German Banking Industry Committee

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Comments

German Banking Industry Committee

Joint consultation paper on draft regulatory technical standards on the uniform conditions of application of the calculation methods on the art. 6.2 of the financial conglomerates directives

Sir or Madam,

We would like to thank you for the opportunity to comment on the aforementioned Consultation Paper. Please find our comments below.

Introduction

First of all, we would like to express our general support for the fundamental review of the Financial Conglomerates Directive envisaged by the EU Commission under due consideration of the regulatory reform projects CRD IV / CRR and Solvency II that will respectively come into full effect in 2013 / 2014 as well as the consequent adjustment needs in terms of the requirements for financial conglomerates.
With a view to a level playing field within the European Union, we feel it would be helpful to develop and implement uniform aggregation rules for the solvency of financial conglomerates. For the sake of completeness we should, however, like to point out at this juncture that we hold the view that the present Consultation Paper goes well beyond the aforementioned mandate (specification of the financial conglomerates calculation rules on the basis of the current Financial Conglomerates Directive). To the extent that there is, for instance a modification of the definitions for non-sector-specific and sector-specific own funds such modification is not covered by the aforementioned mandate. Instead, it must rather be seen as a pre-emption of the forthcoming amendment of the Financial Conglomerates Directive.
Both financial sector reform projects, i.e. CRD IV / CRR and Solvency II are highly complex. To date, the banking and insurance sector have not been able to analyse the implications and the sheer scale as well as the

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details of these reform projects. Hence, the present comments are of a purely preliminary nature and cannot be seen as exhaustive. This applies especially in view of the fact that the finalisation of questions which are of paramount importance in the two sectoral sets of rules is still pending. Based on the foregoing, we should like to underline the paramount need for a renewed consultation of this document once the final sector-specific rules have been established. This is the only way for arriving at a meaningful and feasible set of methods for calculating solvency within financial conglomerates. In addition to this, the present Consultation Paper currently serves as the basis for an impact assessment. Although the deadline for feedback will be after the end of the consultation period, it should still be possible to take the respective findings from the impact assessment into account during the consultation process.

Specific comments

The GBIC appreciates the fact that the provisions of the RTS draft (RTS-D) are essentially based on the industry specific rules and their definitions. The incorporation of sector-specific transitional and grandfathering rules is therefore consistent and ought to be welcomed. This incurs major complexity during the calculations for banks' capital planning process. [Hence], the GBIC feels that clear and unambiguous definitions are of paramount importance as regards the cross-sectoral rules. The same applies to the rules which are aimed at creating a level playing field for bank-led and insurance-led financial conglomerates.

1. When covering the calculation rules for Method 1, Article 14(8) addresses the insurance industry valuations pursuant to the Solvency II rules. At this juncture, we feel the need for an unambiguous clarification that comprehensive use of the Solvency II valuation approaches for assets and liabilities is equally permissible for the calculations under Method 1. Up to now, the "accounting consolidation method" only allowed using data from the consolidated financial statement. Due to the fact that this constitutes a fundamental departure from the existing approach, this should also be documented in an explicit and transparent manner.

2. This equally applies to the consolidation rules. Article 7 allows exclusively insurance-led financial conglomerates the predication on the consolidation scope pursuant to the Solvency II rules. However, in order to ensure feasibility also at this juncture it is indispensable that also for bank-led financial conglomerates the use of consolidation scope under the Solvency II rules for the Method 1 calculations will be generally admissible. Of course, at this point the fact that adjustments need to be made in order to avoid double gearing of the existing capital and in order to take account of internal transactions is self-evident. If the suggested methodology remains, bankled-financial conglomerates opposite to insurance-led financial conglomerates have to arrange an extensive transitional calculation from the on balance sheet own funds of the consolidated financial statement to the Basic Own Funds on Solvency II basis. There is no methodolgy for such complex calculations yet.

3. In our view there needs to be a clarification under Article 6(2) that when defining the applicable calculation method, the current approach shall remain unchanged to the effect that a hearing of the superior financial conglomerate company is envisaged (cf. Section 2(1) Financial Conglomerates Solvency Ordinance). The current wording either suggests that the competent supervisory authority shall first consult with the other supervisory bodies and then single-handedly define the applicable method or that bank-led financial conglomerates will even have to constantly use all three methods for the calculations and then will invariably have to select the most conservative approach for reporting purposes. Both alternatives are utterly inacceptable. Besides, it is absolutely unclear why this rule should solely apply to bank-led financial conglomerates. There should

be a clarification to the effect that (regardless of whether the financial conglomerate concerned is bank-led or insurance-led) the competent supervisor shall receive a plausible justification for the choice of the envisaged calculation method. This choice will then be subject to approval by the competent supervisor. Already on the grounds of the required continuity of methods and due to the consequent lack of comparability (cf. Article 6(1), any constant parallel calculation and use of the respectively most prudent approach is utterly unacceptable.

4. Treating the technical principles, Article 4 sets out that cross-sectoral own funds at the level of the conglomerate shall only eligible if they meet the requirements in terms of transferability and availability. This provision ensures that only those own funds will be deemed eligible at the level of the conglomerate which are also *de facto* available in due course in order to offset a potential capital shortfall. At this point, however, there is a considerable discrepancy in the requirements concerning the banking sector, on the one hand, and the insurance sector, on the other hand: Whilst a 9 month window of time shall apply to a transfer into the insurance industry, the banking sector shall only be granted 3 calendar days for such a transfer. The rationale for this differentiation is not immediately obvious. Especially if the decisive criterion at the level of the conglomerate consists in the non-sector-specific transferability, the rationale for the large time discrepancy between the sector-specific requirements remains opaque. This raises the question how the diverging deadlines and, most notably, the extremely short deadline for the transferability into the banking industry are supposed to be met. To our knowledge, the 9 month deadline for the transfer of own funds into the insurance sector stems from the Level 2 discussions on Solvency II. If and when the objective is transferability of own funds within the own (banking) sector, it would be more suitable to revert to the banking sector's provisions on restructuring and the concepts and models applicable to a potential crisis situation of an individual financial institution in the banking industry. Said concepts and models do not stipulate a maximum deadline for the transferability of own funds. Hence, the priority of the sector-specific provisions should be taken into account also at the level of the financial conglomerate and there should be no stipulation of an idiosyncratic requirement.
   From the legal point of view it is worth noting that the timing requirements for transferability should be brought into line with the statutory requirements under company law. If and when "own funds" are meant in the narrow sense as defined under prudential supervision law, generally speaking, this term will also subsume company capital or comparable equity. Whilst a (majority) holding company may indeed have sufficient influence to also transfer said capital from one location to a different destination, such changes cannot take effect unless the bodies which will take these decisions have been convened. Generally, it will also be necessary for the respective registry entries to take effect under the registry rules. Based on the foregoing and objectively speaking, compliance with the envisaged deadline of 3 calendar days is virtually impossible. A justification of this requirement may also consist in the fact that during "stress periods" (and the swift transferability requirement seems to be geared towards these periods) it does not appear necessary to mobilise "genuine capital". At this point mobilising other flows of funds (funds in a broader sense) should be sufficient. Whilst shorter deadlines would be acceptable for these other flows of funds, a mere deadline of 3 calendar days would still be insufficient. In this context, however, it still remains unclear why the deadline for the transferability is still more stringent (in terms of the time afforded) than the sector-specific requirements. After all, the loss absorption capacity is of major importance also in the sectors and this does not presuppose – like for instance in the banking group – that funds can be transferred within 3 calendar days. Hence, one possible interpretation is that this constitutes a departure from Article 46 CRR.

Generally speaking, it is unclear how this requirement is supposed to be implemented in practice. These reservations are owed to the fact that there merely is a specification of the sector into which the own funds are supposed to be transferred. For the purposes of [determining]eligibility as cross-sectoral own funds, however, there needs to be an assessment of the nature of existing own funds in both industries. At this point the transfer destination of these funds in the event of a crisis (whether they will be transferred inside the sector or across different sectors) still remains open. At present, however, the eligibility cannot depend on the internal plans for crisis scenarios - unless the underlying assumption was a general non-sector-specific transferability. Provided this requirement seeks to ensure swift non-sector-specific transfers of own funds, the rationale behind these diverging deadlines is hence not immediately obvious.
We therefore definitely advocate in favour of a consistent, realistic window of time for transferability. This could be, for instance, 9 months for both industries. We also propose considering the sector-specific requirements for measures to be adopted during crisis situations. This will help prevent unilateral discriminations against bancassurance groups compared to pure banking-led or insurance-led groups. It also avoids mispremised incentives for the capital allocation inside of conglomerates.

5. Article 5 RTS-D sets out that deficits of own funds at the level of the financial conglomerate may, as a general rule, only be remedied by cross-sectoral own funds. This is consistent with the existing rule and, on principle, it is a meaningful proposal. Yet, the CRD IV / CRR as well as Solvency II have resulted in more stringent rules on sector-specific own funds. In the absence of a simultaneous sufficient harmonisation of the individual capital categories' eligibility criteria, the aggregate impact of these more stringent rules adds up and results in the fact that meeting all of these sector-specific requirements becomes sheer impossible. For instance hybrid capital issued by insurance firms which form part of a financial conglomerate will have to additionally meet each and any banking industry requirement including the infinite maturity, the trigger events which are based on the banking industry's minimum capital ratios for a write-down of the capital amount or the conversion into Common Equity Tier 1 etc.
   We therefore would like to advocate exempting *ex ante* Additional Tier 1 or restricted Basic Own Funds and Tier 2 Capital for the specific criteria of the respectively other industry. For instance, this would affect trigger events in Additional Tier 1 Capital for the conversion into Common Equity Tier 1 or the write-down of the amount of capital as well as approval reservation rights of the German supervisor BaFin for early repayment of Additional Tier 1 and Tier 2 Capital in the banking sector. Otherwise, financial conglomerates would be faced with a problem: If there was a deficit at the level of conglomerate they would only be able to raise capital of the highest capital category (Common Equity Tier 1 in accordance with the CRR or Unrestricted Basic Own Funds in accordance with Solvency II). More likely than not, the implementation of CRD IV / CRR and Solvency II will lead to clearly more volatilities in the trend of own funds and the solvency requirements resulting in possible future deficits at the level of conglomerates. Whilst, at such a point in time, a certain number of companies will be able to draw upon issues in the field of hybrid capital and Tier 2, particularly unlisted public limited companies in their capacity as parent companies of a financial conglomerate will be faced with a considerable problem: They will be forced to create Common Equity Tier 1 or Unrestricted Basic Own Funds at short notice, for instance by issuing new shares. In practice, this will hardly be feasible in the short term.

6. We suggest amending the definition of the sector-specific own funds under Article 10 of the RTS-D: Own funds should comprise those own funds which can be included at a sectoral level (under

due consideration of all sector-specific qualifications) and which do not fall within the category of cross-sector own funds. In its current wording, Article 10 lends itself to the interpretation that only capital instruments shall be deemed as sector-specific own funds that fall neither within the category of cross-sector own funds nor within the category of sector-specific own funds. Hence, the word "not" should be deleted in Article 10(1) sentence 2 RTS-D.

7. Article 10 sets out a ceiling for sector-specific own funds. Unless said ceiling is immediately necessary for compliance with the solvency requirements, we feel this provision is utterly inacceptable. More likely than not, there will be a higher volatility of own funds. Together with the corresponding higher solvency requirements at the respective sector levels, this means that adequate buffers need to be maintained at group level. Typically, at least part of these buffers will consist in sector-specific own funds. *De facto,* these own funds will be available in order to absorb losses in the own sector. If there is a deficit in another sector, they will also be needed in order to meet the own sector's solvency requirements and in order to be able to transfer own funds to other sectors. Hence, the rationale is not immediately obvious why these own funds cannot be *ex ante* eligible for recognition at the level of the conglomerate. Whilst taking account the sector-specific own funds which are not eligible for recognition at the level of the conglomerate, implementation of this requirement would at best lead to a kind of "shadow pro rata system".

8. The draft RTS remain largely silent on one aspect which is of paramount importance for bank-led financial conglomerates, i.e. the deduction of insurance interests. In this regard, a clarification is required not only in the final CRR but also in the technical standard accompanying the CRR: Insurance interests in bank-led financial conglomerates do not have to be deducted by the entity regarded as ultimately leading if and when this interest is already taken into account accordingly at the level of the conglomerate. The present RTS-D remains silent on harmonisation issues which are of paramount importance for bank-led conglomerates.
   Concerning own funds, the draft RTS points out that own funds will have to be calculated after adjustment for the creation of capital, expenditure and income. On principle, the solvency requirements shall be adopted from the sectoral requirements. There is a fundamentally different treatment of risks. This particularly relates to the treatment of exposures resulting from participations which leads to double counting. This approach results in a clear discrimination against bank-led conglomerates compared to insurance led conglomerates with a consistent treatment pursuant to Solvency II.

   At this juncture, the treatment of capital deductions resulting from participations in the financial industry according to CRD IV / CRR is of major importance. For unconsolidated direct and indirect participations in the financial industry, mandatory [capital] deductions are required under the CRD IV / CRR. However, under the provisions of Solvency II, it is also possible to opt for capital backing. Due to the fact that prudential supervision of conglomerates merely constitutes an additional supervision, the sectoral requirements for capital deductions shall respectively be applied on the upstream group level. In effect, this means that, in a first step, all indirect participations in the financial industry will have to be deducted from the banking group's group own funds and, if applicable, will have to be simultaneously backed by capital under the provisions of Solvency II. The RTS-D neither envisage an adjustment nor an appropriate waiver in the sectoral requirements.

   Presently, there are waivers for these capital deductions e.g. at the level of banking groups if and when participations are deducted at the level of the conglomerate. However, these waivers only

apply to the companies which can be explicitly ascribed to the other sector (on the one hand [financial] institutions and on the other hand (re)insurance companies). However, this waiver shall not apply to financial undertakings. At this juncture, under the current proposals of the CRD IV / CRR and Solvency II, double counting at the respective group levels will be inevitable and will incur a corresponding need for adjustment at the level of the conglomerate. As far as complex and deeply integrated banking groups are concerned, this ties up considerable additional resources for capital control purposes. Hence, it is worth considering counting financial institutions / financial undertakings only once as a capital deduction item in one of the two sectors. Once they have been captured for capital deduction purposes, this should then give rise to a waiver at the group level of the respectively other sector (provided an appropriate inclusion in the aggregation takes place at the level of the financial conglomerate).

A similar situation results for overlapping consolidation scopes. For instance, in a bank-led financial conglomerate, sub-subsidiaries (financial institutions) which are at the same time subsidiaries of the insurance undertaking shall and must be consolidated in the banking group. Pursuant to the Solvency II requirements, these undertakings will have to be equally captured with own funds and solvency requirements in the insurance group pursuant to the requirements of the banking industry. Also these cases of double gearing have to be adjusted again at the level of the conglomerate. In order to reduce these wrong steering effects, the Financial Conglomerates Directive should stipulate waivers to the effect that recognition in one of the two sectoral groups on the basis of the respective industry rules will give rise to a waiver for recognition in the respectively other group (provided an appropriate aggregation takes place at the level of the conglomerate).

In our view, the latter two topics cannot be deemed as risk drivers for the financial conglomerate as a whole. This means that it should be possible to accomodate the bank's interest in efficient capital control.

Responses to the list of specific questions:

1. What are the cost implications of a requirement for conglomerates to follow the clarifications for calculating own funds and solvency requirements described in this paper? If possible, please provide estimates of incremental compliance cost that may arise from the requirements, relative to following the Directive in the absence of the Regulatory Technical Standards.

   - In the short term, a quantification of said costs is not possible. Qualitatively, however, it is possible to point out that if the current draft is not amended and the proposals for recognition of the buffers during the calculation will be implemented, the capital adequacy requirement will no longer amount to the customary 8% measured on the basis of the existing RWAs. Which then will constitute an important cost factor during the calculation of the own funds requirements for the financial conglomerate. At this juncture, in our view, there is a fundamental departure from the current approach adopted under the Financial Conglomerates Directive. Therefore, there ought to be a stringent predication on the existing calculation method (8% of the RWAs).

2. How, in your opinion would the proposed clarifications impact on conglomerates' business models?

   - In the short term, an assessment of the impact is not possible. Perhaps the forthcoming qualitative impact assessment (which is being conducted simultaneously with the present Consultative Document) will provide further insights. Although the consultation period antedates the feedback deadline for the qualitative feedback assessment, we feel it would be judicious to make further findings available for consultation purposes. At any rate, however, as mentioned under item 4, we perceive a danger that there will be wrong incentives (c.f. above).

3. How far would the suggested clarifications change current market practices?

   - In the short term, an impact assessment is not possible.

4. Are the Technical Principles in Title II sufficiently clear? If not, what areas require further clarification?

   - Cf. particularly items 1 and 2 in our specific comments above.

5. Are there any areas of ambiguity in the way that the Technical Principles in Title II apply to the three consolidation methods? Are there any areas of ambiguity in the way that Method 1 needs to be carried out?

   - Cf. particularly item 1 and 2 above in our specific comments.

7. How much of an operational burden is the use of consolidated accounts of the conglomerate as a starting point for Method 1? Is there an alternative more straightforward method/way to eliminate the intra-group creation of own funds?

   - We see no alternative if and when "consolidated accounts" means using the consolidated solvency overview for the insurance group and the consolidated view according to the German Banking Act for the banking group.

8. Do you foresee any problems in applying sectoral rules to own funds under Method 1? If so, what refinements to the method would you propose?

   - To be discussed / analysed. Currently there is still an absence of harmonised capital terms or reconciliation rules between own funds categories defined at a sectoral level. This can only be assessed in a reliable manner on the basis of the final versions of the CRR / CRD IV or Solvency II (including Level 2 provisions).

9. Are they any areas of ambiguity in the way that Method 2 needs to be carried out?

   - N/A since we expect to use Method 1.

10. For the purpose of assessing the transferability of "funds" to entities subject to CRR, under Article 4, is "three calendar days" a sufficient timeframe in a period of stress?

    - Cf. our comments under item 4 of our specific comments.

We would appreciate it if our comments were taken into account during the further consultation process.

Yours sincerely,
on behalf of the German Banking Industry Committee
National Association of German Cooperative Banks

Gerhard Hofmann

pp.

Dr. Olaf Achtelik