/participations receive more favourable treatment than intra-sectorial investments. In turn, this should translate, on the one hand, to an increase in the quantitative threshold for applying deduction; and on the other, to recognition of the fact, in the rationale underpinning the regulations on deduction, that the existence of durable links in relations between investor and investee companies is of no relevance in terms of whether or not the investor company's capital is more exposed to risks.[3]. All this means that the reference to the subsistence or otherwise of durable links in the definition of holding/participation[4] is inconsistent with the purposes of the rules on deduction.

4. The criterion for deducting inter-sectorial holdings/participations, in its current formulation, raises another area of difficulty that generates major competitive imbalances and creates opportunities for potential regulatory arbitrage. Such opportunities, which have also been noted by the CEBS,[5] have yet to be analysed or assessed in any depth.

The fact that the conglomerates directive took its definition of holding/participation from directive 78/66/CEE on companies' annual accounting, which introduced the concept of durable links, has brought about generated considerable uncertainty in terms of interpreting the regulation, with broad differences in how the latter is applied. In particular, while some countries have made provision for deducting only shareholdings in excess of the 20% threshold, in others it also applies to holdings below the 20% level where there is a durable link between the two companies[6]; a rule which itself is interpreted differently from country to country. The effects of such different applications is to create competitive disadvantages for banks in countries where the regulation is applied restrictively, putting them at a disadvantage in their investment activity compared to their non-domestic competitors.

5. In conclusion, and in view of the foregoing, we would ask the Committee in its final document to make clear the need for defining a single, univocal rule for deducting inter-sectorial holdings/participations, on the following terms:

(a) by setting the quantitative threshold at 20%, on account of the positive effects this could have in terms of risk diversification;

(b) abolishing the durable link criterion from the definition of shareholdings relevant for purposes of deduction.

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[3] Indeed, it could be argued that the existence of durable links could lead to an increased diversification and mitigation of the risk to which the conglomerate's overall capital is exposed, with the positive effects that a similar condition usually entails from the prudential supervisory standpoint.

[4] Cf. Article 4, point 10 of directive 2006/48/CE, pursuant to which "participation" is defined as "a participating interests as defined pursuant to Article 17, paragraph 1, of fourth Council directive 78/660/CEE issued on 25 July 1978, in relation to annual accounts for certain types of company, or the fact of directly or indirectly holding at least 20% of the voting rights or share capital of a company". Article 17, paragraph 1 of directive 78/660/CEE itself provides that participating interest "shall mean rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to increase the company's assets".

[5] Cf. the first part of the "*Survey of the implementation of the current rules on own funds across Member State*", issued on 23 June 2006 and the "Report on Part A" ("*Report on the impact of the differences in sectorial rules on the calculation of own funds of financial conglomerates*") issued in August 2007.

[6] See in this connection Annex 10 to the survey by CEBS ("*Overview table – Ancillary Own funds*", pp. 15ff.), containing a table summarizing the rules for deduction as implemented in the various member states. In this sense, for example, Spain has opted for the first solution and Italy and France for the second.