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German Banking Industry Committee Comments regarding "EBA, EIOPA and ESMA's Joint Consultation Paper on its proposed response to the European Commission's Call for Advice on the Fundamental Review of the Financial Conglomerates Directive"

Ladies and Gentlemen,

On behalf of the German Banking Industry Committee we welcome the opportunity to comment on the aforementioned Consultation Paper on the Financial Conglomerates Directive (FiCOD) published 14 May 2012.

General Comments

Generally speaking, especially in view of the regulatory gaps identified during the financial crisis (lessons learnt) we welcome the EU Commission's plans for a fundamental review of the Financial Conglomerates Directive. These aspects are discussed in detail in the three supervisory authorities' recommendations. The latter contain proposals for meaningful corrective action in order to tackle risks stemming from unregulated companies that were previously not taken into account in an adequate manner. They also contain proposals for suitable internal control and risk management systems. Notwithstanding the foregoing, we have a number of observations regarding the content of the proposed methodology for adequately including securitisation SPEs/SPVs.

Furthermore, we see a paramount need for harmonisation of the regulatory reform projects CRD IV / CRR I and Solvency II (scheduled to take effect in 2013 / 2014) with the requisite adjustments resulting at the level of the financial conglomerates' rules. The financial sector's two reform projects are highly complex. To date, the banking and insurance industry have not had an opportunity to fully analyse the implications of the sheer magnitude and details thereof. This means that the FiCOD review should be performed very carefully and – wherever necessary – in an incremental manner. Along with focussing on identified regulatory gaps, we would also like to suggest a particular focus on waivers and derogation rules and, wherever

necessary, on adjustments to the aggregation methods for the purposes of financial conglomerate solvability. The aim should be facilitating a smooth joint impact of the sectoral prudential supervision rules and keeping overlapping sectoral regulatory perimeters to a minimum. The importance of effective and efficient sectoral Steering scopes should not be underestimated. This is due to the fact that, in years to come, probably both sectors will have to build up considerable additional capital buffers.

Whilst not limited to, this applies in particular to the provisions on capital management and capital adequacy. Given the high complexity of the sectoral provisions and the multifaceted interaction of the regulatory frameworks, we are concerned that this might result in an ever-increasing duplication of work. In the sector, this could occasionally cause considerable implementation costs and it might create a need for constant workflows that fail to live up to a cost-benefit analysis.

Furthermore, we would like to emphasize our preliminary understanding that the regulatory scope of a reviewed FiCOD will also and explicitly be confined to the supervision of specific additional aspects pertaining to financial conglomerates. If and when an appropriate sectoral supervision is already in place, the sectors shall and must not become subject to any duplication of (originary) supervision requirements. The financial crisis has revealed that bancassurance groups generally feature a higher degree of financial stability. This is due to the fact that there is no 100% positive correlation between the banking and the insurance industry.

In our view, the regulatory scope of the forthcoming provisions ends whenever it touches upon non-negotiable requirements under company law or whenever *de facto* circumstances prevent a consistent implementation. This is regularly the case if a company is included in two financial conglomerates. However, it is equally the case where there are mere minority holdings which do not grant the shareholder those information rights and steering options that are necessary for a supervisory inclusion at conglomerate level. Also in view of the fact that, generally, these constellations do not present material risk drivers in the overall shareholding structure, at this juncture, national supervisors should be given the right to apply a waiver to the minority shareholder exempting them from the comprehensive application of the provisions on risk concentrations and intra group transactions ([any forthcoming rules should be subject to the] principle of proportionality).

Last but not least, we would like to seize this opportunity in order to address a number of issues that have already been identified but which are still absent from the consultations on a fundamental review of the FiCOD. Notwithstanding the foregoing, these issues are still of major importance for bancassurance groups.

Under principle 20, the December 2011 Consultation Paper "Principles for the supervision of financial conglomerates‟ published by the Basel Committee for Banking Supervision (BCBS) refers to conglomerate-wide, consistent liquidity requirements as Pillar I provisions. For (groups of) institutions, the CRD IV / CRR I already cover rules for liquidity measurement and liquidity control. However, the latter two sets of rules are currently seeing a renewed discussion. At present, we are unaware whether comparable provisions have been prepared for the insurance sector. Hence, we advocate in favour of a solution where conglomerate-wide Pillar I liquidity requirements may only be tackled after implementation of the specific Pillar I requirements in both sectors. If and when possible, this should subsequently build on the sectors' existing regulatory frameworks.

Specific comments

We basically welcome the principle under which the supervision of financial conglomerates shall have to adequately capture all risks stemming from financial activities that are relevant for the group. This led to a proposal concerning the inclusion of e.g. Securitisation SPEs/SPVs. From a supervisory point of view this is perfectly understandable. However, it is at least partly questionable in how far consolidated supervision frameworks are the right approach for adequately capturing the risks pertaining to Securitisation SPEs/SPVs that have been conceived of in a bankruptcy remote manner (ring fenced).
There are considerable differences in the sectoral provisions under the CRR I or, respectively, under Solvency II for inclusion of such SPEs/SPVs. Whilst for SPEs/SPVs, Solvency II, as far as the regulatory consolidation is concerned, calculates these solvability requirements in line with the prudential supervision requirements, the CRR I securitisation framework develops differentiated economic measurement approaches for the banking industry. As an alternative to a consolidation, the latter allows capturing counterparty default risks of the Securitisation SPEs/SPVs in a more risk sensitive manner. By way of example, we would like to mention the "internal assessment approach (IAA)". Through use of a rating methodology approved by supervisors, this approach allows an assessment and comprehensive consideration of the credit risk pertaining to the liquidity line extended by the sponsor bank to the conduit. This credit line usually also covers the assets' counterparty default risks. Should the structure under the present version of the CRD remain as is, this methodology is not permissible if a securitisation vehicle is being consolidated. In the event of a consolidation, the assessment of the risks from the securitised assets will usually have to be based on the relatively simple standardised approach (credit risk). Hence, in essence we would like to suggest prioritising a comprehensive and appropriate approach towards capturing the risks deriving from Securitisation SPEs/SPVs over a homogenous, cross-sectoral consolidation methodology.

In order to achieve a level playing field for financial conglomerates which are mainly involved in insurance activities on the one hand and financial conglomerates which are mainly involved in the financial sector, on the other hand, a detailed and differentiated comparison of the regulatory requirements for individual scenarios under the new regulatory frameworks Solvency II and CRD IV/CRR I is necessary in the context of the financial conglomerate's overall capital adequacy requirements.
Financial conglomerates undertaking mainly insurance activities do not require an additional Directive for financial conglomerates. This is due to the fact that Solvency II already requires the inclusion of e.g. banking sector companies affiliated with the group. However, parallel regulatory perimeters result at the level of institution groups and at the level of the conglomerate in the case of financial conglomerates undertaking mainly banking activities.
At this juncture, the treatment of capital deductions from interests in the financial sector is of pivotal importance. Whilst the CRD IV / CRR I and the current provisions under Solvency I stipulate strict deduction obligations in this respect, Solvency II integrates these interests either into the sectoral own funds requirements within the insurance group or it includes them in the market risk module for calculation of the solvability requirements.
Given that the supervision for financial conglomerates merely constitutes a supplementary supervision, the sectoral provisions for inclusion of interests in the financial sector are respectively to be applied on the upstream group level.
As a result, once the CRR I comes into effect, as far as the banking industry is concerned, all direct and indirect interests in the financial sector would first have to be deducted from the institution group's own funds.
At present, there are waivers concerning both industries' existing deduction principle (CRD III and Solvency I or, moreover, section 53(c) subsection (3)(d) of the German Insurance Supervision Act).

These waivers can be applied in those cases where the interests are included in the aggregation at the level of the conglomerate. Both, present and future waivers for the banking sector are based on Article 46(1) CRR I. However the latter only applies to (re)insurance undertakings and insurance holding companies. It does not apply to financial holding companies. As a result, as soon as CRR I comes into effect but prior to the comprehensive implementation of Solvency II, financial conglomerates mainly involved in banking activities will already be placed at a disadvantage compared to financial conglomerates primarily involved in insurance activities. This is due to the fact that each and any direct and indirect, deduction relevant intra-group financial company interest will have to be deducted within the banking group, whilst the insurance group may apply a waiver rule by referring to the aggregation at the level of the conglomerate. By and large, the CRR de facto abrogates the existing symmetrical waiver rules which provided scope for capital management. Therefore, pending the full implementation of Solvency II, the transitional period should see the continued existence of the present waiver rules for capital deductions regarding financial conglomerates mainly involved in banking activities which should also be extended to financial companies.
Once Solvency II will fully take effect, the prudential supervision methods of both industries at the group level feature fundamental differences. [Whilst] the CRR I envisages capital deductions (cf. above), Solvency II plans to integrate financial sector interests into the consolidation or the calculation of solvability requirements (*de facto* financial conglomerate perspective). Henceforth, financial conglomerates mainly involved in insurance activities would thus largely be covered by the sectoral Solvency II rules meaning that they would no longer require supplementary financial conglomerate solvency supervision. Contrary to this, financial conglomerates mainly involved in banking activities would be compelled to keep deducting all deduction relevant interests in financial institutions / financial undertakings at group level. At the conglomerate level, this would beg the question how to achieve an appropriate adjustment approach for double inclusions. Furthermore, this adjustment approach ought to prevent the creation of entirely new regulatory perimeters because this way there will no longer be any consolidation scopes without any overlapping areas.
One possibility would be granting financial conglomerates primarily involved in banking activities the right to treat the risk adequate consideration of direct and indirect interests in the financial sector under Solvency II as an eligibility criterion for exemption of the entire banking group. Otherwise, given that capital deductions have a massive impact on the banking group’s own funds, in terms of capital management and in terms of the build-up of considerable additional capital buffers at the respective group levels, this would result in considerable additional burdens for complex and vertically integrated banking groups.

A similarly complex situation results for overlapping consolidation scopes. For instance, in a financial conglomerate which is mainly involved in banking activities, sub-subsidiaries (financial institutions) which are at the same time subsidiaries of the insurance undertaking, have to be consolidated (on a mandatory basis) within the group of institutions. Pursuant to the provisions under Solvency II, these undertakings need to be simultaneously included in the insurance group both in terms of own funds and in terms of solvability requirements. Also these double inclusions have to be adjusted again on the level of the financial conglomerate. In order to reduce these misleading impacts, the FiCOD should include derogation rules pursuant to which the inclusion in one of the two sectoral groups (based on the respective industry rules) will give rise to an exemption from mandatory inclusion in the respectively other group, provided there is an adequate aggregation at the level of the conglomerate.
In our view, the two latter scenarios do not constitute risk drivers for the financial conglomerate as a whole meaning that the banks’ interests in efficient capital management could be accommodated.

Given that, to date, sectoral waiver rules for financial conglomerates are regulated in the Financial Conglomerates Directive, the waiver rules for the leverage ratio should equally be laid down in this Directive. Currently, under Article 416(4) (2), the draft CRR I stipulates that the exposure values from financial sector entities in which banking groups hold significant investments which are consolidated in their accounting group but not in their regulatory group need to be included into the banking group's leverage ratio. Whilst this methodology is understandable when it is about material risks at group level which, indeed, were not captured up to now (neither as capital deductions nor as companies in their prudential consolidation), bancassurance groups under the aegis of a bank however, are being placed at a disadvantage under this approach. This is due to the fact that the prudential consolidation of the insurance subsidiaries only takes place at the next higher level. This is a considerable disadvantage for bancassurance groups as far as the leverage ratio is concerned. In our view, this is inconsistent with the European legislator's original intent and purposes.

Under the Financial Conglomerates Directive it is permissible to refrain from deducting the book value of the insurance when calculating the risk weighted capital ratio. This is due to the fact that supervision of the solvability is ensured by means of the financial conglomerate's capital-solvency margin relation. In our view, by way of analogy to the waiver for the mandatory deduction requirements for the carrying amounts of interests, a waiver for mandatory inclusion of the insurance subgroups into the leverage ratio should be allowed if and when the financial interest is being adequately included into the aggregation at the financial conglomerate level.

In our view, the provisions on the calculation of the solvability ratio at the level of the conglomerate presents another area of cardinal interest. Whilst the sectoral provisions under the CRD IV / CRR I and Solvency II both basically envisage capital classes ("tiers"), at the present point in time the definitions are mutually incompatible. Hence, we firstly advocate for a sufficient degree of harmonisation. Secondly, until a sufficiently operationalised harmonisation of the own funds terminology will have been achieved, we suggest keeping the existing aggregation methodology for the purposes of the solvability requirements pursuant to which the sum total of the adjusted, eligible own funds will be juxtaposed with the sum total of the adjusted solvability / own funds requirements.

This would also resolve one further problem inherent in a single, uniform minimum solvability requirement at the level of conglomerate. Consequently, after introduction of the wide variety of country specific and institution specific capital buffers which are determined in a heterogeneous manner, there will be highly heterogeneous minimum capital ratios for banking groups across the different EU Member States.

We would appreciate it if our views were taken into account in the ongoing consultation process. We would be happy to provide further information about any of the issues raised.

Yours faithfully,
On behalf of the German Banking Industry Committee
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