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COMMISSION STAFF WORKING DOCUMENT

Technical analysis

Accompanying the document

Report from the Commission to the European Parliament and the Council

Report on the review of the Directive 2002/87/EC of the European Parliament and the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

{COM(2012) 785 final}

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1. INTRODUCTION & OBJECTIVES

1.1. Background

The Financial Conglomerate Directive (FICOD) was adopted on 20 November 2002.[1] It follows the Joint Forum's principles of 1999,[2] aiming in particular to provide methods for assessing the capital adequacy of conglomerates, including: detecting multiple gearing; facilitating the exchange of information among supervisors; coordination among supervisors; testing the fitness and propriety of managers, directors, and major shareholders of the conglomerate; and the prudent management and control of risk concentrations and intra-group transactions and exposures.

The first review of FICOD (FICOD1) was adopted in November 2011[3] following the lessons learnt during the financial crisis of 2007-2009. Revision was needed to fill the identified gaps immediately by giving supervisors more powers. FICOD1 amended the sector-specific directives to enable supervisors to perform consolidated banking supervision and insurance group supervision at the level of the ultimate parent entity, also if that entity was a mixed financial holding company. In addition to that urgently needed solution, FICOD1 introduced a waiver for the smallest conglomerates, added a transparency requirement for a group's legal and operational structures, and brought non-harmonised asset managers within the scope of supplementary supervision in the same way as harmonised asset-managers.

Given the need to review further aspects to determine whether the Directive is achieving its objective, FICOD1 required the Commission to deliver a review report before 31 December 2012, and to follow it up with legislation if deemed necessary (Article 5):

The Commission shall fully review Directive 2002/87/EC, including the delegated and implementing acts adopted pursuant thereto. Following that review, the Commission shall send a report to the European Parliament and to the Council by 31 December 2012, addressing, in particular, the scope of that Directive, including whether the scope should be extended by reviewing Article 3, and the application of that Directive to non-regulated entities, in particular special purpose vehicles. The report shall also cover the identification criteria of financial conglomerates owned by wider non-financial groups, whose total activities in the banking sector, insurance sector and investment services sector are materially relevant in the internal market for financial services. The Commission shall also consider whether the ESAs should, through the Joint Committee, issue guidelines for the assessment of this material relevance.

In the same context, the report shall cover systemically relevant financial conglomerates, whose size, inter-connectedness or complexity make them particularly vulnerable, and

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1 Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC.

2 The Joint Forum is the joint body of the international standard setters: the Basel Committee for Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), and the International Organisation of Securities Committees (IOSCO).

3 Directive 2011/89/EU of the European Parliament and of the Council of 16 November 2011 amending Directives 98/78/EC, 2002/87/EC, 2006/48/EC and 2009/138/EC as regards the supplementary supervision of financial entities in a financial conglomerate.

which are to be identified by analogy with the evolving standards of the Financial Stability Board and the Basel Committee on Banking Supervision. In addition, that report shall review the possibility to introduce mandatory stress testing. The report shall be followed, if necessary, by appropriate legislative proposals.

This Staff Working Document accompanies the Commission Report. It explains in more detail the analysis carried out by the Commission, building on work done in international fora, discussions with stakeholders, supervisors and Member State experts, and a vast amount of literature on lessons learnt during the crisis with respect to large, complex financial groups. For issues needing supervisory expertise and experience, the Commission asked advice from the Joint Committee Subcommittee on Financial Conglomerates.[4] To obtain the views of a larger group of stakeholders, the Commission organised two conferences in June 2010[5] and June 2012,[6] and carried out a consultation between February and April 2012.[7]

1.2. The purpose of the review and the Joint Forum's revised principles

1.2.1. Review objective given new market dynamics

This review is guided by the objective of FICOD, which is to ensure the supplementary supervision of regulated entities that form part of a conglomerate. To do this, FICOD focuses on the potential risks of contagion, complexity and concentration, i.e. the group risks, and the detection and correction of double gearing as well as the multiple use of capital. The review aims to analyse whether the current provisions of FICOD, in conjunction with the relevant sectoral rules for group and consolidated supervision, are effective beyond the provisions introduced by FICOD1. The review is justified as the market dynamics in which financial conglomerates operate have changed substantially since the Directive entered into force in 2002.

The financial crisis showed how group risks materialised across the entire financial sector. This demonstrates the importance of group-wide supervision of such inter-linkages within financial groups and among financial institutions, supplementing the sector-specific authorisation requirements.

1.2.2. The Joint Forum's revised principles

The Commission participates in G20 work streams dealing with crisis lessons. In this particular area, the Joint Forum's revised 2012 principles for the supervision of financial conglomerates are important. The revised principles follow up recommendations endorsed by the Financial Stability Board (FSB) on 9 January 2010, with specific regard to the inclusion of non-regulated entities within the scope of supervision and the inclusion of the full spectrum of risks that a financial group can be exposed to.

The Joint Forum's revised 2012 principles recognise that the financial crisis that began in 2007 highlighted the significant role played by financial groups, including

4 https://eiopa.europa.eu/consultations/consultation-papers/2012-closed-consultations/may-2012/eba-eiopa-and-esmas-joint-consultation-paper-on-its-proposed-response-to-the-european-commissions-call-for-advice-on-the-fundamental-review-of-the-financial-conglomerates-directive-jccp201201/index.html All the references to ESAs' advice in this text refer to this particular advice.

5 http://ec.europa.eu/internal_market/financial-conglomerates/supervision_en.htm.

6 http://ec.europa.eu/internal_market/financial-conglomerates/conference_28062012_en.htm.

7 http://ec.europa.eu/internal_market/financial-conglomerates/call_for_evidence_en.htm.

conglomerates, in the stability of global and local economies. Due to their economic reach and the mix of regulated and unregulated entities (such as special purpose entities and unregulated holding companies), financial conglomerates cross sector boundaries and present challenges for sector-specific supervisory oversight. In hindsight, the crisis exposed situations where regulatory requirements and oversight did not fully capture all the activities of financial conglomerates or fully consider the impact and cost that these activities may pose to the financial system.

At the request of the Financial Stability Board in 2009, the Joint Forum delivered a report in January 2010 on the differentiated nature and scope of regulation (DNSR report),[8] with the aim of identifying gaps in the overall framework of prudential supervision. The DNSR report noted a number of issues that, if addressed, could improve supervision. The report recommended that all financial groups, particularly those active across borders, should be subject to regulation and supervision covering the full spectrum of their group-wide activities and risks, including all risks from entities within the group (whether regulated or unregulated) that may have a significant impact on the financial position of the group. The report also noted that gaps in regulation and supervision should be avoided and the potential for regulatory arbitrage minimised.

The DNSR report stated that the Joint Forum's 1999 principles should be updated to

(i) ensure that the principles properly address developments in sectoral frameworks and in markets since 1999;

(ii) facilitate more effective monitoring of activities and risks within a financial group, particularly when these activities span borders and the boundaries across the regulated and unregulated areas of the financial system;

(iii) provide a basis for increased supervision and regulation of financial groups, particularly when a group or any of its parts is identified as systemically important;

(iv) improve international collaboration, coordination, and cooperation among supervisors across sectors;

(v) clarify the responsibility and power of supervisors with respect to the risks in their jurisdictions stemming from an entity being part of a financial group;

(vi) ensure that a financial group's structures are transparent and consistent with its business plan, and do not hinder sound risk management; and

(vii) provide, as far as possible, credible and effective options for action during a crisis or to avoid a crisis.

The Joint Forum's revised 2012 principles are referred to and cited in this document where appropriate. An overview of the principles and the EU framework is presented in Annex 6.

8 http://www.bis.org/press/p100108a.htm.

2. THE SCOPE OF THE DIRECTIVE AND THE LEGAL ADDRESSEES OF THE REQUIREMENTS

2.1. Scope

2.1.1. The scope of FICOD and sectoral legislation

Most of the groups operating in the financial sector have a broad spectrum of authorisations. Focusing on the supervision of only one type of authorised entity ignores other factors that may have a significant impact on the risk profile of the entity's activity. Fragmented supervisory approaches are not sufficient to cope with the challenges that current group structures pose to supervision.

The supplementary supervision framework for conglomerates is meant to strengthen and complete the full set of rules applicable to financial groups, across sectors and across borders. However, from a regulatory standpoint, this should not mean that additional layers of supervision have to be added when the sectoral requirements already cover all types of risk that may arise in a group.

Technical provisions, own funds and insurance-specific capital rules are well catered for by Solvency II[9], and are crucial for sound insurers both on a stand-alone basis and as part of a group. Capital requirements for banking exposures[10] are crucial for adequate pricing of the assets of licensed banking entities, the continuous monitoring and measuring of risks, and the availability of own funds to absorb unexpected losses. The monitoring, measurement, pricing and control of sector-specific risks forms the core of the sectoral frameworks and should not be touched upon in a context of complex conglomerates with many licences.

2.1.2. Coverage of unregulated entities including those not carrying out financial activities

In order to address group risks, which was the original aim of FICOD and the Joint Forum's 1999 principles, as re-affirmed by the revised 2012 principles, group supervision should cover all entities in the group which are relevant for the risk profile of the regulated entities in the group. The FICOD definitions of a group and a financial conglomerate do not exclude unregulated entities. However, the lack of a harmonised approach towards unregulated entities may have caused uncertainty and inconsistencies in the application of the requirements by supervisory authorities in Europe.

The Joint Forum suggests including unregulated entities, as it is important for supervisors to consider risks arising from the activities of entities that form part of the financial conglomerate (or the wider group to which the financial conglomerate belongs) but are not directly prudentially regulated. Each unregulated entity may present different risks to a financial conglomerate and each may require separate consideration and treatment. In deciding which unregulated entities are relevant, the Joint Forum suggests considering, as a minimum, holding companies (including intermediate holding companies),

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9 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

10 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), as amended by Directive 2011/89/EU of the European Parliament and of the Council of 16 November 2011.

unregulated parent companies and subsidiaries, and special purpose entities (SPEs). This implies a total balance sheet approach, aiming not to regulate all entities related to the regulated financial entities, but to include all entities relevant for the risk profile of the regulated financial entities within supervisory monitoring.

The number of SPEs and the complexity of their structures increased significantly before the financial crisis, in conjunction with the growth of markets for securitisation and structured finance products, but have declined since then. While the use of SPEs yields benefits and may not be inherently problematic, the crisis has illustrated that poor risk management and a misunderstanding of the risks of SPEs can lead to disruption and failure. The need for enhanced monitoring of intra-group relationships with SPEs was highlighted in the Joint Forum's 2009 SPE report[11]. Inclusion is also supported by the scope of consolidation under the accounting rules. According to the current accounting standards (IAS27/SIC12), and even more so under the new principles (IFRS10), controlled special purpose entities are included within the scope of accounting consolidation. IFRS12 will require disclosure of material SPEs that would not be consolidated under the IFRS10 standard. This approach is also in line with the approach in Solvency II, where a specific set of provisions is established for special purpose entities, at both individual and group level.[12]

In their advice, the ESAs recommend enlarging the scope of supervision to ensure a more thorough group-wide supervision and avoid possible regulatory arbitrage, by extending the groups of entities that can be included in the identification of financial conglomerates. Accordingly, the ESAs propose a more consistent and broader identification of financial conglomerates and suggest modifying the definition of 'financial sector' [according to Article 2 (8) FICOD] and/or the definition of 'regulated entities' [according to Article 2 (4) FICOD]. With regard to SPEs, they recommend that in principle all special purpose entities must fall under the supervision of a financial conglomerate, because they may not always be covered by sectoral legislation or accounting rules. The inclusion of these entities should guarantee that the risks arising from entities within a group are appropriately captured, regardless of their nature (e.g. shadow banking).

The ESAs have assessed whether institutions for occupational retirement provision (IORPs) should be included as part of a financial conglomerate and are mindful of the national specificities of IORPs. Views are mixed, especially as the national specificities are very diverse. The ESAs recommend maintaining the status quo for the time being, i.e. FICOD should not include IORPs within group-wide supervision at cross-sectoral level. The ESAs note that the IORP Directive is currently being reviewed and a quantitative impact assessment is being carried out in order to determine the capital requirements for

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11 http://www.bis.org/publ/joint23.pdf

12 At individual level, special purpose entities may be regulated entities under the Solvency II Framework Directive, including conditions for the authorisation of undertakings that assume risks from insurance and reinsurance undertakings and fully fund their exposure. These conditions will be further specified in a delegated act. They include the specification of the fully funded principle, together with fit and proper requirements for shareholders and accounting and reporting procedures. These provisions were meant to strike the right balance between the need to preserve the beneficial role played by SPEs in the financial market and the need to subject them to a minimum set of prudential requirements.
Moreover, the Commission intends to make sure in the delegated acts that SPEs are subject to group supervision and, where relevant, to group solvency calculation to fully capture the risk of SPEs where risk is not really transferred to the SPE from the sponsor undertakings..

IORP activities. The work is expected to be completed by June 2013. The ESAs therefore recommend that the Commission should then include a review clause and mandate the ESAs to work on this issue again.

The inclusion of non-regulated entities within the scope of group supervision should be consistent across the various sectors, in order to prevent restructuring to avoid regulation in a specific sector. This should also apply to the way unregulated entities are consolidated in order to calculate sector-specific capital requirements.

2.1.3. Coverage of systemically relevant financial conglomerates

The FICOD1 review clause also covers systemically relevant financial conglomerates. The challenges of supervising conglomerates are most evident for groups whose size, inter-connectedness and complexity make them particularly vulnerable.

Any systemically important financial institution (SIFI) should in the first place be subject to more intense supervision through application of the CRD IV[13] and Solvency II framework, both at individual and group/consolidated level. If the SIFI is also a conglomerate, supplementary supervision under FICOD would also be applicable. Although most SIFIs are conglomerates, this is not necessarily always the case. Also, systemic risks are not necessarily the same as group risks. Therefore, it does not seem meaningful to try to bring all SIFIs under FICOD. Furthermore, discussions at international level are still continuing on insurance SIFIs, and the sectoral legislation, including the treatment of banking SIFIs, is not yet stable.

2.1.4. Thresholds for identifying a financial conglomerate

The supplementary group supervision provisions under FICOD should be applied proportionally. It does not seem necessary to apply them to groups that are fully covered by one sector-specific framework, as their risks are already addressed in the sectoral legislation. However, when one or more regulated entities in a financial sector are combined with other regulated or non-regulated entities outside the 'original' sector, the group risks to which the conglomerate is exposed should be covered by supplementary supervision.

The existing thresholds in FICOD are meant to take into account proportionality and materiality in identifying conglomerates that should be subject to supplementary supervision of group risks. The two thresholds set out in Article 3 serve two different purposes: the first restricts supplementary supervision to those conglomerates that carryout business in the financial sector and the second restricts application to very large groups.

The level of the thresholds limits supplementary supervision to very large groups, as 10% of the billions in mostly banking assets is a very large amount in insurance assets. This has led to a situation where a small number of very large banking groups that are also serious players in the European insurance market are not identified as conglomerates. It should, indeed, be noted that some European banks identified as

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13 Commission proposals COM(2011) 452 and COM(2011) 453 final for a Regulation on prudential requirements for credit institutions and investment firms final and for a Directive on the access to activity of credit institutions and prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC on financial conglomerates

systemically important (SIBs) are not subject to supplementary supervision. The identification of systemically important insurance-led groups is still being discussed by the Financial Stability Board (FSB)

FSB SIBs[14]	FICOD groups[15]	
Bank of America	Aegon	Gruppo Azimut
Bank of China	AIG	Gruppo Carige
Bank of New York Mellon	Allianz	Holmo
Barclays	Alm. Brand	ING
BBVA	Ameriprise	Inter Group
BNP Paribas	Argenta	Intesa San Paolo
Citigroup	Avanza	Jernbane-personalets
Credit Suisse	Axa (Belgium)	KD-AS Finančni Konglomerat
Deutsche Bank	Banco Comercial Português	Länsförsäkringar
Goldman Sachs	Bank of Ireland	Lloyds Banking Group
Groupe BPCE	Banque Neuflize OBC	Mediolanum
Group Crédit Agricole	Banque Postale	National Australia Group
HSBC	Belfius Bank	Nordnet
ING Bank	BNP Paribas	Old Mutual
JP Morgan Chase	Caixa Geral de Depositos	OP-Pohjola Group
Mitsubishi UFJ FG	Co-operative Banking	Petr Kellner
Mizuho FG	Group Limited	Rabo-Eureko
Morgan Stanley	Credit Agricole	Resurs
Nordea	Credit Mutuel	RZB — UNIQA
Royal Bank of Scotland	Danske Bank	Sampo
Santander	DEBEKA Group	SEB
Société Générale	Delta Lloyd	Signal Iduna Gruppe
Standard Chartered	Deutsche Bank	SNS-Reaal
State Street	DnB-NOR	Societe Generale
Sumitomo Mitsui FG	DZ Bank Gruppe	Sparebank1
UBS	EVROHOLD	Storebrand
Unicredit Group	Generali	Svenska Handelsbanken
Wells Fargo	Gjensidige	Swiss Re
	GRAWE	Terra Group
	Groupe BPCE	Triglav Group
		Wüstenrot
		Wüstenrot und
		Württembergische Group

The table above shows which groups, on the left, should be subject to more intense supervision, higher loss absorbency standards, and living will obligations, according to the FSB. These groups are exposed to group risks, but are not necessarily subject to supplementary group risk provisions under the current conglomerates framework. Comparing the two columns, it is not clear whether the thresholds, combined with the

14 http://www.financialstabilityboard.org/publications/r_121031ac.pdf List dated 1 November 2012.
15 http://www.eba.europa.eu/cebs/media/Joint-Committee/List-of-Identified-Financial-Conglomerates-as-at-1-July-2012.pdf List dated 20 July 2012

possibility for supervisors to waive the application of FICOD where groups have less than 10% of their total assets in the smaller financial sector, even though these smaller sector assets exceed the absolute threshold of €6 billion will ensure coverage of the most relevant financial conglomerates. Supervisors report that the thresholds can hamper rather than support the proportional application of supplementary group supervision. At the same time, it is considered important that the definition and criteria for identification of a financial conglomerate are clear and enforceable in court. Simple thresholds would meet this need and at the same time ensure a level playing field across the European Union. However, to take account of the risks of certain complex groups, a more risk-sensitive approach to the thresholds is called for. Furthermore, the wording of the identification provision may leave room for different ways to determine the significance of cross-sectoral activities. It could be improved to ensure consistent application across sectors and borders.

The Joint Forum does not apply thresholds, nor does it distinguish only two sectors like the current FICOD. If the Joint Forum's definition were to be applied, without further restriction by thresholds, the intensity of supplementary supervision for group risks would become inherent to the complexity of the group structure. In the European context, however, it needs to be remembered that credit institutions and investment banks are subject to the same rules under the CRD, and a different regime for supplementary supervision could lead to an unclear regulatory situation.

2.1.5. *Coverage of industrial groups owning financial conglomerates*

The current regulatory framework for prudential supervision builds on the notion of authorising specified businesses. If an undertaking wants to engage in financial business such as banking or insurance, it needs to apply for an authorisation. However, when hundreds or even thousands of legal entities with or without authorisation are combined in one and the same group with one and the same business strategy, the authorisation of individual legal entities lacks a group-wide view. This is why the supplementary framework for conglomerates was invented in the first place. However, the crisis showed that this supplementary set of provisions was ineffective in managing the risks that conglomerates are exposed to. While there is agreement that regulated financial entities are exposed to group risks from the wider industrial group to which they might belong, no conclusion can be drawn at this stage as to how to extend the FICOD requirements to wider non-financial groups in addition to what is discussed below regarding the establishment of an intermediate financial holding company. Currently there is no legislation on the supervision of industrial groups owning financial conglomerates and the ESAs have no empowerment to issue guidelines. Therefore, while the ESAs will certainly play a key role in ensuring the consistent application of FICOD, it is premature to reach any conclusions on the need for the ESAs to issue guidelines on this specific topic.

2.2. Entities responsible for meeting group-level requirements

Article 5 of FICOD determines the scope of supplementary supervision and describes which entities should be subject to the requirements of Section II. Member States should determine which legal entities fit the description of Article 5 in their national legal framework. However, a closer look at the list of entities in Article 5(2) reveals that only the regulated entity heading the conglomerate can actually comply with the requirements set out by FICOD for conglomerates. What remains unclear is the distinction between:

- the entities to be included within the scope of supplementary supervision,
- the entities that can be held liable for any breach of the supplementary supervision requirements, i.e. the ultimately responsible entities.

The academic literature confirms that FICOD does not sufficiently capture certain group structures. De Vuyst (2010 p. 314 et seq.) observes that the entities subject to the requirements of the Directive as described in Article 5 may not cover all possible group structures. Gruson (2004) observes that the range of entities listed in Article 5 implies a huge administrative reporting burden, the supervisory effectiveness of which may be questionable. Sarsa (2005) adds that the responsibilities of supervisors in FICOD Section 3 do not match the list of entities subject to supervision in Article 5. The requirements do not target either the entity that can take responsibility for meeting them, or the authority that is to enforce them.

The provisions of FICOD to detect and control group risks and multiple gearing have by their nature group-wide relevance. The entity in charge of decisions on how to meet the requirements should be the main or ultimate entity responsible, in order to enable supervisors to impose sanctions on breaches. Also, the entity responsible for compliance with the requirements needs to be the entity that can determine how to meet these requirements.

At the same time, the Treaty on the Functioning of the European Union ensures freedom of entrepreneurship and does not harmonise the legal form for businesses. Determining which entity should be the responsible entity, while not affecting the choice of legal statute, could thus be guided by clear criteria. According to that line of reasoning, Member States should ensure that supplementary supervision applies to those legal entities that meet the criteria within their national legal frameworks. The ESAs note that prudential supervision cannot go against company law principles, such as the fundamental principle of each entity within a group having legal personality and the reverse side of this principle, namely that the group as such cannot be addressed by supervisors. Similarly, the answers given to a JCFC questionnaire when the ESAs were preparing their advice to the Commission indicate that the interaction between company law and the content of the responsibility for compliance with group requirements needs to be considered.

The ESAs recommend making mixed financial holding companies (MFHCs), even if unregulated, subject to supplementary supervision or the requirements proposed below. Accordingly, MFHCs should be regarded together with regulated entities as the legal addressees of supplementary supervision.

Moreover, the ESAs recommend a different approach for companies pursuing solely industrial activities (with no financial services activity at all), such as industrial conglomerates, as the supervisory focus might be diverted from financial undertakings. The ESAs explain that mixed-activity holding companies (MAHCs) and mixed-activity insurance holding companies (MAIHCs) should not be directly addressed by FICOD, but the supervisor should be able to access relevant information from such MAHCs and MAIHCs as part of its supervisory tool kit. This could be done by requiring the establishment of an intermediate financial holding company, by identifying a point of entry for supervisors, or by designating one regulated entity explicitly as the point of entry for group supervision.

The ESAs ask the Commission to identify and define an entity ultimately responsible for the financial conglomerate according to the following minimum criteria:

a. Control: the company ultimately at the top of the financial conglomerate is presumed to exercise legal or de facto control over most of the entities of the group and to drive the activities of the whole group. Accordingly, the ultimately responsible entity should in general be the ultimate parent company.

b. Market counterparty / listed entity: Where a financial conglomerate is listed on a stock market, the listed entity is likely to be the ultimate parent entity and, in principle, qualifies as the ultimately responsible entity. However, if the financial conglomerate includes a company that, although not the parent company, influences through its relations with the market the overall setting (in terms of both structure and strategy) of the group, then such a company would qualify as the ultimately responsible entity.

c. Ability: In cases where there are no control relationships (e.g. horizontal groups) or in cases when no single decision-making entity can be identified (for example, when company law provides for a particular governance agreement under which direction is exercised in consensus with controlled entities), the criteria for identification of the ultimately responsible entity will relate to the ability to perform specific duties towards supervisors and other entities within the group. When the ultimate parent does not have this ability, it will explicitly indicate which entity within the financial conglomerate possesses this ability.

According to the ESAs, the ultimately responsible entity should be responsible for compliance with group-wide requirements. The ESAs ask the Commission to propose that the ultimately responsible entity should have a coordinating and directing role over the other entities of the conglomerate. Moreover, some existing requirements for regulated entities and requirements that can be derived from the ESAs' guidelines on internal controls should also apply to the top parent entity, whether the entity is a holding company or a financial holding company (FHC), insurance holding company (IHC) or an MFHC.

Following their own analysis as well as the Joint Forum's revised principles, the ESAs suggest assigning the following 'responsibilities' to ultimately responsible entities as examples:

a) Acting as a reference point for supervision and meeting reporting obligations towards supervisors for the whole conglomerate.

b) Providing consolidated accounts for the whole financial conglomerate. It is proposed that the scope of these duties should cover 'participations'. This would take into account the fact that FICOD/FICOD1 already provides for some 'supplementary supervisory' tools to have a wider scope than the equivalent supervisory tool at sectoral level.

c) Ensuring adequate group structure and organisation, so that the supervision of each entity in the conglomerate, the exchange of information among group entities, and the performance of the duties under a) and b) above are not impeded. This strengthens the idea that the group's autonomous choice of internal structure and governance cannot put at risk (or prevail over) the objectives of supervision, for both the group and each entity in the group.

d) Coordinating and directing other entities in the group.

e) Ensuring that the conglomerate complies with conglomerate-level requirements.

These responsibilities have two objectives: one relates to the need for supervisors to have a single point of entry for specific intervention (including in stress and emergency situations) in the financial conglomerate; the other relates to the need for groups to have an internal organisation that ensures compliance with supervisory rules at both individual and group level.

2.3. Summary

The current framework does not specifically cover the monitoring of unregulated entities, which hampers effective group supervision. Unregulated entities should be included within the scope of supplementary supervision in the same way across all sectors, not as regulated entities, but as entities whose activities matter for the risk profile of regulated entities and as such should be monitored. It should be clear as to what constitutes a relevant group for supervisory purposes, without regulating each and every single legal entity in the group. Special attention needs to be paid to SPEs. Unregulated entities should be treated by group supervision in the same way across all sector-specific frameworks.

The combined application of the two thresholds and the use of the waiver by supervisors have led to a situation where very big banking groups that are also serious players in the European insurance market are not subject to supplementary supervision. At the same time, it is considered important that the definition and identification criteria for a financial conglomerate are clear and enforceable in court. However, the question is whether the thresholds and waivers should be amended or complemented by applying supervision in a proportionate manner depending on the risk inherent to the group. Furthermore, the wording of the identification provision may leave room for different ways to determine the significance of cross-sectoral activities. It could be improved to ensure consistent application across sectors and borders.

Part of that question concerns the distinction between only two sectors, the combined banking and investment firm sector versus the insurance sector, instead of a distinction between three sectors (banking, insurance, securities) as in the Joint Forum definition. However, as the CRD applies equally to credit institutions and investment firms, the clarity and coherence of the legislative framework needs to be ensured. The lack of group risk provisions for complex banking groups that do not meet the FICOD thresholds may be a question for the CRD rather than for FICOD.

The setting of requirements at group level should be accompanied by clear identification of the ultimately responsible entity in a financial group, which should be in charge of controlling risks on a group-wide basis and responsible for regulatory compliance with group requirements. This would ensure more effective enforcement by the supervisory authorities. The interaction with company law needs to be considered.

3. GROUP RISK REQUIREMENTS

The objective of the supplementary framework is to detect, monitor and control group risks. Group-wide requirements are important to achieve that end. The framework assumes that sector-specific risks, taken by the authorised entities, are sufficiently addressed in the sector-specific (authorisation) frameworks.

Group risks are generally considered to include the risk of multiple gearing of capital, the risk of contagion, risk concentration, conflicts of interest, and complexity (the 5 Cs). Among these are risks that increase with size and complexity: leverage risk and funding risk. Assessing group risks is all the more important in a context where risk-based supervision is organised according to apparently distinguishable, pre-defined risk categories, the detectability of which is often an illusion (Hutter 2005). The Solvency II framework recognised this by adding a separate chapter on group supervision to the chapters on dealing with sector-specific risks. Consequently, Solvency II and FICOD overlap to a large extent in both aim and substance.[16]

As the Joint Forum points out, accounting consolidation mitigates supervisory concerns as to double gearing, which FICOD Article 6 is intended to combat. The two main tools to control the other group risks are structural regulation (certain types of financial business activities are not compatible) and behavioural regulation (corporate structure and internal incentives should be adequate for proper group-wide risk management) (Lumpkin 2010, p. 120). As to structural regulation, FICOD contains two requirements: the monitoring of group-wide risk concentration and the possibility to restrict this (Article 7) and the monitoring of intra-group transactions and the possibility to restrict these (Article 8). There are no general group structure requirements in the current framework. Finally, behavioural concerns should be mitigated by sound internal control and transparent governance structures, regulated by Articles 9 and 13.

3.1. Capital — Article 6

3.1.1. Harmonisation of calculation methods

Article 6 is meant to enable supervisors to check and correct double gearing. It lists two methods, the consolidation method and the deduction & aggregation method, and requires sector-specific requirements to be met when these two methods are applied. The Joint Forum investigated economic capital models and their use in capital calculation and risk aggregation in order to understand how capital and risks are aggregated.

The JCFC's Capital Advice, published in three parts in 2007 and 2008,[17] revealed that authorities applied in an inconsistent way the consolidation methods when calculating available and required capital at the level of the conglomerate. This hampered the calculation of sector-specific capital requirements to allow for consolidation of cross-sector holdings if entities are part of the same integrated internal control system. More harmonisation of calculation methods was called for, which is why an invitation to draft binding technical standards was included in the Omnibus I initiative in October 2010.[18] This invitation was changed into a requirement in the CRD IV proposal. A draft

[16] The reason for not including supplementary supervision in the banking framework is because the Basel bodies structure their frameworks this way too: Basel 2/3 + Joint Forum principles = CRD + FICOD. Indeed, the CRD, like the Basel agreements, does not have a group risk regime for groups of banking entities only. IAIS does not have a similar framework yet, so the Commission has pursued its own initiative.

[17] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002L0087:20110104:EN:PDF.

[18] Level 2 measures for Solvency II will be published after Omnibus 2 is approved.

regulatory technical standard (RTS) was published for consultation on 31 August 2012[19] and will, if adopted, specify the methods for the calculation of capital. The standard should be ready in time for the implementation of Basel III, as part of the improved banking regulation framework. In parallel, delegated acts for Articles 228 and 230 of Solvency II will be developed to specify how the consolidation has to be carried out for the purpose of insurance capital requirements.

3.1.2. Availability of own funds

However, the discussions accompanying the development of these technical calculation standards revealed another concern regarding group-wide capital policy. Supervisors sometimes lack insight into the availability of capital at the level of the conglomerate. Solvency II sets requirements for the availability of capital at the level of the group and reporting requirements as regards the classification and tiering (quality) of own funds at group level and their availability. The availability of own funds across the constituent entities of a banking group is not the primary target of the banking requirements, leaving room for banks to allocate the excess capital of their subsidiaries, over the minimum required amount, across their group in line with fiscal drivers.

Given the complexity problem in large banking groups, the High-Level Expert Group on reforming the structure of the EU banking sector also observes in its report[20] that capital intended to serve as a buffer against certain types of high risk should be available in the entities that engage in such high-risk activities. The consolidation approach in the current framework does not give any explicit guarantee that this will be case.

As a separate issue, the eligibility requirements for capital, i.e. the quality of the capital buffers, were in justified cases harmonised as far as possible across CRD II and Solvency II, following the JCFC's Capital Advice in 2008.[21] However, Basel III re-defined the eligibility of capital and new differences emerged.

3.2. Risk concentration — Article 7

3.2.1. Current requirements and supervisory powers

Article 7 of FICOD gives a lot of discretion to supervisors to perform one of the most important functions of FICOD: the detection of an excessive build-up of aggregated risks across the group. As the 1999 Joint Forum principles pointed out, risk concentrations can take many forms, including exposures to individual counterparties, groups of individual counterparties or related entities, counterparties in specific geographical locations, industry sectors, specific products, and service providers. In addition, specific risk types can build up if aggregated across the group, such as market risk, interest rate risk and operational risk. Article 7 is accordingly drafted in a broad manner, enabling supervisors to limit certain concentrations of risk, including funding risk. However, according to academic studies (see for example Blundell-Wignall 2009, p. 5), supervisors have not made use of this possibility. The lack of clarity as to legal addressees may explain this

[19] http://eba.europa.eu/News--Communications/Year/2012/ESAs-consult-on-the-application-of-the-capital-cal.aspx.

[20] High-Level Expert Group on reforming the structure of the EU banking sector, Final report, Brussels 2 October 2012, page 95.

[21] https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/IWCFCAdvice.pdf.

lack of intervention, but so may the lack of clarity as to what is possible with the discretionary powers in Article 7.

FICOD1 introduced in Article 7 a requirement for ESAs to develop guidelines aimed at the convergence of supervisory practices and to align the supervisory tools addressing risk concentration policy for conglomerates with those applied to insurance groups and banking groups, following Article 244 Solvency II and Section 5 of CRD IV (the large exposures regime). In an internal study the JCFC has been investigating this specific area in relation to European supervisors' practices, but no guidelines have yet been published.

Ever since 1999, the Joint Forum has been pointing out how risk concentrations build up in the system and what supervisors could do to correct excesses. In all those exercises it turned out that the supervisory community still lacked sufficient tools to detect and correct risk concentrations.[22]

Credit default swaps (CDS) and subprime markets are a case in point. An analysis issued by the Joint Forum in April 2008 highlights that while CDS may allow effective mitigation of risk concentrations, it can at times give rise to 'new' exposures or risk combinations for firms (see Annex 1 for a summary) The risk concentrations observed during the crisis starting in August 2007 and continuing into 2008 were:

– excessive exposures to adverse developments in market liquidity conditions,

– exposures to asset pipelines or warehousing,

– exposures to new (institutional) counterparties (e.g. hedge funds),

– legal or reputational risks leading to buy-back decisions,

– basis risks not previously recognised,

– frequency at which, or terms under which, insurance or reinsurance contracts are altered.

3.2.2. Inter-related exposures

The Joint Forum made a number of suggestions on how to better detect the build-up of risk concentrations (see Annex 1). It noted that risk concentrations in most financial conglomerates are still chiefly identified, measured and managed within separate risk categories and within business lines. For instance, credit exposures are considered within banking business units, catastrophe risk concentrations within insurance business units and so on. It characterises this as 'silo management'. Though this is the predominant practice, some financial conglomerates are striving for a more 'horizontal' (i.e. across risk categories) view of risk concentrations as it is becoming increasingly clear that risk concentrations may arise from interrelated exposures across risk categories.

The groups surveyed in the Joint Forum exercise had started to develop management tools to acquire relevant data across the group and present it to senior cross-group risk management committees. The first step within groups taking this approach was typically

[22] This was explained at the first public hearing about the FICOD review, on 8 September 2008: http://ec.europa.eu/internal_market/financial-conglomerates/docs/efcc_newsletter_sep2008.pdf.

the creation of a risk management structure with an overview of, and responsibility for, the group as a whole. This step could yield immediate benefits with a modest investment in sophisticated risk measurement tools.[23] Against this background of increasing group-wide risk management structures and the search for a common measurement methodology to support greater integration, the Joint Forum experts have seen a significant growth in risk transfer markets over the last few years.

Even without such developments, there are many more 'second-order effects' that need to be considered in a comprehensive approach to identifying risk concentrations. Second-order effects are indirect effects on a firm's exposure(s) caused by a change in economic or financial market conditions, from a shock or a change in policy. This can be within a risk category or involve contagion from one risk category to another risk category.[24]

It is also important to consider how risk mitigation approaches play out under stressful market conditions. It is impossible to compile a comprehensive list of such possible interactions, but the Joint Forum strongly believes that such hidden risk concentrations are best identified and managed through stress testing and scenario analysis. Hence, groups should invest meaningful time in preparing for extreme scenarios and exploring unlikely connections between risks.

The High-Level Expert Group on reforming the structure of the EU banking sector also observes major concentrations of risk confined to large complex banking groups, which are not covered by the current large exposures regime, nor sufficiently captured by current capital requirements.[25] The group points to model risk and tail risk as ignored risk types in the current framework, which was also observed by the Joint Forum in their Risk Aggregation analyses (see Annex 3 for a summary of the Joint Forum's study on risk aggregation models).

3.3. Intra-group transactions — Article 8

3.3.1. Current requirements and supervisory powers

Article 8 of FICOD requires regulated entities in a conglomerate to report regularly on intra-group transactions to enable the supervisor to gain a deeper understanding of any transaction and exposure between entities in a group. FICOD1 furthermore allowed Member States to set quantitative limits and qualitative requirements for intra-group transactions. FICOD1 also introduced in Article 8 a requirement for ESAs to develop guidelines aimed at the convergence of supervisory practices and to align the supervisory

[23] For instance, the Joint Forum noted an appreciation of the extent to which common exposures net out and, in addition, an appreciation of the extent to which diversification increases across a broader group. For example, interest rate risks between banking and insurance operations tend to offset one another naturally, whereas equity risks are positively correlated and benefit only from diversification effects. One sophisticated method now used by many groups is developing and embedding economic capital model frameworks across their enterprises. These approaches can improve the consistency of risk identification, but can also lead groups to focus more heavily on the perceived benefits of diversification rather than the identification of concentrations.

[24] An example of a second-order effect would be the additional loss arising from the inability of a group to liquidate some assets following a sharp decline in the value of those assets. Another example would be the additional losses from declines in the value of holdings of bonds issued by airline companies due to an increase in oil prices. Another would be the additional losses incurred by the increase in lapse rates on insurance policies due to a change in interest rate movements.

[25] High-Level Expert Group, final report, page 74.

tools concerning intra-group transaction policy for conglomerates with those applied to insurance groups and banking groups, following Article 245 Solvency II.

3.3.2. Features of intra-group transactions

In their 1999 principles, the Joint Forum explained that intra-group transactions and exposures (ITEs) can facilitate synergies within different parts of the conglomerate and thereby lead to cost efficiencies and profit maximisation, improved risk management, and more effective control of capital and funding. Achieving these benefits is a major goal of the organisational structures that give rise to ITEs. At the same time, material ITEs represent avenues of contagion within the conglomerate and complicate the resolution of an institution that is failing or has failed. Achieving the appropriate balance between the benefits and risks of integrated groups, as exemplified by ITEs, is an important objective for conglomerates and for supervisors, and the appropriate balance may vary across activities and types of ITEs. This is why FICOD Article 8 is drafted in a broad manner.

In order to keep track of potential contagion channels, supervisors need to monitor ITEs. ITEs take the form of direct and indirect claims between entities within financial conglomerates. ITEs can originate in a variety of ways, e.g. through:

- cross-shareholdings;
- trading operations where one group company deals with, or on behalf of, another group company;
- central management of short-term liquidity within the conglomerate;
- guarantees, loans and commitments provided to, or received from, other companies in the group;
- the provision of management and other service arrangements, e.g. pension arrangements or back-office services;
- exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees);
- exposures arising through the placement of client assets with other group companies;
- purchases or sales of assets with other group companies;
- transfer of risk through reinsurance; and
- transactions to shift third-party-related risk exposures between entities within the conglomerate.

In the 1999 set of principles, the Joint Forum noted that a sound risk management process for ITEs begins with policies and procedures approved by the board of directors or other appropriate body and active oversight by both the board and senior management of each regulated entity, in other words with sound internal governance. This guided the drafting of FICOD Article 8.

Since then, the Joint Forum has been following the impact of ITEs on financial groups and the financial system. A general observation is that the very same transaction or exposure can be beneficial in normal times and contagious in times of stress. A general recommendation with respect to ITEs is thus that constant monitoring of the changing character of the relationship is crucial in order to detect and control contagion channels (for more see Annex 4). The High-Level Expert Group on reforming the structure of the EU banking sector confirms the problem of usually beneficial, but potentially contagious, intra-group exposures[26] and suggests applying the large exposures limit for credit institutions not only to external parties, but also to internal, non-credit-institution parties.[27]

3.4. Corporate governance — Articles 9 and 13

The Joint Forum's revised 2012 principles describe corporate governance broadly as the processes, policies and laws that govern how a company or group is directed, administered or controlled. It defines the set of relationships between a company's management, its board, its shareholders, and other recognised stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means to attain those objectives and to monitor performance are determined.

Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system within an individual company or group helps to provide the degree of confidence necessary for the proper functioning of a market economy.

Financial conglomerates are often complex groups with multiple business lines and risk characteristics and comprising numerous regulated and unregulated financial and other entities. Given this inherent complexity, corporate governance must carefully consider and balance the combination of interests of recognised stakeholders of the ultimate parent, and the regulated financial and other entities of the group. The governance system should ensure that a common strategy achieves that balance and that regulated entities comply with regulation on both an individual and an aggregate basis. Establishing the governance system is a fiduciary responsibility of the board of directors.

FICOD Article 9 contains a requirement for conglomerates to have in place adequate risk management processes and internal control mechanisms. Article 13 contains a fit and proper requirement for those who effectively direct the business of a mixed financial holding company. Omnibus 1 added a living will requirement to Article 9, and FICOD 1 added a transparency requirement for the legal and organisational structures of groups as well as a requirement for supervisors to make the best possible use of the available governance requirements in CRD and Solvency II. CRD III and the proposal for CRD IV included, and Solvency II will include, further strengthening of corporate governance and remuneration policy following the lessons learnt during the crisis.

The Joint Forum's revised 2012 principles note the need for a comprehensive and consistent governance framework across the group with ultimate responsibility in the hands of the head of the financial conglomerate. The framework should include the treatment of conflict of interest, transparency of organisational and managerial structure,

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[26] High-Level Expert Group, sections 3.4 and 5.3.
[27] Idem, pages 74 and 89.

suitability of board members, senior managers and key persons in control functions, and remuneration policy.

3.4.1. *Responsibilities of the board and senior management of the head of the conglomerate; conflict of interest*

De Vuyst (2010) focuses on the accountability of the managers that steer a financial conglomerate. By definition, there is a constant conflict of interest between the group as a whole and its individual entities.

In order to balance and ensure the soundness of the conglomerate as a whole and the soundness of all of its constituent entities, De Vuyst (2010) suggests applying the Rozenblum doctrine, applied in some jurisdictions, in a prudential setting as a set of governance requirements. The doctrine basically builds on three pillars: (1) the group should have a common strategy that enforces the common interest, (2) any instruction by a parent entity to a subsidiary should not harm the subsidiary's financial soundness, (3) the benefits of the relationship should be two-way, i.e. there is a balance between the benefits and costs for both sides of the intra-group relationship. Applying this to financial conglomerates, the parent entity should, in return for the benefit of steering its licensed subsidiaries and given the guarantee schemes, steer the subsidiaries in such a way that the financial soundness of the subsidiaries is at all times ensured.

Another layer of complexity in the treatment of conflict of interest stems from the existence of different business sectors in a financial conglomerate, where conflict of interest may arise between the insurance side and the banking side of the conglomerate. Internal control and governance should also capture this potential conflict of interest.

A.O. Laeven (2009), Westman (2011) and Esty (1998) observe that the ultimate parent entity's managers are bound by the instructions of the owners of the group. They have an incentive to follow the instructions of these owners, as the latter can hire or fire them. The incentive to ensure the subsidiaries' individual soundness may be less disciplining than the incentives provided by the owners. For these managers, the problem of looking after subsidiaries is less pressing than the problem of following the owners' instructions, because the depositors and policy holders of the individual banks and insurers in the conglomerate benefit from guarantees provided by their governments. Westman (2011) suggests increasing the monitoring incentives for the (supervisory) board, especially in banks where the safety net reduces the monitoring incentives of depositors. Esty (1998) suggests extending the liability of owners.

The High-Level Expert Group on the structure of the EU banking sector, pointing to the studies listed above, also underlined the crucial role of the board and management in a complex group and suggests strengthening governance and control requirements for boards and management, and making those requirements enforceable by competent authorities.[28]

3.4.2. *Complexity and business structures*

Lumpkin (2010) argues that the greater financial and economic impacts associated with problems at larger institutions require a holistic approach that combines transparency, governance, regulation and supervision. Confirming the main recommendation of the

[28] Idem, section 5.5.5.

Joint Forum's DNSR report, he asserts that, to be effective, the supervision of financial groups needs to fully capture and treat all risks and entities in the group, including any unregulated companies. Furthermore, the threat of failure is a core component of market discipline, Lumpkin says, because participants have incentives to protect their own interests only if they are not fully protected. He advises incentivising behaviour consistent with the longer-term view of the institution as a going concern; a strengthening of the accountability of managers would be part of such behavioural incentives.

Blundell-Wignall et al. (2009) argue differently: group structures should be simplified, and a non-operating holding company (NOHC) structure should distinguish between the different kinds of business a conglomerate operates in. In their view, this is the only way to ensure that volatile investment banking functions do not dominate the future stability of the commercial banking and financial intermediation environment that is so critical for economic activity. An NOHC structure allows for the protected capitalisation of the separate silos and legal separation of the capital pools for subsidiaries, without which, they claim, contagion risk cannot properly be addressed. Comparing state-aided and non-state-aided banks, which were subject to the exact same rules but were operating in businesses with very different risk profiles, they find that every other structure gives too much leeway for risky activities impacting on crucial financial intermediation activities. Resolution mechanisms for smaller, legally separate entities would be more credible than those required for the large complex groups that needed to be rescued by their governments. As in Lumpkin's argument (2010), it is the threat of failure that disciplines the group; the necessary simplified structure is a consequence of the necessary discipline. This is in line with Westman's (2011) observation that, for mixed groups, no credible threat can be found.

3.4.3. *Living wills*

A powerful mechanism to promote responsible behaviour is to ensure that the managers of financial institutions and their counterparties are aware of the possibility of their failure, and therefore the need to be concerned about risk. The threat of failure — market exit — is a core component of market discipline; it keeps all participants honest (Lumpkin 2010, p. 131). This is why a living will requirement was added to Article 9 in Omnibus I. The Bank Recovery and Resolution framework[29] would roll out this requirement to the entire banking sector and thus add to credibility.

The living will concept was introduced when the awareness of 'too big to fail' hit our economies. It is important to note, however, that 'too big to fail' has much less to do with size than with structure, as Blundell-Wignall et al. (2009) pointed out. These authors argue that systemic impact stems from two factors: the potential interruption of financial intermediation in an economy to the extent that the economy would suffer significantly, and the connections of counterparties to the failing firm to an extent that would also impact the financial intermediation function in the economy. In particular, those firms that engage relatively more in derivative instruments are more interconnected with counterparties and thus expose an economy to systemic risks.

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[29] Commission proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010.

The ESAs, in their advice, also note that group risks and resolution issues have less to do with size than with complexity. They underline that even in small conglomerates apparently non-correlated risks might interact to produce negative effects especially in times of stress.

3.5. Summary

3.5.1. Capital — Article 6

The regulatory technical standard (RTS) for Article 6(2) FICOD is expected to deal sufficiently with the inconsistent use of methods to calculate capital for the purpose of regulatory capital requirements and to ensure that only transferable capital is counted as available for the regulated entities of the group. What needs to be addressed is the lack of insight into the availability of capital at conglomerate level. This could be done by requiring supervisory reporting and market disclosure of capital on an individual or sub-consolidated basis in addition to the consolidated level.

3.5.2. Risk concentrations and intra-group transactions — Articles 7 and 8

Articles 7 and 8 on risk concentrations and intra-group transactions already impose reporting requirements on undertakings. Combined with the potential extension of supervision to unregulated entities and identification of the entity ultimately responsible for compliance with FICOD requirements, including the reporting obligations, these requirements should provide an adequate framework of supplementary supervision with regard to risk concentrations and intra-group transactions.

The guidelines to be developed by ESAs should ensure that the supervision of risk concentration and intra-group transactions is carried out in a consistent way.

Given the Joint Forum recommendations referred to in section 3.2.2 above, applying the large exposures regime at the level of the conglomerate could be considered, along with the need to tailor it to fit the context of conglomerates.

3.5.3. Corporate governance — Articles 9 and 13

FICOD, CRD and Solvency II contain or will contain requirements for regulated entities with respect to their governance and remuneration. The living will requirement in FICOD1 would be strengthened by the Bank Recovery and Resolution Framework.

What these frameworks do not yet cover is the enforceable responsibility of the head of the group or the requirement for this legal entity to be ready for any resolution and ensure a sound group structure and the treatment of conflicts of interest. This is also discussed in section 2.2 above concerning the legal addressees of the requirements. The Bank Recovery and Resolution Framework would require the preparation of group resolution plans covering the holding company and the banking group as a whole.

4. SUPERVISORY TOOLS AND POWERS

4.1. The current regime and the need to strengthen supervisory tools and powers

4.1.1. Supervisory powers under FICOD

FICOD contains a number of tools and powers for supervisors together with enforcement measures:

- Article 14 enables supervisors to access any information relevant for supervisory purposes. There are views expressed by legal experts that this provision could actually be more useful than perceived. According to these views, if necessary for the sake of financial stability, this power even overrides the ordinary rule in company law that information cannot be shared with minority owners (or their supervisors) if not shared with the other owners.

- Article 16 empowers the coordinator to take measures with respect to the holding company, and supervisors of regulated entities to act against these entities, upon non-compliance with requirements concerning capital, risk concentrations, intra-group transactions and governance (Articles 6-9). The Article only refers to ‘necessary measures’ to rectify the situation but does not specify such measures. Omnibus I gave ESAs the possibility to develop guidelines for measures in respect of mixed financial holding companies, but these guidelines have not yet been developed.

- Article 17 requires Member States to provide for penalties or corrective measures to be imposed on mixed financial holding companies or their effective managers if they breach the provisions implementing FICOD. The Article also requires Member States to confer powers upon supervisors to avoid or deal with the circumvention of sectoral rules by regulated entities in a financial conglomerate.

The wording of Article 16 and the lack of guidelines has led to a situation where is no EU-wide enforcement framework specifically designed for financial conglomerates. As a result, the supervision of financial conglomerates is sectorally based with differences in national implementation. The ESAs point out furthermore that the strengthened sanctioning regime in the CRD IV proposal may create an uneven playing field between financial conglomerates depending on whether they are bank or insurance-led. At the same time, according to the ESAs, most national supervisory authorities consider that the measures available for sectoral supervision are also appropriate for the supervision of financial conglomerates. Strengthening the supervision of financial conglomerates could be achieved by improving the actual use of the instruments.

As to the Article 17 requirement that Member States must provide for credible sanctions to make the requirements credibly enforceable, no such sanctioning regime is known for conglomerates. This may be due to the lack of correspondence between breaches at conglomerate level and authorisation powers at individual level. Generally, regarding the sanctioning regimes of the Member States, the Commission survey[30] revealed differences in the availability of sanctioning powers, the form and substance of available instruments, the level of application, and the actual use of enforcement powers.

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[30] http://ec.europa.eu/internal_market/consultations /docs/2010/sanctions/COM_0716_en.pdf.

4.1.2. Enhancing enforcement to cover the ultimately responsible entity

As discussed in chapters 2.2 and 2.3 above, the setting of requirements at the level of the group should be accompanied by clear identification of an ultimately responsible entity in a financial group, which should be in charge of controlling risks on a group-wide basis and be responsible for regulatory compliance with group requirements. To give effect to these responsibilities, the ESAs' view is that supervisors should be given more power to enforce compliance by this entity. Also, discussions with those applying the Directive, Member State experts and supervisors, reveal that imposing group-wide requirements on a group of entities would be meaningless without powers over the entity that controls these entities. If the responsibility to meet group-wide requirements needs to be imposed on a parent entity, specific additional powers are necessary with respect to these parent entities. Currently, there are different approaches in the Member States. Some supervisors can impose measures directly on non-regulated holding companies whereas others apply enforcement measures only through the regulated entities.

The ESAs recommend developing an enforcement regime covering the ultimately responsible entity and its subsidiaries, in order to ensure that the group-wide requirements are enforceable. This would imply a dual approach with enforcement powers with respect to the top entity for group-wide risks and with respect to the individual entities for their respective responsibilities. Corrective measures should be directed at the entity responsible for the breach concerned.

Furthermore, the ESAs argue, the supervisor should have a minimum set of informative and investigative measures available with regard to MAHCs and MAIHCs. Supervisors should be able to impose sanctions on MAHCs or MAIHCs if these entities do not provide the requested information. Moreover, when an intermediate financial holding company has been established, supervisors should be able to impose sanctions on this intermediate financial holding company.

4.1.3. Supervisory responsibilities; existing supervisory coordination provisions

Both the determination of a coordinator in Article 10 and the list of coordinating tasks in Articles 11 and 12 are widely appreciated and since 2002 have been copied into the banking and insurance group frameworks. The substance of those provisions thus seems relevant; in particular, the group-structure provisions seem even more relevant today. These provisions were even strengthened in the Omnibus I and FICOD1 exercises, by adding the gathering and distribution of information on the transparency of group structures as a further important task for the coordinator and the relevant competent authorities.

However, as noted above, this list of tasks for the coordinator and the relevant competent authorities is not supported by any requirement other than the requirement to Member States to provide for credible sanctions and measures with respect to the holding company in Article 17. The question is then whether information exchange and coordination are sufficient as obligations for coordinating supervisors in the light of the objective of the Directive.

The Joint Forum revised 2012 principles reveal that the responsibilities of the head of a financial conglomerate should be mirrored by the responsibilities of the authority supervising it. This is necessary because a holding company as such is not authorised, so the rule of ‘licenser supervises licensee’ is not applicable to the head of a group of licences if that head is a holding company.

The Joint Forum notes that, in order to develop and maintain a sound understanding of the operations of a financial conglomerate, supervisors should have the following responsibilities (quoting from the principles, non-exhaustive list):

(i) To review the consistency of the financial conglomerate’s own assessment of its risks at sector and aggregate level;

(ii) To have sufficient interaction with the board and senior management of the head of the financial conglomerate, the board and senior management of the ultimate parent, and the boards and senior managements of material and relevant entities within the financial conglomerate;

(iii) To understand the broader risks to which the financial conglomerate is exposed from the environment in which it operates;

(iv) To have a forward-looking assessment of the sources of risk to the financial conglomerate;

(v) To impose sanctions or corrective action to be taken by the financial conglomerate or its constituent entities, such as restricting current or future activities, suspending dividends to shareholders of relevant entities within the financial conglomerate, and other measures to prevent capital from falling below the required levels;

(vi) To possess both an ability and willingness to take timely action when appropriate.

These responsibilities are broadly covered by FICOD Articles 11 and 12.

4.2. The possibility to introduce mandatory stress testing

The possibility to require conglomerates to carry out stress tests might be an additional supervisory tool to enhance the early and effective monitoring of risks in conglomerates. FICOD1 introduced the possibility (though not an obligation) for the supervisor to perform stress tests on a regular basis. In addition, when EU-wide stress tests are performed, the ESAs may take into account parameters that capture the specific risks of financial conglomerates.

The Joint Forum’s revised 2012 principles recognise that supervisors should require, where appropriate, financial conglomerates to periodically carry out group-wide stress test and scenario analyses for their major sources of risk.

The ESAs recognises that it could be useful to strengthen risk management with a group-wide perspective on the basis of specific ESA guidelines as indicated in FICOD Article 9(6) or through stress tests at group-wide level in accordance with FICOD Article 9b.

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ANNEX 1 — RISK CONCENTRATIONS, CRISIS LESSONS

The Joint Forum report on risk concentrations[31] included an analysis of how the largest complex groups across the globe currently deal with this kind of group risk and the lessons learned from the crisis. Below is an impression of the report:

The market events of the second half of 2007 and the rise of risk concentrations

In this section, the focus is on the emergence of risk concentrations within financial conglomerates as the market conditions initially precipitated by credit quality problems in the US subprime mortgage market developed during the latter half of 2007, and the challenges or difficulties this posed to firms' management processes.

The risk measurement methods and valuation approaches that are key to the credit risk transfer markets were called into question in the latter half of 2007. For OTC derivatives and securitisation products, the valuation process is fundamental to understanding the risks of these positions. The reliance of firms on liquid markets to value their positions may have led some to neglect more fundamental analysis of the risk of such positions. Consequently, the subsequent valuation difficulties affected the assessments by some financial conglomerates of their potential exposures in businesses across trading book activities, investment portfolios, warehousing and counterparty exposures.

The risk characteristics of credit risk transfer products (e.g. ABS CDOs) differ from those of single-name bonds or loans. Investments in these products can affect the risk characteristics of firms' credit portfolios. There are a number of factors to consider in assessing these effects. First, through the pooling of collateral, (higher grade) securitisation notes can represent significant exposures to systematic risk even while reducing specific risk. Second, if defaults become more correlated (which is the case for a systemic credit event), the probability that the losses will affect the higher-rated tranches increases. Third, a risk feature called negative convexity can be present in credit-structured products. This implies that a widening of credit spreads has a stronger impact on prices than a narrowing, and that prices decline at an increasing rate the more spreads widen. The correlation and negative convexity features reinforce one another, in that as the number of defaults increases the decline in ABS prices gains in speed, and as negative convexity increases the prices decline further. Fourth, securitisation products and investment strategies often incorporate additional leverage. In general, these features increase the 'extent' and 'speed' of a systemic event during a period of price decline. In addition, a feature that comes into play in a portfolio context is the dependency between securitisation notes. In general, compared to common single-name bonds and loans, the dependencies between securitisation notes are relatively stronger. It is clear that these characteristics of relatively higher exposure to systematic risk, stronger correlated exposures, significant negative convexity and high leverage may quickly lead to concentrated exposures to systematic factors. Risk management approaches that did not fully recognise these risk characteristics were not able to capture the potential risk concentrations within the firm stemming from their credit securitisation exposures.

[31] http://www.bis.org/publ/joint19.htm.

A systematic credit event, which first showed up in the US subprime mortgage market, quickly spread through other markets, affecting many different business lines within financial conglomerates:

The sharp rise in default rates for US subprime mortgages, coupled with tremendous uncertainty surrounding the valuation and risk measurement approaches to ABS and a loss of confidence in credit-rating agency ratings, led to a drop in investor demand (as investors could not confidently quantify the risks of these products and as CDOs, CLOs, SIVs and conduits were experiencing difficulties). These developments, in turn, led to the almost complete absence of market liquidity for asset-backed commercial paper. Several originating companies encountered difficulty funding their mortgage loans, and started to draw down the back-up lines of credit provided by their respective banks. In addition, for the firms originating the assets and structuring the ABS, these events led to an unexpected build-up of concentrated exposures from assets in the warehouse pipeline, since the assets could not be transferred and had to be taken on the books at the same time that liquidity support for similar assets was being drawn down.

he lack of confidence in the ability of market participants to determine the quality of some assets and the increased risk aversion among investors led to significant deterioration in the market liquidity of the ABCP markets. This in turn led to soaring rates on ABCP and the restructuring of CP funding with overnight or very short-term debt (generally one week and under). The shortening of ABCP funding maturities increased the funding concentrations of firms in short-term maturities, making them increasingly exposed to sudden liquidity events.

The funding difficulties (i.e. the difficulty of rolling over commercial paper) required some issuers to sell a portion of their assets to their liquidity providers or sponsors, while others drew on their back-up lines of credit or tried to extend the maturity of their CP or medium-term notes. In sum, the market events severely affected the off-balance sheet banking conduits, including SIVs. For the sponsoring firms or the banks providing liquidity facility lines, this systematically led to a further build-up of exposures to (structured) credit assets and put pressure on their liquidity positions.

The credit event, coupled with the deterioration in market liquidity and the subsequent rise in risk aversion, led to large declines in the value of ABS and the underlying assets. Under these circumstances, the degree of risk mitigation provided by initial margins and collateral may have been less than firms anticipated, due to the dynamics of the initial price shocks, the consequent increases in haircuts and the further price declines due to the sale of collateral in illiquid markets. The additional collateral requirements led to a further deterioration in the liquidity situation of several firms.

The hedging of credit risk exposures was also limited by the market events and proved difficult to manage. Even the effectiveness of some of the more common hedges for structured credit products, such as traded reference indices or particular credit tranches, were called into question. For instance, the hedging of subprime mortgage exposures via the ABX index proved to be quite difficult. Nevertheless, in some cases, reference indices were the only hedging instruments that maintained their liquidity, forcing firms to switch their hedges from instruments that lost their liquidity to these reference indices. This often led to significant increases in basis risk. Additionally, the stress events also showed that some model-based valuation methods may not have fully captured the entire risk profile of exposure under these market conditions, giving rise to additional unexpected basis risk. As some hedging strategies proved inadequate or had to be altered in the midst of a market liquidity squeeze, some firms were exposed to unexpected concentrated risk exposures and basis risk.

The liquidity squeeze, combined with the higher sensitivity to credit risk and elevated concerns about financial institutions' exposure to structured credit products and liquidity facilities, spread to the interbank markets. Firms that were still relatively liquid were not willing to supply funds in the interbank market, due to their own contingent exposures or due to the uncertainty regarding the financial health of their interbank counterparties. These uncertainties resulted in steep increases in short-term interest rates for some firms, making interbank term funding extremely expensive or even impossible in some cases. This again forced certain firms' funding towards short-term (often overnight) maturities, heightening their sensitivity to unexpected liquidity events. In addition, firms that increased their reliance on the interbank markets to meet the additional liquidity demand (and thus may have been concentrated in these markets) saw an ultimate liquidity source being constrained.

The extensive downgrading of ABS has also put enormous pressure on monoline insurance companies, as some financial guarantors have guaranteed large amounts of AAA rated (and super-senior) CDO tranches. This pressure has the potential to affect the entire ABS spectrum, bringing further price declines in particular for the already weakened higher-grade notes. The deterioration in the credit ratings for ABS could have second-order implications, as, for instance, institutional investors that are only allowed to hold highly rated paper could be forced to sell in the event of a downgrade, leading to additional price pressure. Additional second-order effects may also include pressure in the US municipal finance market as municipalities may find it more difficult to obtain the bond insurance needed to obtain their desired credit rating and borrowing costs. Thus, firms might have unexpected second-order, concentrated exposures to certain monoline insurance companies, either directly or as a result of agreements to fund or buy back certain positions in the event of multi-notch downgrades of assets.

While the credit risk transfer markets have provided financial institutions with increased opportunities to more actively manage the portfolios of risks that they hold, the recent market turmoil also demonstrates that these activities can also lead to additional risk exposures that are sometimes difficult to measure and manage. As recent events indicate, the greater a firm's reliance on the risk transfer markets — whether for an originate-to-distribute business, for the securitisation of assets, as an alternative funding source, or for the hedging of risk exposures and the extended use of collateral to manage counterparty risk — the more dependent it is on the existence of liquid markets. Additionally, risk transfer markets can deepen the link between market liquidity and funding liquidity risk and may create significant exposures across risk categories (i.e. market, credit and liquidity risk). Recent events also show that different business activities across a financial conglomerate may be affected at the same time, possibly compounding the exposures in the different businesses (and increasing the potential of contagion to unaffected activities). The interactions between risk exposures can give rise to the rapid growth of 'unexpected' risk positions at the same time that they become increasingly difficult to measure and manage.

The market events of the second half of 2007 and integrated risk management approaches

Risk concentrations are determined by the extent of the exposures and the interdependencies between these exposures. Recent market events have shown that the magnitude of the risk exposures and their simultaneous realisation across much of the global financial system were not fully anticipated. The report discussed how risk methods may have missed certain risk characteristics of the credit risk transfer products and thereby may have missed the potential concentrated exposures that can arise during systemic events. It also summarised how the credit event spread through the markets, affecting the different activities of financial conglomerates and leading to a number of risk concentrations. Economic capital models generally lack the flexibility to fully integrate the rich interdependency structures between exposures and tend not to incorporate the second-order effects. Scenario stress testing is regarded as a more appropriate tool to capture the dependencies, the second-order effects, and the simultaneous realisations due to contagion. However, in the Joint Forum interviews with firms, the majority indicated that they had not conducted any stress tests or scenario analysis that had detected and prepared their institutions for the potential ramifications of this financial shock. In general, stress tests, for instance, did not adequately capture (systemic) market shocks, had optimistic assumptions as to asset marketability (via loan sales or securitisation), underestimated or ignored the risks of extending liquidity support to conduits and SIVs, and ignored potential contingent risks from reputational issues.

In general, the scenario stress tests of the financial conglomerates do not consider systemic shocks or events; rather, they mainly look at name-specific events. Systemic shocks are often considered to have an extremely low probability of occurrence, so are usually considered to be too severe to be practical for the purposes of stress testing. However, while standard distributions may allot an extremely low probability to these systemic shocks occurring, recent experience may give a different picture of their likelihood. Moreover, many firms question the feasibility of predicting the actual development of particular shocks. While the precise timing, triggers and development of a systemic shock are hard to predict exactly, accurately predicting specific market events is not necessary to incorporate systemic risk within a scenario. Thorough analysis and understanding of the economic and financial environment, coupled with views on further market developments, the identification of how different risk factors could potentially play out, the identification of the drivers of potential market dislocations, the ways in which contagion may spread, and the firm’s own behaviour during these events, will increase the preparedness and robustness of financial conglomerates to cope with such turmoil events.

The events in the latter half of 2007 clearly showed how positions can suddenly become concentrated because of the actions of other market participants. In reality, market participants sometimes initially overreact to certain events (which may be due to information gaps and asymmetries), which can lead to a drying-up of market liquidity. Even so, the limited number of financial conglomerates that reported the inclusion of market liquidity issues in their stress tests tended to see market liquidity risk only as a material issue in markets with a limited number of dealers. Overall, these conglomerates saw the exposure of the entire group to these narrow markets to be rather limited. Recent market events, however, have shown that the issue of market liquidity is not restricted to highly concentrated markets and that risk concentrations may quickly arise in financial conglomerates when broader market liquidity dries up.

Firms should also consider how different market structures (that originally may be intended to protect individual positions) may lead to or reinforce a systemic event. For instance, the market triggers present in different CDOs reinforced the initial price declines in ABS. Common investment rules forced some market participants to simultaneously exit certain positions, with these asset sales leading to further price declines (and to potential second-order effects). The liquidity-constrained SIVs were particularly prone to second-order effects: fire sales had the potential to trigger a domino effect spreading to other SIVs holding similar assets. This reduction in asset value could set off certain triggers, forcing the SIVs in turn to sell assets to meet their liquidity requirements. The market volatility also led to some firms' VaR models breaching their limits, which dampened risk appetite. In general, besides a firm's own management actions, firms should also consider the potential reactions of market participants to stress events in their scenarios (for instance when determining the severity of such scenarios). In particular, the self-reinforcing behaviour due to certain market structures should be incorporated into scenario stress tests.

The 2007 market events also showed the importance of legal and reputational risk issues. Several financial conglomerates faced the threat of legal action by various investors for the losses suffered on their ABS investments. To avoid some of these legal actions and the associated reputational risk, several firms bought back ABS, incurring additional unexpected losses. Firms that sponsored or provided liquidity support to off-balance sheet conduits also felt obligated, in some cases, to buy back or consolidate assets even though they had no legal obligation to do so, often for reputational reasons. Similarly, some firms that manage money market funds had to reimburse their clients, after freezing withdrawals, when clients started to redraw from money market funds that invested in ABCP or other CRT products.

ANNEX 2 — SPECIAL PURPOSE ENTITIES

Below is an impression of the Joint Forum SPE report.[32]

Features

An SPE is a legal entity created at the direction of a sponsoring firm (which may also be referred to as the sponsor, originator, seller, or administrator). The sponsor is typically a major bank, finance company, investment bank or insurance company. An SPE can take the form of a corporation, trust, partnership, corporation or a limited liability company. An SPE is a vehicle whose operations are typically limited to the acquisition and financing of specific assets or liabilities. In this respect, a distinction should be drawn between asset securitisations and liability securitisations. Asset securitisations are usually undertaken by banks and finance companies, and typically involve issuing bonds that are backed by the cash flows of income-generating assets (ranging from credit card receivables to residential mortgage loans). Liability securitisations are usually undertaken by insurance companies, and typically involve issuing bonds that assume the risk of a potential insurance liability (ranging from a catastrophic natural event to an unexpected claims level on a certain product type).

The application of SPEs across financial sectors and to different asset classes is broad. For example, these structures are employed in programmes for residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised debt obligations (CDOs), collateralised loan obligations (CLOs), asset-backed commercial paper (ABCP), and structured investment vehicles (SIVs). Repackaging vehicles are another significant business that involves SPEs, one which permits clients to acquire tailored exposure to a variety of asset classes and risk profiles through a single instrument. For example, an investor seeking a structured return might request that a financial institution structure a transaction that combines otherwise unrelated credit components (exposure to one or more corporate entities), interest rate components (fixed, floating, inflation-linked, etc.) and maturity components (bullet, scheduled maturity, etc.) that are not currently available ‘packaged together’ in the marketplace.

In contrast to asset securitisations, institutions in the insurance sector have used SPEs in products that transfer exposures to liabilities, such as bonds that transfer catastrophic event risk to the capital markets. Additionally, financial guaranty providers have created transformer structures that incorporate credit default swaps to provide the equivalent of guaranty insurance.

A defining feature common to many SPEs is that of bankruptcy remoteness, whereby an SPE’s assets are isolated from any creditors of its sponsoring firm should the latter go into bankruptcy. This feature can be achieved through a variety of methods, including limiting the SPE’s purpose, indebtedness, assets, and other liabilities (or non-financial obligations), as well as by ensuring through its corporate governance process that decisions regarding bankruptcy will be made from the point of view of the SPE itself (not its sponsor or other affiliate). A ‘true sale’ of assets from the sponsor’s balance sheet to such a bankruptcy-remote SPE should ensure that the recourse of investors to assets held as security in the SPE is unlikely to be successfully challenged. In the US, the legal

[32] http://www.bis.org/publ/joint23.pdf

separateness of SPEs is considered fairly well established. However, bankruptcy remoteness may be harder to achieve in certain jurisdictions, or may be less certain where securitisation is a relatively recent development. These factors may explain why the use of SPEs is not as prevalent in such jurisdictions.

In some jurisdictions, most transactions involving SPEs are treated as on-balance sheet, while similar transactions in other countries will appear off-balance sheet. This distinction between on- and off-balance sheet treatments for accounting purposes, however, does factor into how transparent these vehicles have been in the international financial system.

Motivations

SPEs and the securitisation transactions that employ them can be viewed as a way of disaggregating the risks of an underlying pool of exposures held by the SPE and reallocating these risks to those parties most willing to take on those risks. This purpose is therefore a motivating factor for both originators and investors. Originating or sponsoring institutions can use SPEs for risk management purposes, such as to transfer credit, interest rate, market, event, or insurance risks to other parties. Originators may also use SPEs to access additional sources of funding and liquidity, or to reduce funding costs. Smaller institutions may use SPE structures to pool exposures and thereby gain greater and more cost-effective access to the capital markets. In some cases, sponsoring firms may be motivated to use SPEs to achieve off-balance sheet accounting treatment for assets, leading to improved financial and capital ratios for the firm.

Generally, off-balance sheet treatment is easier to achieve under US GAAP than under IFRS. However, recent changes to US accounting rules relating to SPEs effective from 2010 will significantly reduce the ability of certain transactions to qualify for off-balance sheet treatment.

Regulatory capital also serves as an important motivating factor for engaging in transactions involving SPEs. In particular, differences between the Basel I and Basel II regulatory capital frameworks present different incentives to enter into particular transactions. These differences manifest themselves along two dimensions. One is the difference in treatment for on-balance sheet loans, and the second relates to differences in the treatment of retained exposures in securitisation transactions.

Investors may be motivated to purchase securities issued by SPEs to gain exposure to new asset classes or possibly to avoid regulatory and internal limits, such as those relating to name concentrations or credit quality. In the case of synthetic transactions, investors may find it beneficial that they would not have to fund credit exposures at the outset.

The relative importance of these motivating factors may vary across jurisdictions. For example, European financial firms generally have less ability to remove assets from their balance sheets by using SPEs. However, this is offset by the fact that risk-based capital requirements are not as closely tied to accounting in Europe. In contrast, while US firms currently can more easily remove assets from their balance sheets, the US implementation of Basel I required more capital for certain exposures than in Europe.

Risk transfer

Vehicle types that tend to achieve a high level of risk transfer for originators include CDO/CLOs, SIVs (with notable exceptions), and RMBS structures. In contrast, high risk retention (implying a need for potential credit support on the part of the sponsor or originator) is generally more likely with programmes such as covered bonds, certain ABCP conduits, and credit card securitisations. The current market crisis has highlighted several areas where firms may have misestimated the degree of risk transfer associated with certain SPE structures. Several factors will determine the level of risk transfer. One factor is whether the originator has retained a position in the capital structure and, if so, what position. The issue becomes more complex given that tranches initially retained at deal inception can be subsequently sold or else transformed through re-securitisation processes. Originating firms also have an asymmetric informational advantage in knowing more about the exposures than investors, which could potentially allow them to structure a deal to most efficiently transfer risk away from themselves.

Another important risk element relates to the existence of triggers in many structured finance transactions, such as early amortisation triggers in revolving securitisation structures and market value triggers in SIVs. Triggers may potentially be interrelated (as could happen in the case of re-securitisations, resulting in two layers of triggers) or else highly correlated (leading to procyclical effects). Beyond these contractual elements, considerations of factors such as reputational risk and franchise risk could lead originators to provide non-contractual support to investors in SPEs.

Due Diligence and Risk Management

Market participants interviewed suggest that originating firms may, in instances, conduct different levels of credit due diligence on assets depending on whether they intend to retain the related risks on their own balance sheets or transfer them to an SPE. In particular, CDO assets that are specifically originated or purchased (and temporarily warehoused) to be sold to an SPE may undergo a less rigorous credit underwriting process compared to credits that the originator intends to retain. On the other hand, most ABCP conduit sponsors seem to apply the same level of due diligence whether or not assets are intended for an SPE, subjecting them to comparable concentration and exposure caps. In between these two extremes are receivables such as small-and-medium enterprise (SME) and leveraged loans, where origination practices vary by institution and vehicle.

For ongoing risk management purposes, many sponsoring firms will maintain a single database that aggregates both on-balance sheet exposures and off-balance sheet (SPE) exposures. This is fairly common for credit card securitisations, where originators view risks on a 'managed asset' basis. However, firms may exclude certain vehicles from this aggregated risk analysis, if they judge those exposures to have been materially transferred. CDO transactions, thought to be done at a greater arm's length, and SIVs are two types of vehicles more commonly omitted from such management information and modelling.

In contrast, some firms either do not perform aggregated risk management analysis to include SPEs, or else do so infrequently (for instance, semi-annually). Firms may also not consider the breadth of roles they may play in relation to an SPE on an ongoing basis. For instance, a bank could have a liquidity facility, swap, and reserve fund linked to a single SPE, but each of these elements could be analysed separately by different business units without the firm necessarily rolling up its overall exposure to this SPE.

Several market participants interviewed noted that, until the market disruptions, some senior managers were unaware of the full extent of their firm's overall linkage to and obligations (explicit or implicit) toward their SPEs. There is no clear pattern that larger institutions understood the risks better than smaller ones. In fact, senior managers at small firms — particularly those operating in a niche or monoline sector which rely on SPEs in their funding strategy — may have an enhanced understanding of these entities.

It was also observed that some investors did not seem to have conducted adequate independent due diligence to understand the risk profiles of SPE transactions that they had invested in. Geographic distinctions were noted for certain sub-sectors of the securitisation markets. For instance, investors in US RMBS transactions seemed unaware primarily of issues surrounding credit quality and asset performance. In contrast, European SPE investors were more surprised by structural features of the transactions and their inability to access analytics and modelling resources for bonds held

Lessons learnt

The monitoring of the changing character of intra-group relationships is particularly relevant for relationships with special purpose entities (SPE), as was shown in the Joint Forum's SPE report.

The number and complexity of SPE structures increased significantly before the financial crisis in conjunction with the growth of markets for securitisation and structured finance products, but have declined since then. The use of SPEs has been proven to be beneficial for the risk management of a financial group. SPEs have been used for many years and have contributed to the operation of the global financial markets by providing financing opportunities for a wide range of securities to meet investor demand.

While the use of SPE structures yields benefits and may not be inherently problematic in and of itself, the crisis has illustrated that poor risk management and a misunderstanding of the risks of SPE usage can lead to failures. In cases where parties to SPEs possessed a comprehensive understanding of the associated risks and possible structural behaviours of these entities under various scenarios, they have effectively engaged in and reaped benefits from their SPE activities. On the other hand, it is unclear that the poor credit quality of assets sold into SPEs can be attributed to the existence of these structures, which were simply the legal form in which such assets were held to issue bonds backed by them. Nonetheless, it is important to address why some of the recent failures in SPE usage occurred.

While recent market events have resulted in a dramatic reduction in the issuance of securities using SPEs, since these structures provide institutions and investors with a variety of uses and benefits, they are likely to continue to be used for financial intermediation and disintermediation going forward. It is accordingly important to ensure that they are properly regulated and their usage supervised.

To that end, the Joint Forum recommended supervisors to develop skills in the areas below. The application of the intra-group transaction provisions of Article 8 FICOD would then be more effective, especially if their scope were enlarged (see section 2.1). It should be noted that this intra-group problem is not specific to financial conglomerates, but inherent to complex groups in general. It may be a question that has to be tackled at the sectoral legislative levels. The Joint Forum recommended the following:

1. Supervisors should ensure that market participants assess all economic risks and business purposes of an SPE throughout the life of a transaction, distinguishing between risk transfer and risk transformation, and are particularly aware that over time the nature of these risks can change. Supervisors should ensure that such assessment is ongoing and that management has sufficient understanding of the risks.

2. Market participants should be able to assess and manage risk factors that increase transaction complexity, such as the structural features of an SPE, including triggers and the roles of parties involved.

3. Firms and supervisors should ensure that the governance of an SPE is commensurate with the complexity of the structure and the degree of active intervention and discretion required of the parties participating in the SPE.

4. Firms should monitor on an ongoing basis the quality of transferred exposures in relation to the risk profile of the firm's remaining portfolios and the impact on its balance sheet components, and supervisors should where appropriate assess systemic implications of risk dispersion to transferees.

5. Firms should have the capability to aggregate, assess and report all their SPE exposure risks in conjunction with all other firm-wide risks.

6. If at inception or at any point throughout the life of an SPE there is a likelihood or evidence of support by the financial firm, including non-contractual support, then the activities of that SPE should be aggregated with those of the institution for both supervisory assessment and internal risk management purposes.

7. Supervisors should support market participants' efforts towards greater standardisation of definitions, documentation, and disclosure requirements for SPE transactions and provide for the communication of any material divergence from these standards to investors in individual transactions.

8. Supervisors should regularly oversee and monitor the use of SPE activity, and assess the implications for regulated firms of the activities of SPEs, in order to identify developments that can lead to systemic weakness and contagion or that can exacerbate procyclicality.

ANNEX 3 — ECONOMIC CAPITAL MODELS

Following up on the risk aggregation exercise described in Annex 1, the Joint Forum investigated economic capital models and found that these are no panacea either. If not designed for their purpose, and if used for other purposes, they could even give rise to compounding risks. The Joint Forum found that risk aggregation models (RAMs) are used to provide information to support decisions contributing to the resilience of complex firms. RAMs are used, for instance, to support decisions on capital allocation and capital adequacy and solvency. They are also used to support risk management functions (including risk identification, monitoring and mitigation). The Joint Forum found that, despite recent advances, RAMs in current use have limitations. They are not adapted to support all the functions and decisions for which they are now used. As a result, firms using them may not see clearly or understand fully the risks they face.

Some of the firms surveyed were addressing these issues. For instance, some were starting to address the assessment of tail events. Some were moving away from using basic 'Value at Risk' (VaR) measures of the risk of independent extreme events to measures such as 'Expected Shortfall' (which is more sensitive to 'tail event' probabilities) and 'Tail VaR' (which accounts for both the probability and severity of an extreme event). Use was also being made of scenario analysis and stress testing. Firms faced a range of practical challenges in using RAMs with cost and quality implications. These included managing the volume and quality of data and communicating results in a meaningful way. Despite these issues, the Joint Forum found there was little or no appetite for fundamentally reassessing or reviewing how risk aggregation processes were managed.

To address the limitations noted, the Joint Forum suggested that firms should consider a number of improvements to the RAMs they currently use. Firms making these improvements would be able to see and understand the risks they face more clearly. This would require significant investment. FICOD Articles 7 and 9 enable supervisors to specify the use and application of the risk concentration provisions in this way, but the Joint Forum did not observe that they did. The improvements were the following:

(i) Firms should reassess risk aggregation processes and methods according to their purpose and function and, where appropriate, reorient them;

(ii) Where RAMs are used for risk identification and monitoring purposes, firms should take steps to ensure they are more sensitive (so as to be able to identify change quickly), granular (so as to be able to drill down to identify and analyse the risk positions that cause changes), flexible (so as to be flexible enough to reflect changes in portfolio characteristics and the external environment); and clear (so as to be able to see and understand the sources of risk and their effect on the firm);

(iii) Firms should consider changes to methodologies used for capital and solvency purposes to better reflect tail events. This includes attributing more appropriate probabilities to potential severe 'real-life events', and conducting robust scenario analysis and stress testing;

(iv) Firms should consider better integrating risk aggregation into business activities and management;

(v) Firms should consider improving the governance of the risk aggregation process, particularly the areas in which expert judgment enters this process. This could be done by enhancing the transparency of such judgment and its potential impact on risk outcomes, and the controls that surround the use of judgment.

Furthermore, the Joint Forum recommended that supervisors, on their part, should recognise and communicate to firms the risks posed by the continued use of RAMs. In doing so, they should highlight the benefits of appropriately calibrated and well-functioning RAMs for improved decision making and risk management within the firm. Supervisors should work with firms to implement these improvements.

ANNEX 4 — INTRA-GROUP TRANSACTIONS AND EXPOSURES TURNING INTO CONTAGION CHANNELS

Van Lelyveld & De Haas (2006, 2010) have shown the benefits of multinational banks for emerging countries in several studies. However, using data on the 48 largest multinational banking groups to compare the lending of their 199 foreign subsidiaries during the 2008-2009 recession with lending by a benchmark group of 202 domestic banks, they found the opposite. Contrary to earlier, more contained crises, parent banks were not a significant source of strength to their subsidiaries during the 2008-09 crisis. As a result, multinational bank subsidiaries had to cut back credit growth about twice as fast as domestic banks. This was in particular the case for subsidiaries of banking groups that relied more on wholesale market funding. Domestic banks were better equipped to continue lending because of their greater use of deposits, a relatively stable funding source during the crisis. They conclude that while multinational banks may contribute to financial stability during local crisis episodes, they also increase the risk of 'importing' instability from abroad (De Haas & Van Lelyveld, 2011). The very same intra-group relationships that are beneficial in one period of time could be contagious in another period of time.

The Joint Forum performed a similar investigation in 2011, looking for potential contagion channels in groups, when authorities were increasingly focused on ways to ensure banks and other financial entities can be wound down in an orderly manner during periods of distress. Investigating a representative group of conglomerates across the G20 countries, the Joint Forum found the following:

1. Intra-group support measures can vary from institution to institution, driven by the regulatory, legal and tax environment, the management style of the particular institution and the cross-border nature of the business. Authorities should be mindful of the complicating effect of these measures on resolution regimes and the recovery process in the event of failure.

2. The majority of respondents surveyed indicated that centralised capital and liquidity management systems were in place. According to proponents, this approach promotes the efficient management of a group's overall capital level and helps maximise liquidity while reducing the cost of funds. However, the respondents that favoured a 'self-sufficiency' approach pointed out that centralised management can potentially increase the contagion risk within a group in the event of distress at any of the subsidiaries. The use of such systems impacts the nature and design of intra-group support measures, with some firms indicating that the way they managed capital and liquidity within the group was a key driver in their decisions on intra-group transactions and the support measures they used.

3. Committed facilities, subordinated loans and guarantees were the most widely used measures. This was evident across all sectors and participating jurisdictions.

4. Internal support measures generally were provided on a one-way basis (e.g. downstream from a parent to a subsidiary). Loans and borrowings, however, were provided in some groups on a reciprocal basis. As the groups surveyed generally operated across borders, most indicated support measures were provided both domestically and internationally. Support measures were also in place between both regulated and unregulated entities and between entities in different sectors.

5. The study found no evidence of intra-group support measures either a) being implemented on anything other than an arm's length basis, or b) resulting in the inappropriate transfer of capital, income or assets from regulated entities or in a way that generated capital resources within a group. However, this does not necessarily mean that supervisory scrutiny of intra-group support measures is unwarranted. As this report is based on industry responses, further in-depth analysis by national supervisors may provide a more complete picture of the risks potentially posed by intra-group support measures.

6. While the existing regulatory frameworks for intra-group support measures are somewhat limited, firms do have certain internal policies and procedures to manage and restrict internal transactions. Respondents pointed out that the regulatory and legal framework can make it difficult for some forms of intra-group support to be provided while supervisors aim to ensure that both regulated entities and stakeholders are protected from risks arising from the use of support measures. For instance, upstream transfers of liquidity and capital are monitored and large exposure rules can limit the extent of intra-group interaction for risk control purposes. Jurisdictional differences in regulatory setting can also pose a challenge for firms operating across borders.

7. Based on the survey, and independently of remaining concerns and information gaps, single-sector supervisors should be aware of the risks that intra-group support measures may pose and should fully understand the measures used by an institution, including its motivations for preferring certain measures over others. In order to obtain further insight into the intra-group support measures put in place by financial institutions within their jurisdiction, national supervisors should, where appropriate, conduct further analysis in this area.

Also, the ESAs note in their advice the anecdotal evidence from JCFC discussions during the recent crisis that banking-led financial conglomerates have used their ability to draw down liquidity from the insurance entities within the group to the benefit of the financial conglomerate, contrasting with the restricted liquidity sources available for pure banking groups. More in general, it has been observed that the financial conglomerates that fared better during the crisis were mostly those that did not have exotic business models. Rather, those that were affected by the crisis ran into serious difficulties predominantly because of the risks of business complexity and contagion. Systemic impacts, the ESAs observed, impaired (or even nullified) the smooth functioning of emergency/resolution practices.

ANNEX 5 — DEFINITION OF GROUP

FICOD defines 'group' in Article 2(12) as a group of undertakings consisting of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a participation, or undertakings linked to each other by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC,[33] including any subgroup. The definition of group does not distinguish between regulated and non-regulated entities. The definition of financial conglomerate specifies that there must be at least a regulated insurer and a regulated credit institution in the same group, but does not exclude non-regulated entities either.

CRD (2006/48) does not define a 'group', as that would be outside its objective, which is to ensure the soundness of banking licenses on an individual and a consolidated basis. If the CRD needs to refer to a group setting, it refers to Directive 83/349 relationships. Some Member States define a banking group as 'a financial holding company plus all its subsidiaries, most of which are credit institutions'.

Solvency II defines 'group' in Article 212(1)(c) as follows:

' "group" means a group of undertakings that:

(i) consists of a participating undertaking, its subsidiaries and the entities in which the participating undertaking or its subsidiaries hold a participation, as well as undertakings linked to each other by a relationship as set out in Article 12(1) of Directive 83/349/EEC; or

(ii) is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those undertakings, and that may include mutual or mutual-type associations, provided that:

– one of those undertakings effectively exercises, through centralised coordination, a dominant influence over the decisions, including financial decisions, of the other undertakings that are part of the group; and

– the establishment and dissolution of such relationships for the purposes of this Title are subject to prior approval by the group supervisor;

where the undertaking exercising the centralised coordination shall be considered as the parent undertaking, and the other undertakings shall be considered as subsidiaries;'

Solvency II thus defines 'group' in the widest sense, therefore enabling insurance supervisors to detect risks coming from any relevant entity, regulated or not.

FICOD1 restricted the scope of the transparency requirement to 'all regulated entities, non-regulated subsidiaries and material branches of the group' and thus excluded only the participations of financial groups, which were assumed to have a temporary character in many cases.

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33 Seventh Council Directive of 13 June 1983 on consolidated accounts (83/349/EEC).

ANNEX 6 — THE JOINT FORUM'S REVISED 2012 PRINCIPLES AND THE EU FRAMEWORK

Following up the report on the differentiated nature and scope of regulation (DNSR) as endorsed by the FSB, the Joint Forum suggests revised or new principles in the following five areas.

The Joint Forum notes that the principles should be applied, on a group-wide basis, to a financial conglomerate, defined for the purpose of this framework as any group of companies under common control or dominant influence, including any financial holding company, which conducts material financial activities in at least two of the regulated banking, securities or insurance sectors.

Jurisdictions should consider the application of the Principles to other financial groups which conduct activities in one of these regulated sectors while also conducting material activities in any other financial sector, where these financial activities are not subject to comprehensive group-wide supervision under the sectoral frameworks. FICOD confines the application of the supplementary provisions to groups that meet the quantitative thresholds only. This excludes the supplementary supervision of some groups that the Joint Forum definition without any thresholds would capture. The issue is discussed in the review.

1. Supervisory powers (Joint Forum principles 1-4)

Observing that the facilitating role of the coordinating supervisor in the 1999 framework appeared to have played quite a minor part in times of high stress, the Joint Forum suggests in the revised principles that it may be worthwhile exploring whether supervisors should be empowered to approach the head of a financial conglomerate and impose corrective measures on this head if deemed necessary.

In European legislation, supervisory provisions apply to authorised entities but not to the holding company as a stand-alone entity, even though this holding company may have an important role as the head of a group of authorised entities, being responsible for group-wide policies. Due to the lack of coordinated European legislation in this area, the head of a financial conglomerate may not be systematically supervised if the head is not itself a regulated entity. This is addressed in the review.

2. Supervisory responsibilities (Joint Forum principles 5-9)

The Joint Forum observes that the regulatory framework up to now has assumed that the resources, skills and systems of supervisory authorities would be sufficient to implement the agreed rules, e.g. the Basel agreements. However, the Financial Sector Assessment Programmes carried out by the International Monetary Fund revealed that countries could be aware of the necessary supervisory programmes, but were sometimes simply not able to implement them because the basic preconditions were not fulfilled. For example, they had no ready-to-use set of prudential standards against which to assess firms' behaviour (other than the capital ratio), including standards for group risks and triggers for corrective action. This could be addressed by adding the same set of basic preconditions to the three sets of Core Principles of the Basel bodies BCBS, IOSCO and IAIS. However, this approach is also included in the Joint Forum's revised principles for financial conglomerate supervision.

In Europe, prudential standards, including those governing supervisory responsibilities, are set out in sectoral legislation and supplemented by FICOD. Their consistent implementation is ensured by supervisory coordination and common standards and guidelines to be developed by ESAs. The European framework for supervision of financial undertakings requires Member States to provide supervisors with the necessary tools to enforce compliance. The review observes that existing tools could be used more effectively and that an enforcement regime applying to the ultimately responsible entity may need to be established.

3. Governance (Joint Forum principles 10-14)

The Joint Forum suggests that a supervisor should be able to require a legal and organisational group structure that is consistent with the group's overall strategy and risk profile and is well understood by the board and senior management of the head company. Also, the Joint Forum suggests imposing an explicit responsibility on the head of the conglomerate to define and implement a group-wide strategy. Finally, the Joint Forum suggests that the remuneration requirements should no longer be limited to regulated entities only, but should apply to any employee of the financial conglomerate.

The European framework for supervision of financial undertakings requires authorised entities to have a sound governance framework in place. FICOD1 (2011/87) requires that supervisors, through the ESAs, find common frameworks to enforce sound governance systems in financial conglomerates. The review notes the need for the comprehensive application of a group-wide set of governance requirements, especially as regards the duties of the parent entity that controls and steers the regulated entities in the group, and the main counterparty for the group in the market.

4. Capital adequacy and liquidity (Joint Forum principles 15-20)

The Joint Forum observes that financial conglomerates should calculate capital adequacy on a group-wide basis and have in place group-wide capital management policies as well as liquidity management policies.

The European prudential framework stipulates that the level of required capital buffers against sector-specific risks is to be addressed within the sector-specific frameworks. However, the supplementary framework should ensure that the allocation of capital across the legal entities of the group as a whole is such that the required capital buffer is indeed available at all times when an unexpected loss hits a regulated entity.

Qualitative liquidity requirements are already in place for credit institutions, and Solvency II will set out requirements for undertakings to identify and manage any kind of risks including liquidity risks. FICOD's provisions on intra-group transactions also cover a broad spectrum of transactions and exposures and could therefore capture liquidity swaps and similar potential liquidity problems.

The problem of the inconsistent use of methods to calculate available capital in conglomerates was signalled with Omnibus I in October 2010, which invited the

ESAs to draft a Binding Technical Standard for the calculation of consolidated capital in a conglomerate. This invitation was changed into a requirement in the CRD IV proposal. The standard was published for consultation by the ESAs in September 2012 and is expected to harmonise the methods of calculating available capital. However, the review observes that supervisors sometimes lack insight into the availability of capital at the level of the conglomerate. This could be addressed by requiring the reporting and market disclosure of capital on an individual or sub-consolidated basis in addition to reporting at the consolidated level of the regulated entity.

5. Risk management (Joint Forum principles 21-29)

The 1999 Joint Forum framework, as well as the 2002 FICOD, included several provisions to deal with group risks, especially risk concentration and intra-group contagion. The Joint Forum has published many additional analyses and guidelines to illustrate, clarify and strengthen the application of these provisions.

The Joint Forum suggests introducing more detailed policy requirements to deal with contagion and risk concentration.

The review observes that FICOD provides several tools to enable supervisors to assess and control risk concentrations and contagion. FICOD already provides for risk reporting and management requirements for undertakings. These, combined with the observed need to extend the scope of supervision to unregulated entities and identification of the ultimately responsible entity for compliance with FICOD requirements, should ensure an adequate framework for the supplementary supervision of risk management.