Consultation Paper

204

Financial Services Authority

Financial groups

October 2003

HM TREASURY

Preface

This is a joint consultation by the FSA and HM Treasury on proposals to implement the Financial Groups Directive in the FSA Handbook and HM Treasury Regulations. It also consults on wider FSA proposals for insurance groups.

Part 1 explains FSA proposals and contains the proposed Handbook text with which firms should comply.

Part 2 explains HM Treasury proposals to legislate for procedural aspects of the Directive and contains the proposed Statutory Instrument.

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The Financial Services Authority invites comments on Part 1 of this Consultation Paper. Please send your comments to reach us by 9 February 2004.
You can send your comments electronically using the form on the FSA's website (www.fsa.gov.uk/pubs/cp/cp204_response.html).

Alternatively, you can send comments in writing to:
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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

HM Treasury invites comments on Part 2 of this Consultation Paper.
Please send your comments in writing by 9 February 2004 to:
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Responses and/or a summary of responses may be published. Any responses or parts of responses which you do not wish published should be clearly marked as confidential.

This document can be accessed via the Treasury's website (www.hm-treasury.gov.uk). To obtain further information about publication of this document, please contact:

HM Treasury, Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

If you consider your comments to be relevant to both Parts of the Consultation Paper, please send or e-mail them to both the FSA and the Treasury.

1 Part 1
Executive summary

1.1 The first part of this Consultation Paper (CP) sets out proposals to implement the Financial Groups Directive in the FSA Handbook. It also proposes that the insurance EEA group-wide capital adequacy calculation should become a 'hard' test to be passed as a matter of regulatory obligation rather than a reporting requirement only. And it proposes to harmonise the existing consolidated supervision requirements for investment firms into a single set of rules.

1.2 Prudential supervision of corporate groups in the banking, investment and insurance sectors is necessary because of the risk that weaknesses in a group could threaten the position of individual regulated firms within the group. These weaknesses could take the form of inadequate capital or poor systems and controls at group level. As such, a regulated firm could face losses arising from either its direct exposures to the rest of the group or a loss of reputation following problems elsewhere in the group.

1.3 At present, EU directives require financial groups to be prudentially supervised within each major business sector. In the case of banking and investment firm groups, this supervision includes the requirement to pass a capital adequacy test for the group. In the case of insurance groups, the result of a group capital calculation must be reported, and supervisory action is liable to follow if the group does not pass the test.

How will the Financial Groups Directive affect firms?

1.4 The Financial Groups Directive will require the introduction (from financial years beginning in 2005) of additional prudential supervision of those groups which straddle the insurance and banking/investment business sectors significantly. The groups affected are called *financial conglomerates* in the directive.

1.5 A group will be a financial conglomerate if at least 40% of its business is financial and at least 10% or Euro 6 billion of its financial business is in each of the insurance and the combined banking/investment sectors. We expect to have between ten and thirty such UK groups, depending on how regulatory discretion allowed is applied in practice. They will be subject to extra prudential requirements at the mixed financial group level, covering the quality of their systems and controls and the adequacy of capital across the conglomerate.

1.6 Our overall approach to implementing the directive is to make it workable for the groups concerned and for ourselves. The rules and guidance proposed here are designed to reflect that approach. The directive leaves some discretion in relation to groups on the borderline of the conglomerate category, and on the detailed application of different capital adequacy methods. We must exercise our discretion by legally binding means: our main tool for doing so will be the OIVOP power (own-initiative variation of permission) given to us by the Financial Services and Markets Act.

1.7 Under the directive, we will also operate arrangements for the prudential supervision of third country groups – that is, financial groups with their top parent outside the EEA. These arrangements will apply not only to financial conglomerates but also to banking/investment groups not categorised as conglomerates. Insurance groups are already required by the Insurance Groups Directive to report a worldwide calculation of their capital adequacy. If a third country conglomerate or banking/investment group is subject to equivalent group-wide supervision in its home country then the need for group-wide supervision from the EEA falls away.

1.8 If the home country regulator does not apply group-wide supervision on a basis that is equivalent to the approach set out in the directive, then the directive leaves us with a choice. We can:

- undertake worldwide group supervision ourselves; or
- we can look to the group to organise itself in such a way that the objectives of group-wide supervision under the directive will be achieved using other methods within the confines of the EEA.

We believe it is unlikely to be possible in practice for us to implement full worldwide group supervision of third country conglomerate or banking/investment groups from the UK, and we shall rely on other methods. This may well require the establishment of a European holding company and restriction of exposures between the European sub-group and the worldwide group (‘ring-fencing’).

Additional proposals for insurance and investment groups

1.9 We are also amending our rules for insurance groups to require group capital adequacy calculations at EEA group level to be met as a regulatory obligation for UK firms. This will come into effect when we implement the Financial Groups Directive. We believe that this is justified by the nature of the risks run by insurance companies and by the risks posed to them from risks arising elsewhere in the groups to which they belong.

1.10 This step is likely to have significant cost implications for some groups and it may take time for them to change debt and equity structures. So, we propose a phased approach which does not include in the group requirement the proposed Enhanced Capital Requirement (ECR) for non-life insurers so long as it remains a reporting requirement only for these firms. This proposal is complementary to those set out in our Consultation Papers on *Enhanced capital requirements and individual capital assessments for non-life insurers* (CP190) and *Enhanced capital requirements and individual capital assessments for life insurers* (CP195).

1.11 We are also proposing to harmonise our rules for consolidated supervision of investment firm groups, and to bring these together into one chapter of the Interim Prudential Sourcebook for investment firms. This may have a significant impact on some groups which contain a principal dealer.

Pre-consultation

1.12 We have previously consulted on the principles of the conglomerates regime (CP97, June 2001) and have taken account in this paper of responses received. More recently we have held informal discussions with market participants to help us identify the main expected impacts of the directive and the most appropriate ways of approaching these in UK rules.

1.13 In view of this, and in order to allow groups as much time as possible to prepare once our final rules have been published, we have only allowed slightly more than three months for formal consultation.

CONSUMERS

This paper will not be of direct interest to retail consumers. But the proposals it makes are designed to enhance consumer protection as well as to further our market confidence objective.

Consumers depend on financial conglomerates and insurance groups for the fulfilment of their rights and expectations, and we expect the measures proposed here to strengthen their ability to do that. At the same time it must be borne in mind that increasing financial solidity carries a cost, and some or all of that cost will ultimately be passed on to consumers.

2 Introduction

2.1 The first part of this Consultation Paper contains three main sets of proposals:

- proposals to give legal effect to the Financial Groups Directive[1] in our Handbook;
- a proposal to move to a 'hard' capital adequacy test (ie one which must be passed as a matter of regulatory obligation) at EEA parent level for UK insurance firms[2]; and
- a proposal to harmonise the existing consolidated supervision rules for investment firms into a single set of rules.

2.2 It also contains 'near-final' rules and guidance on group systems and controls. We consulted on an earlier version of this in CP97 (Integrated Prudential sourcebook, June 2001). Although outside the formal scope of this consultation, we would still welcome any comments on the post-consultative text on group systems and controls.

Financial Groups Directive

2.3 The financial services industry has continued to see the formation of financial groups with activities in the banking, investment and insurance sectors. This has prompted international regulators to consider the structures necessary for containing and supervising the risks arising in these groups (known as

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 of the European Parliament and of the Council. The FSA website has a link, through the Financial Groups section – see later in this chapter.

2 We stated our intention to propose such a hard test in CP50 *Implementing the EC Directive on Insurance Groups* (chapter 4, footnote 10) and this is noted also in the Interim Prudential Sourcebook for Insurers, Guidance Note 10.1 para 22

financial conglomerates). In the EEA, this has resulted in the adoption of internationally agreed Principles[3] in the Financial Groups Directive (FGD).

2.4 FGD was published in February 2003 and comes into effect for firms and groups affected for financial years beginning on or after 1 January 2005.

2.5 The main purpose of the directive is to introduce a new prudential regime for financial conglomerates, that is groups with significant activities in the banking and investment sectors on the one hand, and the insurance sector on the other hand. It does this by:

- setting out four methods to measure financial conglomerate capital adequacy to eliminate double counting of capital and excessive leveraging;
- requiring that financial conglomerates have enough capital to meet a capital adequacy test – the tests are binding rather than indicative;
- requiring financial conglomerates to have adequate systems and controls to monitor intra-group exposures and risk concentrations across sectors;
- requiring a single supervisory co-ordinator in the EEA to be appointed for each financial conglomerate, with defined obligations, including group supervisory oversight, information exchange and cooperation; and
- setting out a process for assessing if non-EEA conglomerates operating in the EEA are subject to equivalent supervision in their home country, and, if not, requiring European group oversight or alternative measures.

2.6 FGD also amends existing European group prudential supervision requirements for sectoral groups – that is, for insurance groups and banking and investment groups – to close gaps in their coverage. It does this by:

- closing loopholes in the technical specification of existing group-wide capital adequacy/solvency measures to prevent double-counting of capital where a sectoral group has subsidiaries or participations in financial firms in a different sector; and
- setting out a process for assessing if non-EEA groups other than insurance groups operating in the EEA are subject to equivalent supervision in their home country. And, if not, requiring European group oversight or other methods to address the objectives of group-wide supervision.

2.7 Table 1, following paragraph 2.16 below, summarises the changes affecting different types of group and when these groups must comply with the new requirements.

3 The Joint Forum *Supervision of Financial Conglomerates*, documents jointly released in February 1999 by the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors. The FSA website has a link, through the Financial Groups section – see later in this chapter.

Insurance Groups

2.8 The Insurance Groups Directive (IGD) introduced a group capital adequacy calculation, but did not prohibit negative results under that calculation. We propose that, as from financial years beginning in 2005, insurance groups must hold the amount of capital indicated by the calculation as a regulatory obligation at the EEA parent level. This hardening of the group test is part of a series of measures we have been taking to overhaul insurance regulation in the UK. As a result, the rights and expectations of policyholders will be more securely protected.

2.9 FGD amends the IGD and the first life and non-life insurance directives, to prevent double counting of capital arising from insurance companies investing in banking and investment firms. These changes are also required from financial years beginning in 2005.

2.10 The proposed Handbook text implementing these changes also incorporates the effects of the wider overhaul of UK insurance requirements proposed in CP190 and CP195. The new text applies generally from when changes in CP190 and CP195 are made; while any requirements applying from financial years beginning in 2005 are marked accordingly.

UK banking and investment groups

2.11 The proposed Basel Accord and EU review of capital standards for banks and investment firms will have a significant impact on supervision at both solo firm and group level from end-2006. In the meanwhile, we propose a minimal implementation of FGD for UK banking and investment firm groups. However, to improve the clarity of consolidated supervision requirements, we propose to bring together consolidated supervision rules for all types of UK investment firm in a single chapter of the interim sourcebook IPRU(INV).

Third country banking and investment groups

2.12 As noted above, FGD introduces new requirements for sectoral (non-conglomerate) banking and investment groups with non-EEA parents, as well as non-EEA conglomerates, and these apply from financial years beginning in 2005.

Group systems and controls

2.13 In CP97 we consulted on draft Handbook text on systems and controls that a firm in a group needs to maintain to monitor the risks it runs through being part of the group; the post-consultative text in this paper is revised to take account of the comments received. We propose that the updated group systems and controls requirements should come into force on the same date as the Integrated Prudential sourcebook chapters on systems and controls in mid 2004.

Handbook architecture and timing

2.14 As explained elsewhere (see CP143 *Integrated Prudential Sourcebook – Feedback on chapters of CP97 applicable to insurance firms and supplementary consultation*), the Integrated Prudential Sourcebook is to be introduced in several phases, with priority being given to systems and controls material and the new insurance regime. So, rules and guidance proposed in this Consultation Paper must be split between the Integrated Prudential Sourcebook and the interim sourcebooks. Unfortunately, this adds to the complexity of the implementing text.

2.15 New requirements for group systems and controls, insurance groups, financial conglomerates, and non-EEA banking and investment groups are implemented in Integrated Prudential Sourcebook text. And minimum required changes to UK banks, building societies, e-money and investment firms are implemented through amendment of interim sourcebooks, pending the EU banking and investment capital review.

2.16 Table 1 highlights the main changes and their proposed timing. As well as these changes there are some proposed amendments to the Supervision manual to reflect new reporting requirements (set out in Annex 5). There are also some related changes to the Handbook (set out in Annex 5 and Annex 6). The powers to make these draft rules and guidance are contained in sections 138, 156 and 157 of the Financial Services and Markets Act 2000.

Table 1: Changes to rules and applicability

Material	Applicable to	Implementation date	Location
Group systems and controls	All firms that are part of a group	With other SYSC	PRU 8.1
UK conglomerate systems and controls	All firms that are part of a UK conglomerate group	Financial year beginning 2005	PRU 8.1
Insurance groups: - earlier proposals	Insurance firms that are part of groups	With CP190 and CP195 changes	PRU 8.3
Insurance groups: FGD changes and hard test	Insurance firms that are part of groups	Financial year beginning 2005	PRU 8.3
FGD requirements: UK conglomerates	Banking, investment firms and insurers within a UK conglomerate	Financial year beginning 2005	PRU 8.4
FGD requirements: non-EEA groups	Firms in non-EEA banking / investment and conglomerate groups	Financial year beginning 2005	PRU 8.5
FGD amendments: UK banking groups	Banks in a UK lead-supervised group	Financial year beginning 2005	IPRU(Bank)
UK building societies	Building societies	Financial year beginning 2005	IPRU(Bsoc)
UK e-money institutions	ELMI in a UK lead-supervised group	Financial year beginning 2005	ELM
UK investment firm groups	Investment firms in a UK-lead supervised group	Accounting year beginning 2005	IPRU(INV) Chapter 14

Pre-consultation

2.17 In CP97 we consulted on aspects of the conglomerate regime in principle, and we have taken account of responses received in this paper. More recently, we have worked to identify the main expected impacts of the directive and the most appropriate ways of approaching these in UK rules. We did this by setting up a practitioner group. This pre-consultation group included members representing both UK and non-EEA groups, and also trade associations and consultants. Minutes of its meetings have been available on the FSA website since March 2003[5]. We have also held discussions with major UK financial groups most likely to be affected by the proposals. We are grateful to all of the above for the help they have given. We continue to work with other EU supervisors to pursue consistency of implementation.

4 The same material applies to Friendly Societies as to insurance firms. The numbering of new Integrated Prudential sourcebook chapters leaves an empty chapter (PRU 8.2) for post banking capital review rules.

5 This can be accessed through the Industry Help section, under Financial Groups (Conglomerates) Directive Implementation. http://www.fsa.gov.uk/international/fgd.html

Structure of Part 1 of this CP

2.18 **Chapter 3** explains how to identify a financial conglomerate, including the process and timing for communication between us and firms. It also explains how requirements under the existing and new directives relate to each other. All firms that are part of a group with activities in more than one sector should read this chapter.

2.19 **Chapter 4** sets out our proposals for UK financial conglomerates. It explains how requirements will be applied to each firm and how UK financial conglomerates will be supervised. The new regime includes a hard capital adequacy requirement and new reporting and monitoring requirements on intra-group exposures and risk concentrations across the conglomerate.

2.20 **Chapter 5** sets out the proposed new regime for insurance groups. It explains the proposed hardening of the EEA parent group test. It then sets out the implications at group level of our wider overhaul of insurance requirements, including Enhanced Capital Requirements, Individual Capital Assessments, and limits on the eligibility of various types of capital. Finally, it explains how we propose to implement FGD-required changes to prevent double counting of capital arising from insurance companies investing in banking and investment firms; this is a significant change from the current market valuation approach.

2.21 **Chapter 6** sets out proposed minimal changes to our existing group requirements for UK banking and investment groups. Consolidated supervision rules for investment firms are brought together in a single new chapter of IPRU(INV) to simplify implementation, and, where appropriate, this takes account of the responses we have received to proposals in CP173. We will publish separately the feedback to CP173.

2.22 **Chapter 7** explains the proposed treatment of firms that are part of third country (non-EEA) financial conglomerates and banking and investment groups. It does not apply to third country insurance groups which are not conglomerates. This section explains the process of deciding equivalence and what happens if a group's supervision is deemed to be non-equivalent.

2.23 **Annex 1** contains a summary of the questions raised in this paper. **Annex 2** contains a compatibility statement, and **Annex 3** a cost-benefit analysis. **Annex 4** contains the new rules and guidance for our proposed new group risk requirements in the Integrated Prudential Sourcebook (PRU 8). **Annex 5** contains proposed changes to other parts of the Handbook. **Annex 6** includes proposed changes to the interim sourcebooks.

2.24 We welcome comments on the questions raised in Part 1 of this paper (in Annex 1) by 9 February 2004, addressed to the FSA.

3 Defining which directive applies

3.1 FGD is designed to bring together supervision across sectors for those financial groups (and sub-groups within larger groups) which have significant cross-sectoral activities. It takes existing EU directives containing group requirements in each sector, i.e. the Banking Consolidated Directive (BCD), Capital Adequacy Directive (CAD), and Insurance Groups Directive (IGD) and uses these directives as building blocks for cross-sectoral requirements at the financial conglomerate level.

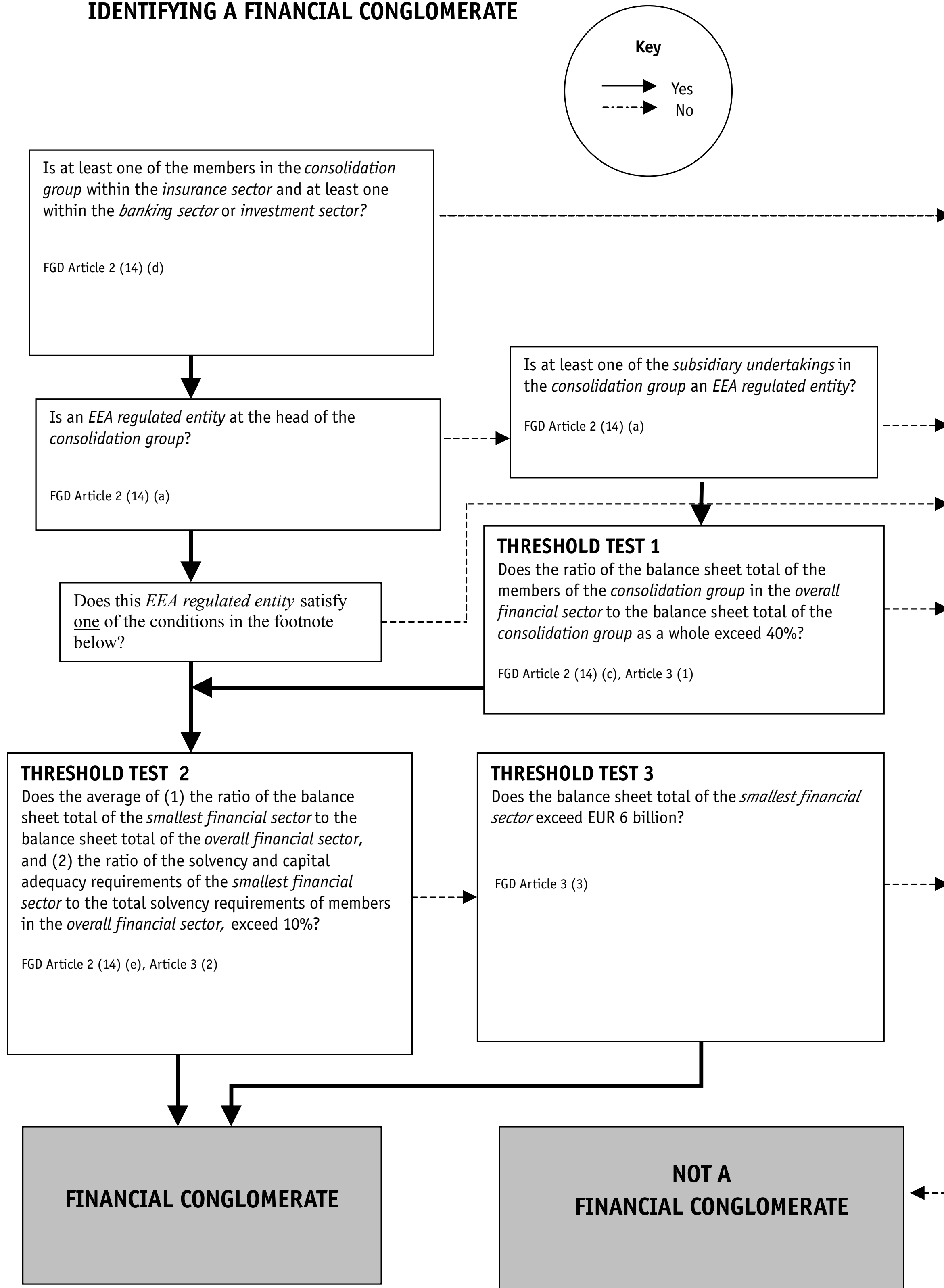
3.2 This chapter sets out how the groups and sub-groups to be subject to cross-sectoral oversight are defined, explaining the various calculations involved and the role of an appointed EU coordinator in exercising discretion to vary or disapply the calculations.

3.3 It then summarises the relationship between the scope of requirements for groups and sub-groups under FGD, BCD/CAD and IGD. It also outlines the lack of flexibility allowed by the directives to waive sub-group requirements where a wider group is subject to supervision under a different directive. We explain our proposal to reduce the effects of this problem by harmonising the detail of our capital adequacy calculations at the various levels within a group. The diagrams at the end of this chapter illustrate the revised scope of the directives as amended by FGD.

3.4 The remaining chapters of this paper explain the requirements we propose to apply under the various directives to the groups and sub-groups identified.

Defining a financial conglomerate

3.5 The decision tree in the box illustrates the calculations and exercise of supervisory discretion needed to define a financial conglomerate group or sub-group. For clarity, we refer to the steps involved as Threshold tests 1, 2, and 3. Our proposed implementation of the tests is set out in Annex 4: see chapter PRU8.4. The rules and guidance there set out the processes involved and the terms used to define the types of firm and group relationships which are to be included in the scope of the tests.



Footnote: The conditions are that the *EEA regulated entity* at the head of the *consolidation group*:

(1) is a *parent undertaking* of a member of the consolidation group in the overall financial sector;

(2) has a *participation* in a member of the *consolidation group* that is in the *overall financial sector*; or

(3) has a *consolidation Article 12(1) relationship* with a member of its *consolidation group* that is in the *overall financial sector*.

Threshold test 1 – is there a financial group?

3.6 This first test identifies the groups or sub-groups of firms within a group structure to which FGD may apply. The test need not be done unless a group or sub-group has activity in each of two sectors: banking and investment (taken as one sector) and insurance.

3.7 The test uses the same basic approach as is used under sectoral group directives to define the scope of group-wide supervision required. That is:

- look upwards in the group structure to the highest parent which is either a regulated firm or a holding company whose business is *mainly* ownership of firms in the sector(s) concerned; and then
- include in the group those entities owned/controlled by that parent which operate in the sector(s) concerned – and they may be either regulated firms or not.

3.8 The sectoral directives do not specify exactly the meaning of *mainly* in this context. However, FGD specifies that parents which are *mainly* in the combined insurance and banking/investment sector are those where 40% or more of their balance-sheet represents activities in these sectors.

3.9 In specifying which types of entities and ownership structures are to be included in the group or sub-group, FGD builds on the sectoral group directives. If a firm should be included in the consolidated group at sectoral level because of the type of business it undertakes and the nature of its relationship with its parent, it should also be included in the test for whether the group or sub-group is a financial conglomerate.

3.10 The effect of threshold test 1 (the 'financial sector test') is that, for some group structures, supervision and a group capital adequacy test will be required to a higher parent level within the group than is required under current EU directives (to bring together the banking/investment and insurance activities). This could have significant effects if:

- the higher level parent directly owns unregulated financial firms (such as leasing or re-insurance) and these are then brought within the scope of group-wide supervision; or
- the higher level parent is outside the EEA and an assessment must then be made on whether the group is subject to equivalent group-wide supervision by a third country authority. The implications of this are discussed in Chapter 7.

Threshold tests 2 and 3 – is the group significantly cross-sectoral?

3.11 Having defined the scope of the group and any sub-group(s) concerned using threshold test 1, the next two tests (the 'cross-sectoral tests') must be applied

to each of these (sub)groups to determine whether the amount of their cross-sector activity is significant.

3.12 FGD defines the amount of each sector's activity as an average of balance-sheet size and the amount of the capital adequacy requirements for each sector. This proxy was agreed after two EU-wide 'mapping exercises' to collect indicative data from firms on possible measures of sectoral activity: these suggested that other possible proxy measures for the balance of business would produce results similar to the definitions used in FGD.

3.13 Threshold test 2 defines significance as being that at least 10% of the (sub)group's activities are in each of the two sectors. (Sub)groups which meet this threshold are defined as a financial conglomerate.

3.14 Groups which do not meet test 2 may still be defined as having significant cross-sectoral activity under test 3, however, if at least Euro 6 billion of the (sub)group's activities are in each sector. However, this absolute size threshold may be disapplied by supervisory discretion, through a process described in the next section.

3.15 FGD also specifies that, when a group has been defined as a financial conglomerate, lower thresholds should apply in the subsequent three years, to avoid groups repeatedly changing their categorisation.

> Q3.1: Have you any comments on the scope of the threshold tests?

Appointment of EU coordinator

3.16 FGD requires that a single EU coordinator be appointed for each financial conglomerate, with a defined role and responsibilities for group-wide supervision. It also requires that other relevant competent authorities are identified for each group and that they are consulted about specified aspects of the supervision. The arrangements and required procedures are explained in more detail in Part 2 of this paper. This section summarises the coordinator's role main points in identifying a financial conglomerate, and the next chapter summarises the main points in relation to supervision of a financial conglomerate.

3.17 The coordinator and relevant competent authorities also have a defined role in exercising discretion over the definition and identification of a financial conglomerate, as explained below.

3.18 FGD has default rules for deciding which EU competent authority is to be appointed as coordinator for each conglomerate, though the authorities concerned may agree to depart from the default rules after consulting the group concerned if the default rules would produce an inappropriate outcome.

3.19 If the group concerned has an existing EU lead supervisor under the BCD or an existing chair of the supervisory coordination committee under IGD, the FGD coordinator will be one of these – the default rule suggests the one responsible for the group's most important sector. The other existing lead supervisor/coordinator is to be one of the relevant competent authorities. In practice, we believe that for most groups the most important sector, and hence which authority is to be coordinator, is clear.

Process for identifying financial conglomerates

3.20 Threshold test 3 may be disapplied only by common agreement of the coordinator and relevant competent authorities for each group (FGD article 3(3)). This requires a staged process of communication between firms (to measure the threshold data) and EU supervisors (to agree whether to disapply threshold 3 and notify the group of this decision). This creates potential uncertainty for groups which do not reach threshold 2 but do meet threshold 3.

3.21 To limit the period of uncertainty for groups, we have already requested information from UK firms on the relevant data and are co-operating through a working group of EU supervisors to assess as quickly as possible for groups active in more than one EU country:

- if they are *likely* to be a financial conglomerate, based on the data; and
- if so, who are the likely coordinator and the relevant competent authorities for the group, so that they may decide whether to disapply threshold 3.

3.22 The questionnaire requesting this information is on the FSA Financial Groups website. It sets out the calculations required by firms with some illustrative guidance (over and above our implementation in PRU8.4.27R-33G).

3.23 Since FGD allows for considerable case-by-case supervisory discretion in applying the threshold tests, we do not believe that it is proportionate or necessary for groups and their supervisors to pursue a great level of detailed consistency in the way accounts are used to carry out the threshold tests.

3.24 We hope to be in a position to notify all UK groups for which we are EU coordinator during the first quarter of 2004 whether we will disapply the Euro 6 billion threshold (after agreement, where required, with other relevant EU competent authorities).

Q3.2: Have you any comments on the proposed process for applying the threshold tests?

Q3.3: Have we given enough information for groups to implement the threshold tests?

Relationship between directives

3.25 FGD has the stated aim (recital 20) of supplementing sectoral rules in such a way as to avoid regulatory arbitrage between the sectoral rules and financial conglomerate rules. It therefore amends the sectoral rules (BCD/CAD, IGD and the insurance life and non-life directives) to achieve minimum harmonisation between them, so that FGD can reasonably attempt to be consistent with them all.

3.26 The most significant harmonisation changes are to the geographical scope of sectoral groups and the required treatment of cross-sectoral subsidiaries at both individual firm and group level, under all directives and in all sectors. These changes are discussed in more detail in Chapters 5-7 of this paper.

3.27 The diagrams at the end of this chapter illustrate changes in the scope and cross-sectoral aspects of the directives which bring them into line with each other and with FGD.

Waivers of sub-group requirements

3.28 The existing sectoral directives (BCD/CAD and IGD) and FGD each separately allow that supervisors may agree to waive supervision and capital adequacy requirements for sub-groups where a wider group is also subject to these requirements in the same directive[6].

3.29 This principle of allowing waivers of sub-group supervision in the presence of wider group supervision reflects what we believe to be the prudential reality that:

- supervision of some sub-groups is worthwhile – for example, to allow an overview of a sub-group within one country or one sector, or a sub-group linked by a common brand; but
- many sub-groups are an incidental part of complex structures and supervising them as sub-groups does not add supervisory value to the requirements applied to individual regulated firms and the wider group as a whole.

3.30 We believe, therefore, that the principle of allowing waivers of sub-group requirements should have been extended to operate where the wider group requirements are imposed by one of the other directives. Unfortunately, this result was not achieved during FGD negotiations. This means that the requirements set out in the following chapters are not mutually exclusive.

3.31 One way to reduce the costs to firms and supervisors of complying with a series of group and sub-group requirements is to make the capital adequacy calculations as similar as possible under the various directives. And, this is

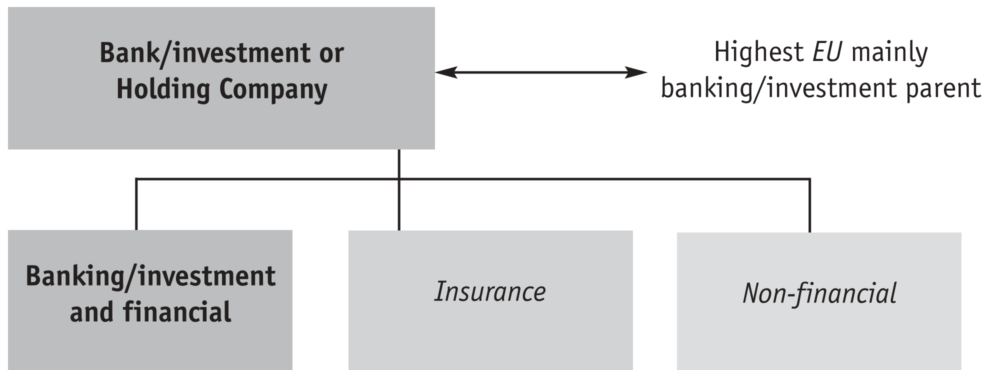
6 The Basel Accord review proposes to reduce the flexibility to waive sub-group requirements.

what we have done in the following chapters of this paper. In particular, the capital adequacy measurements we will impose on each financial conglomerate group or sub-group will normally be the same as would apply under the relevant sectoral directive if it were not a financial conglomerate.

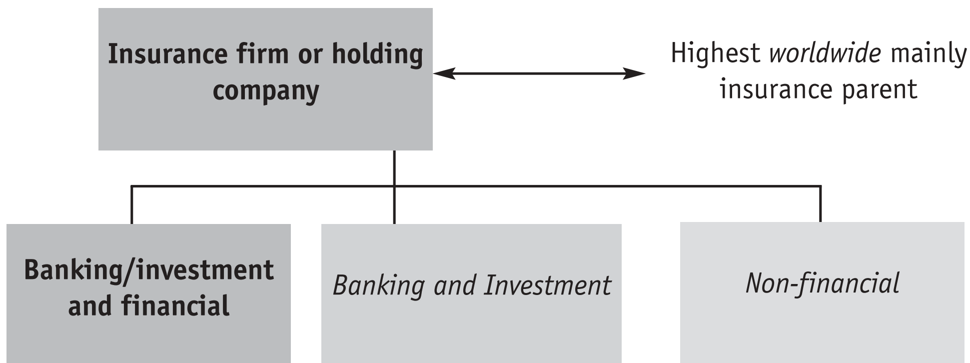
3.32 This is one of the outcomes allowed by FGD and the solo and sectoral directives (as amended). FGD also envisages different capital adequacy methods for financial conglomerates being available, as explained in the next chapter, but these would not necessarily avoid overlapping calculations on different bases throughout the group, and we believe it is unlikely that groups will wish to adopt these.

> Q3.4: Have you any comments on how we propose to handle the relationship between sub-group and group requirements under different directives?

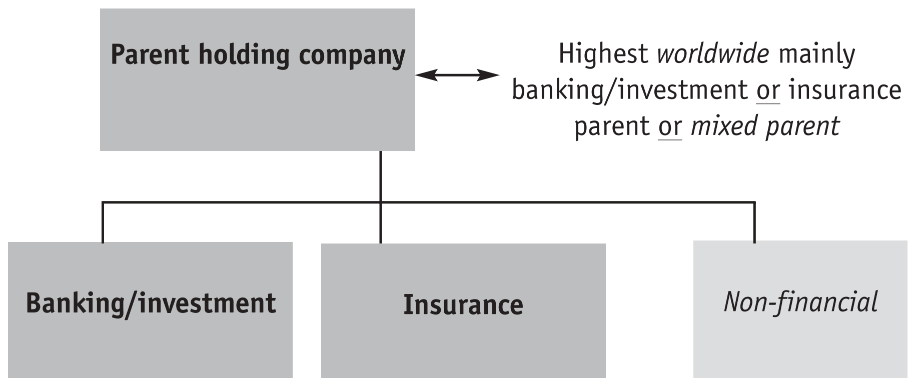
Scope of current Banking Consolidated Directive & Capital Adequacy Directive



Scope of current Insurance Groups Directive



Scope of new Financial Groups Directive & amended BCD/CAD &IGD



4 UK Financial Conglomerates

4.1 This chapter explains our proposed implementation of new requirements for EEA groups or sub-groups defined as financial conglomerates, for which we are the EU co-ordinator. The proposed rules and guidance are set out in Annex 4: see Chapter PRU 8. As explained in chapter 3 of this paper, the requirements in this chapter apply in addition to any requirements set out in other chapters of this paper.

Role of the coordinator

4.2 FGD specifies a process for appointing a single EU coordinator and relevant EU competent authorities for each conglomerate (see chapter 3 of this paper). It also specifies in some detail (FGD articles 11 and 12) the respective roles of the coordinator and relevant competent authorities in supervising the group.

4.3 The roles of the coordinator are essentially to exchange information and co-operate with the relevant competent authorities to take a cross-sectoral overview of the group and whether it meets the requirements set out below. It is a cross-sectoral extension of the existing lead supervision arrangements under BCD/CAD and coordinator arrangements under IGD, and FGD is more specific about what is required. The duties of the coordinator are described in more detail in Part 2 of this paper, and proposed implementing legislation is set out in Annex 1 of Part 2.

4.4 The appointment of a single EU supervisory coordinator could have some benefits for firms, by streamlining their interaction with supervisors concerning group issues. As with existing arrangements, however, oversight of the group does not remove regulatory requirements on individual regulated firms within it.

> Q4.1: Have you any comments on the role of the coordinator in supervising the group?

Systems and controls and management requirements

4.5 FGD builds on existing sectoral group requirements by requiring that conglomerates have adequate governance and management at the cross-sectoral conglomerate level and systems and controls to manage its risks across the sectors. As explained in Chapter 2 of this paper, we consulted on group systems and controls in CP97, and the post-consultative text in this paper is revised to take account of the comments received: see PRU 8.1. The additional FGD requirements are set out in PRU 8.1.10R-11R, and they will apply from financial years beginning in 2005.

4.6 FGD also requires that financial conglomerates monitor and report to the coordinator both significant risk concentrations (to third parties) and significant intra-group transactions and exposures (to other entities in the group) on a cross-sectoral basis. These requirements are explained in the next section, and they will apply from financial years beginning in 2005.

Cross-sectoral monitoring of intra-group transactions and exposures (ITEs) and risk concentrations (RCs)

4.7 FGD articles 7 and 8 and Annex 2 set requirements concerning ITEs and RCs for financial conglomerates. Our proposed implementation of these is set out in PRU8.4.53G – 60G. FGD also sets wider reporting requirements for reporting of significant ITEs by credit institutions and investment firms, and this is explained in Chapter 6 of this paper.

4.8 FGD requirements for financial conglomerates build on existing sectoral requirements, and these remain significantly different across the sectors (even after the amendment explained in Chapter 6). Rather than attempting to harmonise fully the sectoral approaches, FGD requires that the rules (if any) of the larger sector (identified in the threshold tests explained in chapter 3) are extended up to any parent mixed financial holding company and its subsidiaries.

4.9 The decision on detailed reporting requirements – including the definition of which transactions and exposures are significant – is left to the co-ordinator, after consultation with the other relevant competent authorities and the conglomerate itself. The Commission is required (FGD Article 31) to report to the EU Financial Conglomerates Committee by mid 2007 on how this has been implemented in different countries, and whether further harmonisation is needed.

4.10 We have had preliminary discussions with practitioners and supervisors on how to implement the extended requirement for conglomerates in a proportionate way. Minutes of the relevant meetings are available on the Financial Groups section of our website. In summary, we have concluded that it would be premature to introduce a new UK standardised measure of significant RCs or ITEs ahead of greater harmonisation between sectoral

requirements and their implementation in the EU, and in light of the Commission's report on this in 2007.

4.11 Instead, we propose to:

- implement the requirements by retaining the definitions of significance in our current sectoral requirements; and
- require financial conglomerates to provide an additional annual summary report giving an overview of these; and
- include in the summary any significant transactions and exposures of the mixed financial holding company parent as defined by the rules of the most important sector of the group.

This report should be developed using internal management information systems of the groups concerned.

4.12 The proposed additional summary reporting requirements are set out in Annex 5, SUP16.7.73R – 74R. The internal management information systems supporting the report must be adequate to allow the group to measure, monitor and control these exposures across the sectors. Also, the report must be adequate to communicate to the coordinating supervisor an overview of the major features of the group's overall position.

4.13 We believe that market practice is still developing in this area, and therefore propose to continue working with group risk managers of individual UK conglomerate groups as they prepare to implement the necessary management information systems. We propose that each group will be required to agree with its supervisor the format and content of its annual summary report for the group as a whole, after the supervisor has consulted the EU relevant competent authorities for the group concerned.

> Q4.2: Do you agree with our proposal to require groups to develop cross-sectoral summary reports of intra-group transactions and exposures and risk concentrations based on their own management information, after discussion with supervisors, rather than introducing a new standardised approach?

Capital adequacy requirements – process

4.14 FGD specifies four possible methods for calculating conglomerate capital adequacy, and that the coordinator and relevant competent authorities should choose which one of the four methods should apply to each conglomerate. Methods 1, 2 and 3 are separate specific methods, and method 4 is a combination of methods 1, 2 and 3.

4.15 For some types of financial conglomerate – i.e., those headed by a regulated parent, or where no other EU competent authority is involved – the directive allows us to specify a single method in our rules. But for financial conglomerates headed by a mixed financial holding company, the directive requires that we can in principle authorise firms to use any of the FGD methods. This is to ensure there is a basis for discussion with the other relevant competent authorities before deciding which method the group must use.

4.16 We must implement our discretion to direct those groups mentioned in the previous paragraph by legally binding means, and our main tool for doing so will be the OIVOP (own-initiative variation of permission) power given to us by the Financial Services and Markets Act. We propose to notify either the highest parent holding company in such groups, or the highest regulated parent in the group, of the method to be used.

> Q4.3: Have you any comments on our proposed use of the own-initiative variation of permission power (OIVOP) to implement the requirements?

Capital adequacy requirements – methods

4.17 We propose amendments to our current sectoral group requirements for banking, investment firm and insurance groups in Chapters 5 and 6 of this paper to make them consistent with FGD method 4. Consistent with our minimal change approach, we propose that these sectoral capital adequacy requirements should also apply to financial conglomerates – either automatically or (in the case of those groups mentioned in the previous two paragraphs) by OIVOP: see PRU8.4.48R – 51R.

4.18 This implementation has the advantage that conglomerates groups and sub-groups will be subject to the same capital adequacy measurement (possibly applied to a group or sub-group with wider scope) as they would be if they had a lower proportion of cross-sectoral business which allowed them to remain below the threshold to be a financial conglomerate.

4.19 Groups headed by a mixed financial holding company will be able to apply for a variation of permission (VOP) to use alternative methods (methods 1, 2, and 3 of the Directive) which are set out in PRU 8 Annex 1 Parts 1 to 3, provided that the principles set out FGD Annex 1 are met: see PRU 8 Annex 1 Part 5. We expect this to happen infrequently, however, as there are technical difficulties in applying methods 1 to 3 to all of the sectors in a way which is consistent with these technical principles.

4.20 The difficulties of interpreting every permutation of method and sector are acknowledged at the European level. So, they will be considered further by a group of technical experts which is working to encourage consistency of

implementation across the EU (the Mixed Technical Group). Further developments – particularly in new International Financial Reporting Standards and arising for banking and investment firms from the EU Risk Based Capital Directive – will complicate their interpretation further.

4.21 We are continuing work to articulate the methods and technical principles in PRU 8 Annex 1 Parts 1 to 3 in light of these forthcoming developments.

> Q4.4: Do you agree with our proposal to direct groups to FGD Annex I method 4 in 2005, while work continues to develop the technical principles for other methods in light of the wider banking and investment capital review and new accounting standards?

5 Insurance Groups

5.1 This chapter sets out our proposals for non-conglomerate insurance groups and for insurance parent undertakings which have a significant investment in another insurance undertaking, bank, investment firm, or financial institution. As explained in Chapter 3, the requirements in this chapter apply in addition to any requirements set out in other chapters of this paper.

5.2 This chapter includes changes which complete our initial IGD implementation, proposals following from our wider review of requirements for UK insurers[7] and changes required by FGD amendments.

Scope of the requirements

5.3 We propose rules which implement amendments made to the IGD and the solo insurance directives[8] by the FGD, for two types of calculation:

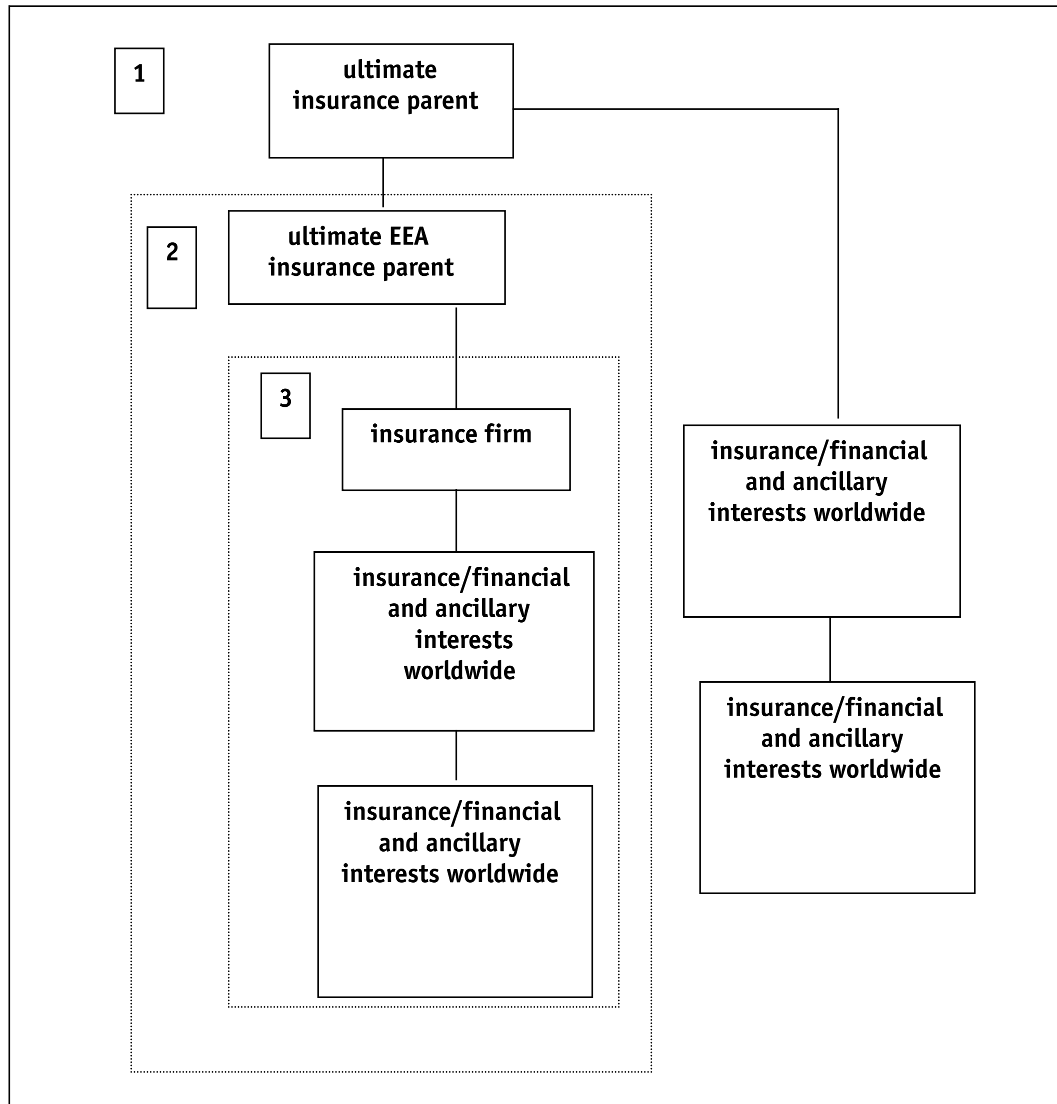
- the capital adequacy position of an insurer, adjusted to take into account its holdings in related insurance and financial undertakings. (Note that IGD already covered related insurance undertakings, and it was amended by FGD also to cover related financial undertakings); and
- the group capital adequacy position at the level of an insurer's parent. (Note that IGD requires this calculation to be analogous to the adjusted capital adequacy calculation.)

5.4 The objective of these calculations is, like those for other sectoral groups, to test whether there is double gearing of capital arising from investments in other group insurance and financial firms or excessive group leveraging due to the financing structure of a parent holding company. The diagram on the next page summarises the scope of the calculations.

7 *Enhanced capital requirements and individual capital assessments for non-life insurers* (CP190) and *Enhanced capital requirements and individual capital assessments for life insurers* (CP195).

8 First and third life insurance directives 79/267/EEC and 92/96/EEC and first and third non-life insurance directives 73/239/EEC and 92/49/EEC

Scope of capital adequacy calculations



1. Worldwide group
2. EEA group
3. Insurance firms with insurance/financial and/or ancillary interests

Completion of our initial IGD implementation

Hard group capital adequacy requirement

5.5 IGD requires the results of a group capital adequacy test to be reported at several levels, including the top worldwide parent insurance holding company. The directive leaves it to the supervisory authority to decide on the action necessary where a group or sub-group does not have a buffer of capital which is sufficient to produce a positive result in these tests.

5.6 In the first two years of our IGD implementation, we have required groups to report results of the tests at the highest EEA and world-wide parent levels, but have not made it a regulatory requirement to meet the tests. This was to allow firms and their supervisors time to analyse the calculations and their prudential implications for firms within groups. We announced our intention, however, to move to a hard requirement to meet the test in our Integrated Prudential Sourcebook (as noted earlier in this paper)[9].

5.7 A capital shortfall at the parent group level does not, of course, imply that any individual insurance undertaking in the group is failing to meet its own capital adequacy (or regulatory 'solvency requirement'). The individual firm requirements (including adjustments for their interests in other insurance firms) are already hard requirements. This implies that the firm must notify us of any breach and take immediate remedial action and also that disciplinary or enforcement action may be triggered.

5.8 We now propose that the top world-wide parent group test for insurance groups should remain a reporting requirement. We will continue to take this into account in assessing whether there is a threat to the solvency of the EEA sub-group or UK insurance undertakings from the wider non-EEA group: see PRU8.3.21R. But we propose that meeting the group capital adequacy test at the top EEA parent insurance holding company level should become a hard requirement from financial years beginning in 2005: see PRU8.3.11R(2).

5.9 This proposed change complements our recent proposals for individual insurance undertakings by ensuring that they are not undermined by excessive risk-taking or leverage in the wider EEA group of which the firm is a part. Experience has shown that this can lead to instability or loss to the individual insurance firm through:

- direct contagion – for example, a regulated firm lends to or guarantees its unregulated parent, or a leveraged parent which is unable to meet its debt

9 *Implementing the EC Directive on Insurance Groups* (CP50 – Chapter 4, footnote 10), and Interim Prudential Sourcebook for Insurers (Guidance Note 10.1 paragraph 22).

service obligations extracts excessive dividend payments from the regulated firms it owns (despite regulatory restrictions designed to prevent this); or

- reputational contagion – for example, an unregulated firm in the group makes large losses or is subject to fraud, and the group has an insufficient buffer of capital to absorb this loss. This can then lead to a generalised loss of confidence in the group leading to a disorderly default or the need for public support to prevent this.

5.10 We believe this step is justified by the nature of insurance firms and the risks they run. It makes our requirements for insurance groups consistent with what we understand to be the way other EEA supervisory authorities have implemented IGD, as well as our requirements for financial conglomerates and banking/investment groups.

5.11 It is, however, likely to have significant cost implications for some groups when taken alongside the proposed new Enhanced Capital Requirements for individual non-life insurance firms. (Our proposals for life insurers have very little impact at the group level because any surplus capital in life funds is already excluded from group resources, being non-transferable). We propose, therefore, to implement the hard group capital adequacy test in stages, by basing it initially on the minimum capital requirements (MCRs) for UK non-life insurers. This is explained in more detail in the next section and in Annex 3.

Effects at group level of new solo requirements

5.12 The material in this section was explained in CP190 and CP195, but a summary is included here again here for completeness.

Enhanced Capital Requirements (ECRs)

5.13 The group capital resources requirement is calculated as the group's proportional share of the sum of the capital resources requirements (or proxy capital resources requirements) of the individual members of the group. The group's capital resources are calculated as set out in the next section.

5.14 Capital which is required as a regulatory obligation in individual firms cannot immediately be assumed to be transferable to other members of the group. So there is a presumption that any 'hard' requirements at solo level feed through to the calculations at higher levels in the group. Capital which is not transferable for other reasons – for example, surplus capital within the long-term fund which could not be allocated to other entities of the group – is also excluded from group capital resources.

5.15 CP190 and CP195 proposed enhanced capital requirements (ECRs) for non-life and life insurers, respectively. In the case of life insurers, we propose that the ECR should be a hard solo requirement, but this should have very limited impact at group level because excess capital in long-term fund is already excluded from group capital resources. In the case of non-life insurers, we proposed initially to introduce the solo ECR as a reporting requirement only, and in the middle of 2004 to decide if this should also become a hard solo test, and, if so, when.

5.16 This means that we propose for our initial implementation of FGD and its amendments to insurance directives that the following amounts feed up into the parent firm and group capital adequacy calculations from UK subsidiary insurance firms:

- for UK life insurer subsidiaries – the higher of the proposed ECR and the MCR; and
- for UK non-life insurer subsidiaries – while the ECR remains only a reporting requirement at the solo level – the MCR.

5.17 If and when the proposed non-life ECR becomes a hard requirement, there is a presumption that this will be included within the group hard requirement, increasing it by the corresponding amount. In deciding a reasonable transitional period for the ECR to become a hard requirement at solo level we shall also, however, consider the appropriate transitional period over which the group test should be updated to include this amount. We will consult further on this (including, of course, a cost benefit analysis): see Annex 3.

5.18 In calculating group capital adequacy, we must also specify which requirements feed up from non-UK subsidiaries. Since capital required by home state regulators is unlikely to be available to support other group companies, we believe that the local capital resources requirement (which we expect to be broadly equivalent to the MCR) should, in principle, be included. However, pending the outcome of current work in the EEA on a consistent approach to this, we will continue to allow firms a choice. Requirements which we propose to include for non-UK subsidiaries in our group calculations are, therefore:

- for insurance subsidiaries in the EEA or authorised in a designated state or territory – groups may choose whether to include the home state requirements or the minimum required by the Solvency 1 directives[10]; and

10 Directive 2002/13/EC

- for subsidiaries that are not regulated in the EEA or a designated state or territory – the minimum which would be required by Solvency 1 directives if they applied to that undertaking.

5.19 In summary, although we want eventually to be in a position where insurance groups are required to hold adequate capital in the EEA group (as banking / investment and financial conglomerates are required to do), we propose a staged approach. Initially, hard group requirements should be based on a rather minimalist set of solo requirements, which will increase over time.

5.20 This will allow us time to assess the impact of the proposed ECRs for non-life insurers before introducing requirements which may involve groups in raising new capital, restructuring, or changing their business mix. Continuing to allow a choice in the treatment of non-UK group firms will also give groups more leeway until there is greater international agreement on insurance capital adequacy standards and further progress towards updated EU directives covering these ('Solvency 2' and the Reinsurance Directive).

> Q5.1: Do you have any comments on our proposal to phase in hard EEA group parent capital adequacy requirements from 2005?

Individual Capital Assessments

5.21 CP190 and CP195 also made proposals for relevant UK regulated firms within a group to meet Individual Capital Adequacy Standards (ICAS) above the minimum. They also explained that when we give individual capital guidance (ICG) for members of a group at a solo level, we may also give ICG for the group capital resources requirement (group ICG).

5.22 Where a firm's ICG has been incorporated into its own requirement by use of our own-initiative variation of permission powers, we would expect to make a corresponding variation of the firm's permission to incorporate ICG into its group capital resources requirement.

5.23 We do not expect capital assessments to be made for every non-regulated firm within a group or for all assessments to be conducted to the same degree of sophistication. However, we do expect group companies subject to the ICAS framework to assess the impact on their financial position of risks materialising in all group companies, whether the other group companies are subject to the ICAS rules or not.

5.24 Many groups carry out their risk assessment and capital planning at a group level or along business lines rather than legal entity lines. Since we see considerable benefits in regulatory capital assessments being integrated with risk management processes, we would not discourage such an approach. So,

groups may perform capital assessments at the group level, provided they result in an assessment of capital for each relevant regulated firm.

5.25 In considering group ICG, we expect to start from the calculations explained in the previous section for aggregating MCR and ECR requirements. The question then arises of whether we expect also to aggregate individual firms' ICG within the group ICG. It has been suggested that the risk profile of groups is generally lower than the sum of the risk profiles of the firms within them. We see two sides to this question:

- on the one hand, diversification may reduce risks across a group, and we should take into account specific evidence of this in giving group ICG; but
- on the other hand, firms may be exposed to additional risks through membership of the group. These include problems from operational weaknesses in group systems, a reduction in control over the individual firm's strategy, reputational damage to the firm arising from failures elsewhere in the group, and intra-group counterparty concentration risks.

5.26 So, we shall make a case by case judgement in giving group ICG as to whether there is evidence of diversification benefits, and if so, how far there are additional group risks which may offset such benefits.

Q5.2: Do you have comments on how we should reflect individual firms' ICG in group ICG?

Presentation of capital adequacy requirements and application of eligibility limits to capital

5.27 We have already proposed new developments relating to capital at all levels (solo and group), and these need to be taken into account in updated parent insurer and group capital adequacy calculations.

- In CP97 (chapters PRCA1 and PRCA2) we proposed a new presentation of insurance solvency/capital adequacy calculations to show capital resources on the one hand, and capital requirements on the other (rather than a single net assets figure), and this presentation was subsequently adopted in CP190 and CP195.
- In CP190 and CP195, we proposed that insurance firms (like banks and investment firms) may count Tier 2 as capital subject to limits on the amount eligible, without having to apply for and receive a waiver.
- In CP190, we proposed that insurance firms (like banks and investment firms) may count innovative Tier 1 instruments as capital, subject to limits on the amount eligible.

5.28 We have taken account of these developments in proposing changes in group capital adequacy calculations to comply with the FGD and the amendments it makes to IGD and the solo insurance directives.

Presentation and calculation methods

5.29 The IGD was implemented relatively recently. Our experience so far has been that presenting requirements within the asset valuation rules (IPRU(INS) 4) for how an insurer should adjust for its investments in related insurance firms in calculating its own capital adequacy has obscured the analogy of this calculation with the group capital adequacy rules.

5.30 Our proposed new rules in PRU8.3 therefore bring together in a single chapter both the group capital adequacy requirements and the rules for calculating the capital adequacy of an insurer which has interests in other insurance/financial firms. The rules for valuing holdings in non-insurance, non-financial undertakings, remain in the valuation chapter (PRAG5 in CP97), since they are not included in the IGD group (either before or after FGD amendments).

> Q5.3: Is the new location of group capital adequacy calculations for both insurance and holding company parents in a single chapter clearer?

5.31 As explained in Chapter 4, FGD allows more than one method for calculating group capital adequacy for financial conglomerates, and this mirrors the earlier IGD approach. Each directive allows a method based on consolidated accounts and a method based on aggregating individual firm accounts (though, unfortunately, the directives number these differently).

5.32 At present, we propose to continue to require the deduction and aggregation method (method 1 in Annex 1.3 of IGD) as the principal method for measuring capital adequacy of an insurance or EEA holding company parent, where we are the IGD coordinator: see PRU8.3.25R and PRU.8.3.28R.

5.33 World-wide capital adequacy calculations reported to us for parents outside the EEA may, if we have been notified, be based on the consolidated accounts method (method 3 in Annex 1.3 of IGD): see PRU8.3.19R-20R. We require notification because we believe that adjustments may be needed to make the calculation based on consolidated accounts comparable in effect to a deduction and aggregation approach in capturing capital **requirements** across the group. Even so, there are advantages to measuring capital **resources** across a group using consolidated accounts, as discussed in the next section.

5.34 We would welcome continuing dialogue with the industry to resolve technical questions outstanding concerning the consolidation approach in relation to insurance groups and insurance conglomerates. In the meantime, we propose to continue our current deduction and aggregation approach for UK insurance

undertakings, and for the EEA parent holding company test where we are the IGD coordinator.

Capital and eligibility limits

5.35 We believe it is the intention of group capital adequacy requirements that limits on eligible amounts of different forms of capital should apply to financial groups as a whole (IGD Annex 1.3). In other words, once ownership of capital by other group companies has been netted out, there should be enough capital of sufficient quality to support the risks assumed by the group's financial firms in total.

5.36 While this principle is clear, it is not straightforward to achieve when measuring group capital on an aggregation approach. As explained in Chapter 6 of this paper, we propose to move away from the aggregation approach for investment firm groups partly for this reason. However, to avoid an additional burden of change for insurance groups which have only recently implemented IGD, we have developed an approach to implementing capital eligibility limits within the deduction and aggregation approach. This is set out in PRU 8.3 32G – 35R, and explained below.

5.37 The application of capital eligibility limits can have potentially large effects on measured group capital adequacy, and it is particularly important to achieve consistent application in this respect. So, we propose a new reporting form which clarifies how the limits on eligible capital work through in the group capital adequacy calculations, while also covering current reporting requirements: see Annex 6 of this paper (proposed annex to IPRU(INS) 9).

5.38 Consistent with our intention to minimise reporting burdens, we propose that groups may continue to report as they currently do, including identifying the parent's share in any deficit in insurance firms in the group. However, they must be able to demonstrate that their calculations are consistent with the method set out in the new reporting form.

5.39 The group's capital resources are calculated by aggregating the group's proportional share of the capital resources of each member of the group and deducting the book value of investments in group undertakings by other group members. To allow the eligibility limits to be applied consistently at group level, the aggregation and deduction process must be performed separately for the different types of capital for each group member: see PRU8.3.36R-37R and PRU8.3.50R-51R.

5.40 Our current rules impose an additional restriction on the amount of surplus Tier 2 capital which may feed into the parent's capital adequacy calculation if the parent is itself an insurance firm (since the adjusted calculation is our single implementation of solo insurance directives and the IGD). This is less

restrictive than our current approach in the banking sector, where we require a solo bank capital adequacy test which deducts banking subsidiaries altogether.

5.41 We propose a partial easing of the current restriction for an insurance parent. This would allow surplus Tier 2 capital in an insurance subsidiary to count towards the parent's capital resources so far as this would release Tier 1 capital which could be transferred to the parent insurer in the form of a dividend, while allowing the subsidiary insurer still to meet the limits on eligible capital: see PRU8.3.52R – 60R.

> Q5.4: Do you have any comments on the application of capital eligibility limits in the group capital adequacy test, and for a parent insurer?

Assets in excess of exposure limits

5.42 The solo insurance directives require that assets supporting the technical provisions are limited in order to avoid concentrations of market, credit and counterparty risk. "Assets in excess of exposure limits" are effectively deducted from the capital resources of the firm.

5.43 If an insurer has an interest in a related insurer we must specify how the asset exposure limits apply in relation to the insurer's capital investment in its related insurer and also any other exposure (such as a loan) to the related insurer. We propose to keep our current approach to this.

5.44 As explained above, FGD amends the solo directives and IGD to require them to take account also of related financial institutions. We propose to specify how the asset exposure limits apply to exposures and interests of an insurance firm in such related financial firms by direct analogy with our current rules.

5.45 So, the proposed common approach for a parent insurer is that:

- asset exposure limits should not be applied to its capital investment in the related insurer or financial institution, as this is excluded through the capital adequacy calculation: see PRU8.3.40G; and
- asset exposure limits should be applied to any other exposures to its related insurer or financial institution in the same way as under our current rules: see PRU8.3.39R – 45R.

5.46 When considering the parent holding company, FGD does not amend the IGD requirements in relation to asset concentrations (Article 7.4). So, we propose to continue our current policy, which does not apply asset concentration limits at holding company level.

Q5.5: Do you have any comments on our proposal to retain our current approach to assets in excess of exposure limits for related insurance interests, and to extend this to related financial institutions?

Changes for related cross-sector investments

5.47 FGD has amended IGD and the solo directives for life and non-life insurers so that firms may no longer include the market value of investments in related banks, investment firms and financial institutions in calculating their own capital adequacy position. The amendment starts from financial years beginning in 2005. We expect the required change to have a significant impact on some of the groups affected: see Annex 3.

5.48 The amended directives allow two choices:

- value such companies at zero in the firm's capital adequacy calculation (i.e. deduct them from capital); or
- include them in a group capital adequacy calculation or make analogous adjustments to the firm's own capital adequacy calculation.

5.49 We propose to implement this requirement by including all related regulated financial undertakings and financial holding companies in group capital adequacy calculations in the same way as related insurance undertakings are currently included. The effect is that any surplus or deficit of the cross-sectoral related firm relative to its own regulatory requirement counts towards the group's measured capital adequacy.

5.50 The proposed capital requirements to be included for the cross-sectoral firms are:

- for related firms in the UK, the requirements set out in our relevant interim prudential rulebooks, including any amounts required above the minimum;
- for related firms in another EEA member state or a country designated as having equivalent regulation, firms may choose either the local regulatory requirement or the EU minimum regulatory requirement; and
- for related firms in a non-designated country, the EU minimum regulatory requirements.

5.51 FGD amendments also apply to significant investments in unregulated financial institutions. For simplicity, we will require the higher of the book value of the investment in such undertakings and their proxy capital resources requirement (i.e. the EU minimum if they were a relevant regulated firm) to be deducted from aggregate capital resources (i.e FGD method 3): see PRU8.3.61R(1).

5.52 Also, consistent with other financial sectors, we propose to introduce a new definition of 'ancillary insurance services undertaking' to ensure that service companies are not used for regulatory arbitrage. This will also help ensure that holdings in these are treated in the same way as for unregulated financial institutions (as described in the previous paragraph): see PRU8.3.61R(2).

Q5.6: Do you have any comments on the proposed treatment of related financial undertakings?

5.53 As explained in chapter 4 of this paper, the combination of methods described above complies with method 4 of FGD. We propose that it will apply also to insurance conglomerates except in cases where the firm's Part IV permission requires it to comply with one of the other FGD methods (1, 2, or 3): see PRU8.4.49R – 51R.

6 UK Banking and Investment firm groups

Introduction

6.1 This chapter covers the changes that will affect banking and investment firm groups (and sub-groups) with an EEA parent. The proposed rules and guidance are in Annex 5 and Annex 6. As explained in Chapter 3, the requirements in this chapter apply in addition to those in other chapters.

6.2 In particular, banking and investment firms may be part of a sub-group subject to requirements in this chapter, while also being part of a wider third country financial group subject to the requirements in Chapter 7. Conversely, they may be part of an overall group subject to the requirements in this chapter, and also part of a sub-group subject to the requirements in Chapter 4.

6.3 We propose a minimal approach to FGD implementation for banks and investment firms. This does include, however, a new harmonised chapter bringing together the rules for consolidated supervision of all types of investment firm group. We explain here:

- our proposals to implement FGD amendments for banking and investment firm groups;
- how these relate to our post-CP173 rules for investment management groups; and
- our proposals to harmonise consolidation rules for all investment firm groups.

Minimal change for banking / investment firm groups

6.4 FGD does not make significant changes to the consolidated supervision regime for banking and investment firm groups. The main change is to introduce mandatory requirements for the treatment by banks and investment

firms of their investments in insurance companies, reinsurance companies, and insurance holding companies.

6.5 FGD makes this change through an amendment to BCD Article 34(2) so that it will require (from financial years beginning in 2005) that significant investments in the capital instruments of insurance firms are deducted from capital. Or, as an alternative, that the insurance firms concerned are included in the consolidated group using one of the capital adequacy methods in FGD Annex I. The latter treatment is effectively applying the group capital adequacy calculation as if the banking or investment firm group were a financial conglomerate.

6.6 In implementing the amended BCD article 34(2) and its alternative 'consolidation' approach, we have aimed:

- to have a single treatment in capital adequacy calculations of banking or investment firms' insurance interests, to avoid distorting competition between similar groups which have slightly different proportions of cross-sectoral business, and to simplify the calculations; and
- to make the minimum changes necessary to the existing banking and investment firm rules ahead of the forthcoming major changes arising from the EU review of capital standards.

6.7 To achieve these aims while complying with the amended BCD, we propose to introduce a new term, *material insurance holdings*. This would be used in calculating both individual firm and group capital adequacy for banks and securities and futures firms which have insurance interests. The proposed new rules to achieve the changes explained in this section are set out in Annex 6 of this paper[11].

6.8 However, for individual personal investment firms and investment management firms, to avoid complicated changes for those which are not members of a group, we propose simply to make the minor changes necessary to our existing illiquid asset and other deductions in the solo calculations. But, at the group level, we propose the same approach as for securities and futures firm groups, i.e., applying the new *material insurance holdings* calculation.

6.9 Turning to the consolidation alternative, FGD Annex I offers three methods. Method 3 does not allow surplus capital in insurance interests to contribute to group capital, but methods 1 and 2 do allow this, subject to a series of technical principles set out there. The principles are set out in Annex 4 of this paper, in PRU8 Annex 1 Part 5. However, the interpretation of these technical principles in relation to surplus capital is dependent on proposed changes in the EU review

11 The changes are to Chapter CA of IPRU(BANK), Chapter 1 of IPRU(BSOC) Volume 1, Chapters 2 and 7 of ELMI, Chapter 10 of IPRU(INV) and new Chapter 14 of IPRU(INV).

of capital standards currently being negotiated. It may also be affected by changes in International Accounting Standards to be introduced in 2005.

6.10 In view of this uncertainty, we propose in the meantime that banking and investment firm groups should continue to use a deduction approach for their insurance interests. This is very close to our current rules and broadly consistent with method 3 of FGD Annex I. It requires banks and investment firms to deduct from their capital the higher of the book value of their investments in insurance firms and the capital requirements of those firms.

> Q6.1: Have you any comments on our proposed treatment of significant insurance interests in the calculation of individual banks' and investment firms' capital adequacy, and in calculating their groups' capital adequacy?

6.11 FGD article 29(9) also amends BCD to set requirements for credit institutions and investment firms to report significant transactions with group mixed activity holding companies other than those already reportable as large exposures (BCD Article 48). Our proposed implementation of this is additional requirement is set out in Annex 5, SUP 16.7.8R – 66R

Consultation Paper 173

6.12 In CP173, we consulted on changes to the consolidated supervision rules for investment management firms. We plan to publish around the same time as this paper the feedback statement to CP173, with final amended rules for Chapter 5 of IPRU(INV). These amendments will have immediate effect.

6.13 In clarifying the consolidation rules applying to investment management firms, we set out a new method for calculating group capital adequacy based on consolidated accounts. We propose to adopt this more widely for investment firms from financial years beginning in 2005, as explained in the following section.

Harmonised rules for investment firm groups

6.14 We propose to bring together all the consolidated supervision requirements for investment firms in a single new chapter 14 of IPRU(INV) from financial years beginning in 2005. This will incorporate the changes made in Chapter 5 of IPRU(INV) for investment management groups following CP173, and

include the necessary amendments for all types of investment firm subject to FGD. The new chapter is included in Annex 6 of this paper[12].

6.15 We are proposing to bring together the consolidation requirements for all investment firms in this way because inconsistencies in the presentation of our current requirements in different chapters (for historical reasons) make it difficult to understand the rules overall.

6.16 We also propose to take this opportunity to simplify and clarify the rules. For example, we have clarified that consolidated supervision applies only to broad scope Chapter 3 firms (mainly commodities brokers) and not to all Chapter 3 firms.[13] (See IPRU(INV) 14.1.1R).

> Q6.2: Have you any comments on the clarity and scope of application of the harmonised requirements for investment firm groups in Chapter 14?

6.17 We have also harmonised our approach to implementing the 'CAD waiver' for all investment firms which are not principal position-takers (see IPRU(INV) 14.1.4R – 6G). We propose that investment firms which do not take principal positions may notify us that they wish to forgo consolidated supervision requirements, subject to the following conditions:

- they can demonstrate that they are ring-fenced from the rest of their group (mainly that they have limited exposures to it);
- they meet the additional requirements set out in the CAD; and
- they continue to report the result of a consolidated capital adequacy calculation for their group.

6.18 We propose that principal position takers (mainly securities and futures firms) may no longer notify us that they wish to forgo consolidated supervision requirements. The consolidated requirements are designed to protect firms from risks arising elsewhere in the groups to which they belong. As with banks and insurance undertakings, we believe it is justified to require this standard to be met in view of the nature of the risks run by firms which take positions as principals. This change could have a significant impact on some groups: see Annex 3 of this paper.

> Q6.3: Have you comments on how we propose to harmonise our approach to implementing the CAD waiver?

12 The current requirements are in IPRU(INV) Chapter 3 (non-ISD securities and futures firms), Chapter 5 (investment management firms), Chapter 7 (UCITS firms), Chapter 10 (ISD securities and futures firms) and Chapter 13 (personal investment firms). Chapters 5,7, 10 and 13 apply to CAD firms, and these are the firms which are affected by the FGD amendments.

13 SFA published these rules in SFA Board Notice 532 (December 1999).

6.19 The harmonised chapter also clarifies the definition of financial resources at group level in cases where there are several investment firms in the group (see IPRU(INV) 14.4.3R). This is necessary to allow proper implementation of FGD for investment-led financial conglomerates, and it will increase clarity for all investment firm groups.

6.20 Finally, we propose a change in the underlying method of consolidation for calculating group capital adequacy to be more consistent with that in the banking sector, as from financial years beginning in 2005. This is reflected in a new reporting form (see SUP16 Ann 18R) on which investment management firms will already begin reporting following CP173.

6.21 Instead of the current approach in which group capital (i.e. the financial resources of the group) is calculated by aggregating the capital resources of individual firms, we propose to require an accounting consolidation method. This requires firms to calculate their group's capital (i.e. its financial resources) using consolidated group accounts. The capital **requirements**, however, must continue to be calculated by aggregating the solo capital requirements set for each firm in the group.

6.22 The advantages of measuring group capital from consolidated accounts are that:

- it is a more transparent implementation of the CAD (which requires the use of consolidated own funds);
- it makes it easier to monitor compliance with group capital eligibility limits, and to ensure that goodwill is appropriately excluded; and
- it allows consistent implementation of BCD/CAD and FGD capital adequacy calculations where there is more than one type of banking/investment firm in the group.

Q6.4: Have you any comments on the proposed capital adequacy method based on consolidated rather than aggregated capital?

7 Third country (non-EEA) groups

Introduction

7.1 This chapter explains the scope and proposed implementation of FGD requirements for third country banking and investment and conglomerate groups (i.e. those with their ultimate parent outside the EEA). Insurance groups must already report their capital adequacy on a world-wide basis (as set out in Chapter 5 of this paper), and this chapter does not apply to non-conglomerate third country insurance groups.

7.2 Our proposals for third country groups set out in PRU8.5 remain brief, as they depend on EU-level processes to produce guidance on third country supervision arrangements. European work is underway to develop this. We explain in this chapter how we believe the EU process may work in practice. We also set out the methods we may use in the light of any EU general guidance produced and consultation with other competent authorities for each group for which we are the EU coordinator.

Purpose and scope of third country provisions

7.3 As explained in Chapters 2 and 3 of this paper, FGD closes a gap in coverage of current (BCD/CAD) group supervision requirements for banking and investment groups operating in the EU. It does this by requiring in principle that group supervision be carried out for the whole of such financial groups, world-wide. It also requires in principle that this harmonised (i.e. IGD/BCD/CAD) worldwide scope is applied in new requirements for third country financial conglomerates.

7.4 FGD requires this geographical extension only, however, if it has been determined through an agreed process (described below) that worldwide group supervision is not already being carried out to an equivalent standard for the group concerned by its home state (third country) supervisory

authority. The directive makes clear that this means group-wide supervision which achieves objectives and outcomes similar (rather than identical) to those of BCD and FGD, respectively.

7.5 We believe that equivalent group-wide supervision by a home country supervisory authority is the best way to protect EU consumers and market confidence, by identifying and mitigating risks in the context of the financial group as a whole. So, we are encouraged by the active development of updated group supervision standards by several third country supervisory authorities.

7.6 However, where such equivalent group-wide supervision is not undertaken the directive allows for either:

- extension of EU requirements, by analogy, to the world-wide group; or
- other approaches designed to achieve the appropriate level of regulation of the part of the group operating within the EU.

Determining equivalence

7.7 The directive establishes a two-step process to determine whether each third country group is subject to equivalent group-wide supervision, as explained below.

General guidance

7.8 The first step, at the political level, is that a European committee may give general guidance on the supervisory arrangements of third country supervisory authorities. For financial conglomerates, this is a new cross-sectoral committee of Member States, the Financial Conglomerates Committee (FCC), and for banking/investment groups, it is the Banking Advisory Committee (BAC).

7.9 FGD (Article 21.5) states that the FCC may give general guidance as to whether the supplementary supervision arrangements of competent authorities are likely to achieve the objectives defined in FGD. It also states that the committee must review and take into account any changes in supervision by particular third country competent authorities. Article 56a of the BCD, inserted by Article 29(11) of FGD, sets out parallel duties for the BAC in relation to that directive.

7.10 Since the objectives of supplementary supervision defined by the respective directives are very similar, we expect guidance from the committees also to be very similar. The FCC and BAC have each requested the expert group which advised the Commission on the Directive - the Mixed Technical Group (MTG) – to provide factual information for their consideration in preparing guidance. We are, naturally, active in these European discussions.

Supervisory judgement

7.11 The second step, at the supervisory level, is that an EU coordinator appointed for each financial group must decide whether the group is subject to equivalent group supervision, having first:

- consulted the relevant committee for the purpose of taking into account any applicable guidance;
- consulted the other relevant (EU) competent authorities for the group; and
- reached agreement with the third country supervisory authority for the group to co-operate concerning supervision of the group (Recital 14).

7.12 The coordinator making the final equivalence judgement for each group is identified by applying the rules and process in FGD article 10 (explained in chapter 3 of this paper). It is clear, however, that the FSA is likely to be the coordinator for many major third country groups operating in the EU.

7.13 As explained above, we expect guidance from the FCC and BAC concerning group-wide supervision arrangements of third country competent authorities to be very similar. So, when we and other EU supervisors take account of such guidance in judging whether third country supervision is equivalent for any particular group, we expect the question of whether the group is a financial conglomerate or a banking or investment group (and, hence, which Committee's guidance is relevant) to be less important than how these arrangements apply in practice to the group concerned.

7.14 Overall, we believe this process strikes a proportionate balance between:

- establishing a consistent EU-wide framework for decision-taking (through common guidance on the general arrangements); and
- the need to take into account the wide variety of group structures and specific supervisory practice (through supervisory judgement and consultation concerning their effect on each particular group).

> Q7.1: Have you any comments on the process for determining whether there is equivalent third country group-wide supervision?

Requirements for equivalent third country groups

7.15 If equivalent third country supervision is in place for a banking/investment or financial conglomerate group, there are no new requirements for the wider group outside the EEA. However, as explained in Chapter 3, the finding of equivalence does not automatically dis-apply existing requirements for any European sub-group within the wider group. European sub-groups continue

to be subject to the requirements set out in Chapters 4-6 of this paper unless they are explicitly waived; and insurance groups continue to be required to report their world-wide parent capital adequacy calculation, as set out in Chapter 5 of this paper.

Requirements for non-equivalent third country groups

7.16 Where equivalence is not found, FGD and BCD require one of two approaches, which are discussed in turn below:

- world-wide group supervision by the EU coordinator, applying the requirements for an EU group or sub-group by analogy to the wider group; or
- the EU coordinator may apply other methods to the group which achieve the objectives of the relevant directive.

EU supervision of world-wide group

7.17 We do not believe it will generally be feasible for the EU coordinator to achieve the oversight of major third country banking and investment groups and conglomerates necessary to assess whether they have adequate capital and adequate systems and controls and management at the top of the financial group. This is because of the complexity of such groups and the extent to which firms within them are exposed to each other. It is not likely, therefore, that we will apply worldwide group supervision to banking and investment or financial conglomerate groups.

7.18 However, there may be particular group structures – for example, where the group is essentially an EEA group but with a single non-EEA parent – where it would be possible to achieve such world-wide group supervision. We have set out requirements for this unusual situation in PRU8.5.13G-14G and PRU 8 Annex 2.

Other methods

7.19 FGD does not specify what other methods might be used to achieve the objectives of the Directive. FGD does, however, set out one possibility, which is to require that the group has a holding company in the EU to cover all its European financial firms. This means, in effect, creating a European sub-group and subjecting it to group supervision (including capital requirements).

7.20 Yet, as explained in Chapter 2, this would not address any weaknesses in the wider financial group outside the EU. To achieve the objectives of the Directive in the absence of equivalent third country supervision, it is also necessary to address the possibility of direct contagion of problems in the wider group to the EU sub-group (if it exists) or to individual EU regulated firms.

7.21 One method which is currently used to reduce the likelihood of direct contagion is to 'ring-fence' UK firms from non-EU group companies, i.e. to restrict exposures of firms within the ring-fence to other group companies outside the ring-fence. We may also require regulated firms within the ring-fence to hold additional capital.

7.22 If we were to apply such methods to implement the new requirements, it would be necessary first to consult with other relevant EU competent authorities for each group on whether such an approach should be applied to the EU sub-group as a whole or to all the EU regulated firms within it. Whatever methods are chosen after this further discussion, the EU coordinator must notify the other authorities involved for the group concerned and the European Commission.

7.23 We do not believe that these methods are a good substitute for world-wide group supervision by the home country supervisor, as they are likely to impose substantial costs on any group which has to restructure to comply with them. Ring-fencing of a European sub-group would be likely to prove particularly burdensome for groups which operate on an integrated basis globally.

> Q7.2: Have you any comments on methods which EU coordinators should propose in discussions with other relevant supervisory authorities for each group?

Timetable and future work

7.24 FGD requires that the arrangements for implementation are in place by August 2004, to enable groups to comply from financial years beginning in 2005. Given the importance of the equivalence decision for third country groups, discussions between some third country authorities and the EU MTG began during negotiation of the Directive, and the process for developing guidance is now underway.

7.25 However, the directive does not require that the EU committees give guidance on every third country supervisory authority. Where there is no applicable guidance, the EU coordinator for each group needs only to consult the other EU supervisors involved for the group concerned. In order to determine as quickly as possible for each third country group which EU supervisory authorities are the coordinator and relevant competent authorities, the MTG has developed a questionnaire for exchanging the necessary information during the remainder of 2003.

7.26 Where we are the EU coordinator, we obviously want to have and take into account any general guidance which the EU committees may give as soon as possible. However, some major third country supervisory authorities have announced that they are in the process of updating their group-wide supervision arrangements significantly. In such cases we would wish to have the guidance delayed until the effects of such changes can be factored in.