Challenges for the supervision of Financial Groups

Introduction
Thank you for the opportunity to speak at this Conference. Today I represent CEIOPS and hence the European insurance and occupational supervisors. However, at the same time I am also the Director General of an integrated regulatory and supervisory authority dealing with all types of financial firms – from a prudential as well as conduct of business point of view. I will thus speak about the challenges of regulating and supervising financial groups and the need for cooperation and coordination among supervisors rather than to talk very specific about insurance groups, conglomerates or banking groups. I define supervision as monitoring that firms comply with regulation and taking remedial action if they are not.

The reason for the Conference is obviously that the landscape of the financial sector is changing. Groups are becoming larger and more complex - also from a regulatory and supervisory perspective. Groups that are not specialised but deal with banking, insurance as well as other lines of business give rise to new challenges. The same applies to groups that own subsidiaries across borders. If such owners are located in a third country rather than in another European country the latter gets even more challenging.

European financial firms do not need to set up subsidiaries in order to enter into another European market within the same line of business. Firms may alternatively choose to operate cross-border through branches or the provision of services. Hence the legal structure of a financial firm or group may be determined by other factors than financial regulation as such. Managing tax liabilities may be one of those factors.

Financial regulators and supervisors have traditionally focused on the regulation and supervision of each individual financial firm – i.e. each legal entity. Today we need a broader view. Firms are tied to each other through exposures, common ownership, outsourcing arrangements etc.

We can not ignore the fact that the legal and operational structures of financial groups may diverge. Important decisions within financial groups are increasingly being taken centrally, as corporate policy on internal control and risk management often are governed by the parent company. Basle II and Solvency II to a certain degree push to this development by allowing the use of internal models for regulatory capital on a group wide basis. One of the main challenges in developing the regulation on groups will be to find solutions which reconcile the economic reality of groups with their legal structure and the consequent responsibility of the supervisors concerned.

We must also acknowledge that there are certain elements of the risk assumption that are unique to groups – first of all the risk of contagion. This risk may not only be due to intra-group financial
exposures. Common branding may also be a source. Having said that, we should not forget that there may contagious relationships between legally independent firms too - or that the probability of contagion within a multi-branch firm is close to one; i.e. if one branch defaults so will all the other.

The latter observation may be particular relevant, when firms or groups have a size that can seriously influence the financial stability in more than one country in case of default. Crisis management in such cases would need to involve home as well as host authorities. However the bargaining position of the host country authorities would be better in case of a group with local subsidiaries rather than a single firm with branches in several countries.

Current regulation of financial groups
Financial groups are today covered by three different directives: The Banking Directive (Chapter 3), the Financial Conglomerate Directive (the FCD) and the Insurance Group Directive (the IGD). These directives have been enacted at different points in time and are to a certain extent based on different cultures.

In the insurance area the supervision has been a "solo plus supervision" where a kind of a bottom up approach has been applied. In the banking area a kind of top-down approach has been applied with full consolidation. Hence as a starting point there has been more focus on group supervision in banking than in the insurance area.

I suspect this is also a reflection that the risk of contagion is higher within banking groups than within insurance groups. It is difficult – if not impossible - to close a commercial bank for new business. However, it is not unusual to see an insurer in run-off mode. In reinsurance run-offs you even see commutation, where the ceding insurer due to concerns regarding the potential default of the reinsurer accepts a reduction in his nominal claim.

In the terminology of the Lamfalussy process the IGD must be considered as a level 1 measure – i.e. European hard law. It has been supplemented by level 3 standards – i.e. soft law – after the members of CEIOPS have signed the Helsinki protocol and issued a paper on "Guidelines for Coordination Committees". According to the Helsinki Protocol cooperation between supervisors concerning cross border insurance groups should take place in a Coordination Committee. So for every cross border insurance group in Europe a "Co Co" is established.

In order to secure consistency and to make the "Co-Co's" work efficiently in practise the "Guidelines" stipulate how this cooperation should work on a number of areas including who participates, structure of meetings, the role of a key and a lead supervisor, solvency, intra group transactions, exchange of information.

In the "Co-Co's" the "Guidelines" are only guidelines and it is possible to tailor the supervision to the specific circumstances of each group concerned. For instance the "Co-Co" may choose to have a coordinator or a key coordinator, where these persons have a primary role of gathering and distribution information – but have no specific supervisory role towards the company. The Co-Co may also choose to have a lead supervisor with more specific supervisory tasks to perform in the group supervision.
The FCD - which also may be seen as a level 1 measure - has been enacted at a later date than the IGD. The FCD hence serves as an inspiration for future changes and amendments in the IGD. The FCD has for instance articles stipulating who should be in charge of the group supervision; it has introduced and defined the concept of a "coordinator" with a specific role in the supervision of the relevant group and specific tasks. The FCD also provides specific provisions that define which are the "relevant competent authorities" that are to participate in the group supervision.

At this stage I may draw your attention to the draft report CEIOPS has issued for consultation regarding possible amendments of the IGD. According to Article 11 of the IGD the Commission is required to submit a report to the EIOPC – the level 2 committee for insurance and occupational pensions - regarding that subject. Hence you may say the CEIOPS final report corresponds to providing technical advice to the Commission for a level 2 measure. The report recommends some – but not fundamental – amendments of the IGD, often to put the IGD in line with the FCD, but at the same time recognizes that most of the desired amendments should be considered in the context of the Solvency II Project. Indeed, the reshaping of the prudential regulation of insurance should have a significant impact in this field. I will refer you to the CEIOPS website www.ceiops.org in case you want further details.

**Future regulation**

Basel II and Solvency II will add new challenges to the cooperation between supervisors of financial groups: validation of internal models, control levels, supervisory review process at group level, sanctions towards groups etc. However, for supervisors of financial conglomerates cooperation will be facilitated if we manage to fulfil one of the objectives of Solvency II - that is compatibility with Basel II. Making the regulatory capital of insurers sensitive to investment risk would be a major step forward in its own right too.

In my own country, we have issued a single Financial Business Act de facto covering all financial firms subject to prudential regulation. We have tried to apply the same provisions where there is no obvious reason not to do so. This also applies in our executive orders. However in some areas it is fairly easy to make common provisions for the various types of financial firms while in others there are some difficulties – some stemming from the EU-directives.

As an example I can mention that it is fairly easy to issue common provisions governing intra group transactions. Here we have qualitative provisions requiring that the arms-length principle has to be applied, that there has to be written terms etc.

When it comes to common provisions for intra group exposures, this is a bit more difficult. We have established an integrated system of approving intra group exposures – using the same principles for all groups, whether they are banking groups, insurance groups or financial conglomerates. The goal is obviously to avoid unbalanced intra-group exposures due to differences in regulation.

In this system we generally allow the financial firms to expose all their excess capital to parents and sisters - in order to avoid minimum capitalisation. However, depending on the specific counterparties and risk mitigations within the group further exposures may be allowed.
It goes without saying that such a system operates well for domestic groups. However we need to provide foreign supervisors with an explanation, when we are applying our integrated system of approving intra-group exposures on foreign parents and sisters to Danish subsidiaries. Hence in my view it would be a step forward to have a level 3 standard regarding intra-group exposures. For obvious reasons it would need to cover all types of financial groups.

I mention this as an example of a more general problem too. Groups are not static. Subsidiaries are often acquired or divested. A conglomerate is a financial group that may change into a banking group or an insurance group and vice versa. When that happens a group will be covered by a different group directive which could potentially change who is responsible for the supervision, the tools available, the possibilities of enforcement, the form of cooperation, possibilities of exempting subgroups from calculations and what is in general being demanded of the group.

How supervisors cooperate is important in that respect. Cooperation has to be efficient, consistent and not too burdensome for the industry. Equivalence in regulation and convergence of supervisory practises is necessary in order to avoid inconsistency.

Coordination among European supervisors has in my view been materially improved after the extension of the Lamfalussy process to banking and insurance.

The Lamfalussy process is not fully extended to financial conglomerates. Even though a de facto level 2 committee has been set up, level 3 work is not yet properly organised. The 3L3 – that is CEIOPS, CEBS and CESR have offered to establish a joint Steering group dealing with level 3 questions for financial conglomerates. In order to emphasise the prudential nature of this work CESR representatives will only be observers.

Such an arrangement will be less costly than setting up a fourth level 3 committee for financial conglomerates – not only in terms of direct costs; we will also avoid lengthy discussions regarding purely organisational aspects – e.g. location of secretariat and budget key. However, most important of all is that we should be better able to avoid inconsistency in the regulation and supervision of banking groups, financial conglomerates and insurance groups respectively.

If we succeed, we may in some years from now have only one EU-directive covering central common issues for financial groups - it remains to be seen.

Thank you for the opportunity to make these opening remarks.