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„Supervision of Financial Holding Companies in Europe:
The Proposed EU Directive on Supplementary Supervision of Financial Conglomerates"

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I. Introduction

On April 24, 2001 the European Commission presented a proposal for a Directive[1] introducing supplementary supervision of financial conglomerates (the *Proposed Directive*). The Proposed Directive requires a closer coordination among supervisory authorities of different sectors of the financial industry and leads to changes in the number of existing Directives relating to the supervision of credit institutions, insurance undertakings and investment firms.[2]

The principal objective of the Proposed Directive is to face the accelerating pace of consolidation in the financial industry and the intensification of links between financial markets. Over the past years, a number of cross-sector groups combining insurance companies, banks and investment firms have been created and have become of significant importance in the European Union (EU). Such groups straddle traditional sectoral boundaries.[3] Combined financial operations may create new prudential risks or exacerbate existing ones.[4] Laws and regulations in the different financial sectors have traditionally adopted different approaches with different definitions of capital, different types of risks and different

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[1] European Commission Proposal for a Directive of the European Parliament and of the Council 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 the Council (Brussels, April 24, 2001), COM(2001) 213 final, O.J. Eur. Comm. No. C 213 E/07 (2001).

[2] The Proposed Directive requires changes in the following Directives:

(1) First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance, O.J. Eur. Comm. No. L 228/3 (1973) [*herein* First Non-Life Insurance Directive].

(2) First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance, O.J. Eur. Comm. No. L 63/1 (1979) [*herein* First Life Assurance Directive].

(3) Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC (third non-life insurance Directive), O.J. Eur. Comm. No. L 228/1 (1992) [*herein* Third Non-Life Insurance Directive].

(4) Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directive 79/267/EEC and 90/619/EEC (third life assurance Directive), O.J. Eur. Comm. No. L 360/1 (1992) [*herein* Third Life Assurance Directive].

(5) Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions, O.J. Eur. Comm. No. L 141/1 (1993) [*herein* Capital Adequacy Directive].

(6) Council Directive 93/22/EEC of 10 May 1993 on the investment services in the securities field, O.J. Eur. Comm. No. L 141/27 (1993) [*herein* Investment Services Directive].

(7) Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group, O.J. Eur. Comm. No. L 330/1 (1998) [*herein* Insurance Groups Directive].

(8) Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, O.J. Eur. Comm. No. L 126/1 (2000) [*herein* Banking Directive].

[3] European Commission, Explanatory Memorandum to the Proposal for a Directive of the European Parliament and of the Council 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 the Council (Brussels, Apr. 24, 2001), COM(2001) 213 final, O.J. Eur. Comm. No. C 213 E/07 (2001) [*herein* Explanatory Memorandum], at 2, *sub* 1.

[4] *Id.*

capital requirements.[5] For instance, insurance supervisors have historically been primarily concerned with the liability side of the balance sheet as the main source of risk, although assets are of course monitored too.[6] Regulations in the banking sector regard the asset side of the balance sheet as the principal source of risk, although an examination of the source of funding is an important aspect of the supervisory process.[7] Securities supervisors require securities firms to have sufficient liquid assets to repay promptly all liabilities at any time.[8] If a financial conglomerate that spans a number of financial markets the scope for potential supervisory problems increases due to the web of financial interrelationships characteristic for financial conglomerates. On the other hand, such conglomerates may gain financial solidity by spreading that risk.[9] The Proposed Directive intends to ensure the stability of the European financial market, to establish common prudential standards for the supervision of such financial groups throughout Europe, and to introduce level playing fields and legal certainty between financial institutions.[10]

The basic philosophy of the Proposed Directive is that the solo supervisions of individually regulated entities should continue to be the foundation for effective supervision, but that there is a need for the various supervisors to establish a coordinated approach to supervision in order that prudential assessment can also be made from a group-wide perspective.[11]

It should be remembered that EU Directives generally are not directly applicable in the Member States, but that they must be transformed into national law. They are addressed to the Member States and bind them in terms of the objectives to be achieved. However, in many cases the Member States are granted discretion with respect to the method by which the objectives will be accomplished in their respective national legislation.

Furthermore, the Proposed Directive constitutes only a proposal by the Commission and still has to pass the Council and the European Parliament where the text is discussed at present. It is anticipated that the Proposed Directive will be finally adopted in December 2002.[12] A number of

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5 Tripartite Group of Bank, Securities and Insurance Regulators, *The Supervision of Financial Conglomerates* (Basle: Bank for International Settlements, July 1995) [*herein* Tripartite Report], at 39, *sub* no. 104; Joint Forum on Financial Conglomerates, *Supervision of Financial Conglomerates* (Feb. 1999) [*herein* Joint Forum Report], at 6, Capital Adequacy Principles Paper, *sub* no. 6.

The Tripartite Group was formed at the initiative of the Basle Committee on Banking Supervision (Basle Committee) in early 1993 to address a range of issues relating to the supervision of financial conglomerates.

The Joint Forum was established in early 1996 under the aegis of the Basle Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to take forward the work of the Tripartite Group.

6 Tripartite Report, *supra* note 5, at 16, *sub* no. 41.

7 *Id*.

8 *Id*.

9 *Id*.

10 Explanatory Memorandum, *supra* note 3, at 2, *sub* 1.

11 Tripartite Report, *supra* note 5, at 16, *sub* no. 42.

12 European Commission, Progress on the Action Plan for Financial Services – Annex, available at http://europa.eu.int/comm/internal_market/en/finances/actionplan/annex.pdf (last visited Mar. 22, 2001), at 10.

interested parties have already commented on the text and proposed amendments.[13] Thus, it is very likely that the present text will be changed in some points.

II. Current Consolidated Supervision of Credit Institutions

According to the Banking Directive,[14] consolidated supervision of credit institutions[15] generally applies to all credit institutions (i) having another credit institution or a financial institution[16] as

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[13] *See, e.g.*, Opinion of the European Central Bank of 13 September 2001 at the request of the Council of the European Union on a proposal for a Directive of the European Parliament and of the Council 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 the Council (COM(2001) 213 final), CON/2001/25, O.J. Eur. Comm. No. C 271/10 (2001); Opinion of the Economic and Social Committee on the 'Proposal for a Directive of the European Parliament and of the Council 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 the Council' (Brussels Oct. 17, 2001), CES 1309/2001 – 2001/0095 COD, O.J. Eur. Comm. No. C 36/1 (2002); Committee on Economic and Monetary Affairs of the European Parliament, Report on the proposal for a European Parliament and Council directive 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 the Council (Feb. 27, 2002), A5-0060/2002, available at http://www2.europarl.eu.int/omk/OM-Europarl?PROG=REPORT&L=EN&PUBREF=-//EP//NONSGML+REPORT+A5-2002-0060+0+DOC+PDF+V0//EN&LEVEL=2&NAV=S (last visited Mar. 22, 2001); Finnish Delegation, Note No. 14019/01 to the Working Party on Financial Services – (Conglomerates) on the Proposal for a Directive of the European Parliament and of the Council 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 the Council (Brussels, Nov. 15, 2001), available at http://register.consilium.eu.int/pdf/en/01/st14/14019en1.pdf (last visited Mar. 22, 2001); Presidency of the Council of the European Union, Report No. 14140/1/01 to the Permanent Representatives Committee/Council on the Proposal for a Directive of the European Parliament and of the Council 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 the Council (Brussels, Nov. 30, 2001), available at http://register.consilium.eu.int/pdf/en/01/st14/14140en1.pdf (last visited Mar. 22, 2001); Position Paper of the Banking Federation of the European Union on the Proposed Directive on the Supplementary Supervision of Financial Conglomerates (Brussels, Oct. 3, 2001), available at http://www.fbe.be/pdf/PositionpaperFiCo.pdf (last visited Mar. 22, 2001).

[14] Art. 52(1) & (2), Banking Directive, *supra* note 2 no. (8). In the Banking Directive several Directives, including Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis, O.J. Eur. Comm. No. L 110/52 (1992), were combined in a single text for reasons of clarity. Regarding the question of consolidated supervision of credit institutions, the Banking Directive did not make any substantive changes. The Banking Directive was amended by Directive 2000/28/EC of the European Parliament and of the Council of 18 September 2000 amending Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, O.J. Eur. Comm. No. L 275/37 (2000), in order to take into account the development of electronic money institutions by including such institutions in the definition of a *credit institution* set out in Art. 1(1), Banking Directive. *Electronic money institutions* are defined in Art. 1(3)(a), Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, O.J. Eur. Comm. No. L 275/39 (2000), as credit institutions issuing means of payment in the form of electronic money.

[15] Pursuant to Art. 1(1), first subparagraph, Banking Directive, *supra* note 2 no. (8), *credit institution* means:

(a) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or

(b) an electronic money institution within its meaning of Directive 2000/46/EC, *see supra* note 14.

For the purpose of supervision on a consolidated basis, *credit institution* means a credit institution according to Art 1(1), first subparagraph, Banking Directive, and any private or public undertaking which corresponds to the definition in Art. 1(1), first subparagraph, Banking Directive, and which has been authorized in a third country.

A credit institution *may*, in addition to deposit taking and lending, engage in any of the activities of Annex I to the Banking Directive. These activities are set forth *infra* note 16.

a subsidiary[17] or holding a participation[18] in such institutions, or (ii) whose parent undertaking is a financial holding company.[19] This means that consolidated supervision is only exercised regarding groups of which the parent companies are either credit institutions or financial institutions.[20]

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[16] Pursuant to Art. 1(5), Banking Directive, *supra* note 2 no. (8), *financial institution* means an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in points 2 to 12 of Annex I, Banking Directive:

2. Lending,
3. Financial leasing,
4. Money transmission services,
5. Issuing and administering means of payment (*e.g.*, credit cards, travellers' cheques and bankers' drafts),
6. Guarantees and commitments,
7. Trading for own account or for account of customers in
   (a) money market instruments (cheques, bills, certificates of deposit, etc.),
   (b) foreign exchange,
   (c) financial futures and options,
   (d) exchange and interest-rate instruments,
   (e) transferable securities,
8. Participation in securities issues and the provision of services related to such issues,
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings,
10. Money broking,
11. Portfolio management and advice,
12. Safekeeping and administration of securities.

Point 1 is "acceptance of deposits and other repayable funds". An institution that engages in that activity (and also makes loans) is a *credit institution*. Point 13 is "credit reference services" and point 14 is "safe custody services".

It is curious that under the wording of Art. 1(5), Banking Directive, *supra* note 2 No. (8), ("… the principal activity of which is to acquire holdings or …"), an undertaking that holds only or principally participations in undertakings that are not engaged in financial activities (*i.e.*, industrial holding company) qualifies as financial institution. *See, e.g.*, for the German approach, § 1(3) *Gesetz über das Kreditwesen* of July 10, 1961, 1961 BGBl. I 881, in the version of Sept. 9, 1998, 1998 BGBl. I 2776, as amended [*herein* KWG], defining financial enterprise (*Finanzunternehmen*) as including such industrial holding companies. *See* Karl-Heinz Boos, Reinfried Fischer & Hermann Schulte-Mattler, KREDITWESENGESETZ, at 171, § 1 annotation 160 (2000). The definition of an industrial holding company as financial institution remains without consequence for purposes of consolidated supervision unless a credit institution is part of the holding group.

[17] According to Art. 1(13), second subparagraph, Banking Directive, *supra* note 2 no. (8), for the purpose of supervision on a consolidated basis, the term *subsidiary* means a subsidiary undertaking as defined in Art. 1(1), Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts, O.J. Eur. Comm. No. L 193/1 (1983) [*herein* Consolidated Accounts Directive], and, in addition, any undertaking over which, in the opinion of the competent authorities, a parent undertaking effectively exercises a dominant influence.

Art. 1(1), Consolidated Accounts Directive defines the terms *parent undertaking* and *subsidiary undertaking* as follows: a parent undertaking is an undertaking

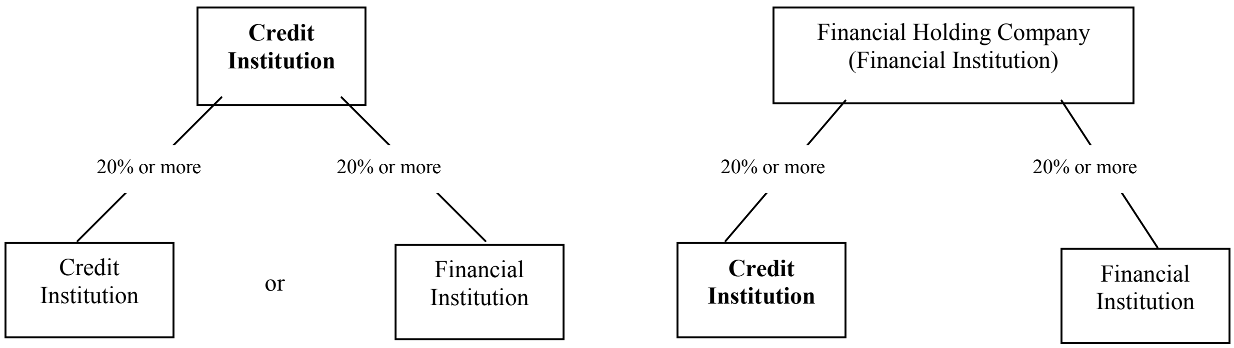
(a) having a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking), or

(b) having the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking, or

(c) having the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions, or

(d) being a shareholder in or member of an undertaking and a majority of the members of the administrative, management or supervisory bodies of that undertaking (a subsidiary undertaking) who have held office during the financial year, during the the preceding financial year and up to the time when the consolidated accounts are drawn up, have been appointed solely as a result of the exercise of its voting rights, or

The following diagram shows the credit institutions that are subject to consolidated supervision under the Banking Directive:



For an understanding of the scope of consolidated supervision under current EU law, it is important to remember that a *financial institution* is an institution that principally carries on one or more of the "banking" activities listed in points 2-12 in Annex I to the Banking Directive[21] but that is not a

(e) being a shareholder in or member of another undertaking (a subsidiary undertaking) and controls alone, pursuant to an agreement with other shareholders in or members of that undertaking a majority of the shareholders' or members' voting rights in that undertaking.

Art. 1(2), Consolidated Accounts Directive states that an undertaking may be considered as a *parent undertaking* if (a) it actually exercises a dominant influence over the subsidiary undertaking, or (b) it and the subsidiary undertaking are managed on a unified basis by the parent undertaking. In any case, the parent undertaking must hold a *participating interest* in the subsidiary undertaking as defined in Art. 17, Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, O.J. Eur. Comm. No. L 222/11 (1978) [*herein* Annual Accounts Directive]. Art. 17, first sentence, Annual Accounts Directive defines the term *participation* as rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company's activities. Art. 17, second sentence, Annual Accounts Directive additionally provides that the holding of a part of the capital of another company shall be presumed to constitute a participating interest where it exceeds a percentage fixed by the Member States that may not exceed 20%.

[18] According to Art. 1(9), Banking Directive, *supra* note 2 no. (8), *participation* for the purpose of supervision on a consolidated basis means the ownership, direct or indirect, of 20% or more of the voting rights or capital of an undertaking.

[19] Under the terms of Art. 1(21), Banking Directive, *supra* note 2 no. (8), *financial holding company* means a financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, one at least of such subsidiaries being a credit institution.

The term *exclusively or mainly* does not refer to the activities of the separate subsidiaries but to the whole group of subsidiaries. Thus, only if most of a financial institution's subsidiaries meet the definitions of credit institution or financial institution, such financial institution qualifies as financial holding company. The German KWG, *supra* note 16, follows the same concept, *see* Boos, Fischer & Schulte-Mattler, *supra* note 16, at 171, § 1 annotation 162.

[20] A financial institution having a large credit institution as a subsidiary in many cases would constitute a financial holding company. However, if a financial institution principally holds participations in the non-financial sector and has one or more credit institutions which in the aggregate play a minor role in the group, the financial institution does not meet the definition of financial holding company because its subsidiaries do not *exclusively or mainly* consist of credit institutions or financial institutions as required in Art. 1(21), Banking Directive, *supra* note 2 no. (8). Thus, the relative size of the credit institution that is a subsidiary of a financial institution as compared to the other subsidiaries of the financial institution determines whether the group is subject to consolidated supervision; the absolute size of the credit institution is not relevant.

[21] *Supra* note 2 no. (8).

depository institution.[22] It is also important to recall that Annex I includes not only deposit taking and lending and other more traditional banking activities, but also activities that in the United States would be considered as investment banking, such as underwriting, dealing and brokering.

Consolidated supervision essentially means that the authority supervising the credit institution being part of a group must apply the financial data of the whole group in monitoring compliance by the credit institution with its supervisory standards (such as capital adequacy, solvency ratio, lending limits, and restrictions on investments by credit institutions in the non-bank sector).[23]

As a general rule, the authorities must require full consolidation of all credit institutions and financial institutions that are subsidiaries of a parent undertaking. However, under certain circumstances, proportional consolidation may be required.[24]

In the case where the parent of a credit institution is another credit institution, supervision on a consolidated basis will be exercised by the Member State of the EU that authorized such parent undertaking.[25] However, where the parent undertaking of a credit institution is a financial holding company, consolidated supervision will be exercised by the Member State of the EU that authorized the credit institution.[26] This means that the credit institution is always the addressee of consolidated supervision. However, when a financial holding company holds credit institution subsidiaries in more than one Member State, supervision on a consolidated basis will be undertaken by the Member State where the financial holding company and one credit institution have been set up.[27] If the financial holding company has been set up in a Member State in which no credit institution subsidiary is located, the Member States concerned (including the Member State in which the financial holding company was set up) will have to reach an agreement as to which Member State shall exercise consolidated supervision.[28] In the absence of such agreement, the supervising Member State is selected on the basis of the largest credit institution balance sheet and, if that figure is the same in two or more Member States, on the basis of the first date of authorization of the credit institution subsidiaries.[29]

With regard to the sectors of insurance groups and investment groups the European legal framework provides similar consolidated supervision of such groups.[30]

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[22] *See supra* notes 15 and 16.

[23] Art. 54, Banking Directive, *supra* note 2 no. (8). For a discussion of the consolidated supervision of credit institutions in the EU, *see* Michael Gruson, *Prudential Regulation by the European Union*, Chapter 6, § 6.04, *in* 2 REGULATION OF FOREIGN BANKS, UNITED STATES AND INTERNATIONAL (Michael Gruson & Ralph Reisner eds., 3d ed. 2000), at 245-251.

[24] Art. 54(1), Banking Directive, *supra* note 2 no. (8).

[25] Art. 53(1), Banking Directive, *supra* note 2 no. (8).

[26] Art. 53(2), first subparagraph, Banking Directive, *supra* note 2 no. (8).

[27] Art. 53(2), second subparagraph, Banking Directive, *supra* note 2 no. (8).

[28] Art. 53(2), third subparagraph, Banking Directive, *supra* note 2 no. (8).

[29] *Id.*

[30] The Capital Adequacy Directive, *supra* note 2 no. (5), requires prudential regulation of investment firm groups, and the Insurance Groups Directive, *supra* note 2 no. (7), requires additional supervision of insurance groups.

III. Determination of Financial Conglomerates and the Addressees of Supplementary Supervision

A. General

The existing EU legal framework for the supervision of financial institutions is incomplete because it only covers the so-called sectoral supervision, *i.e.*, supervision over institutions within a particular sector of the financial industry.[31] Cross-sectoral supervision of financial groups, combining institutions from different financial sectors, exists only to a limited extent.[32] The Proposed Directive uses the term *financial sector* to refer to the banking, insurance, or investment services sector or a combination of all or some of such sectors.[33] A *regulated entity* is defined as a credit institution, an insurance undertaking or an investment firm.[34] This definition itself does not require that the regulated entity must be located in the EU and therefore also includes non-EU entities. However, only such regulated entities which have obtained an authorization pursuant to one of the sectoral Directives[35] are subject to supplementary supervision within the meaning of the Proposed Directive.[36] Such an

[31] The Banking Directive, *supra* note 2 no. (8), provides for consolidated supervision of banking groups; the Capital Adequacy Directive, *supra* note 2 no. (5), provides for prudential regulation of investment firm groups; and the Insurance Groups Directive, *supra* note 2 no. (7), provides for additional supervision of insurance groups.

[32] *E.g.,* Arts. 55(2) & 56(4), Banking Directive, *supra* note 2 no. (8), require cooperation and exchange of information between the different supervisory authorities if a credit institution, financial holding company or mixed-activity holding company has as a subsidiary an insurance company or another undertaking providing investment services.

[33] Art. 2(7), Proposed Directive. *Sectoral rules* means the EU legislation relating to the prudential supervision, in particular laid down in the First Non-Life Insurance Directive, *supra* note 2 no. (1), the First Life Assurance Directive, *supra* note 2 no. (2), the Insurance Groups Directive, *supra* note 2 no. (7), the Capital Adequacy Directive, *supra* note 2 no. (5), the Investment Services Directive, *supra* note 2 no. (6), and the Banking Directive, *supra* note 2 no. (8). Art. 2(6), Proposed Directive.

[34] Art. 2(4), Proposed Directive.

For the purpose of the Proposed Directive, the following definitions apply:

> According to Art. 2(1), Proposed Directive *credit institution* means a credit institution within the meaning of Art. 1(1), second subparagraph, Banking Directive, *supra* note 2 no. (8) (*see supra* note 15).
>
> According to Art. 2(2), Proposed Directive *insurance undertaking* means an undertaking within the meaning of Art. 6, First Non-Life Insurance Directive, *supra* note 2 no. (1), Art. 6, First Life Assurance Directive, *supra* note 2 no. (2), or Art. 1(b), Insurance Groups Directive, *supra* note 2 no. (7).
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> According to Art. 2(3), Proposed Directive, *investment firm* means an investment firm within the meaning of Art. 1(2), Investment Services Directive, *supra* note 2 no. (6): any legal person whose regular occupation or business it is to provide any investment service for third parties on a professional basis, *i.e.*, any of the following activities listed in the Annex to the Investment Services Directive: brokerage, dealing as principal, portfolio management, underwriting, offering underwriting related services, investment advice, making margin loans and safekeeping and administration, all in connection with certain types of securities, and giving advice on capital structure, industrial strategy and merger and acquisition advice and providing safe custody services and foreign exchange services where these foreign exchange services are connected with the provision of investment services. Art. 2(3), Proposed Directive also includes in the definition of *investment firm* so-called *recognized third-country investment firms* as referred to in Art. 2(4), Capital Adequacy Directive, *supra* note 2 no. (5). Pursuant to that definition, an undertaking constitutes a recognized third-country investment firm if it (i) would be covered by the definition of investment firm in Art. 2(2), Capital Adequacy Directive if it were established within the EU, (ii) is authorized in a third country, and (iii) complies with prudential rules considered by the competent authorities as at least as stringent as those laid down in the Capital Adequacy Directive.

[35] Art. 6, First Non-Life Insurance Directive, *supra* note 2 no. (1); Art. 6, First Life Assurance Directive, *supra* note 2 no. (2); Art. 3(1), Investment Services Directive, *supra* note 2 no. (6); Art. 4, Banking Directive, *supra* note 2 no. (8).

[36] Arts. 1 & 4(1), Proposed Directive.

authorization is only required for undertakings that are located in the EU.[37] Thus, supplementary supervision only applies to regulated entities that are established and authorized in the EU.[38]

It is important to note that the Proposed Directive does not replace the existing supervision of the different sectoral groups but introduces a *supplementary* supervision of the regulated entities. This supplementary supervision deals with the relations among the single regulated entities within the group. It does not lead to supervision of unregulated entities within a group on a stand-alone basis.[39]

B. Financial Conglomerates

The Proposed Directive applies directly to certain regulated entities (credit institutions, insurance undertakings and investment firms) that have obtained an authorization pursuant to one of the sectoral Directives.[40] If such entities are part of a *financial conglomerate*, they are subject to *supplementary* prudential supervision.[41] In order to determine whether a regulated entity is subject to supplementary supervision, two inquiries must be made: first, whether the regulated entity is part of a financial conglomerate, and, second, whether the regulated entity is one that is subject to supplementary supervision.

According to the Proposed Directive a *financial conglomerate* is defined as a *group*[42] of undertakings. A U.S. observer would say that a group is determined by concepts very similar to the U.S.

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[37] Art. 6, First Non-Life Insurance Directive, *supra* note 2 no. (1), and Art. 6, First Life Assurance Directive, *supra* note 2 no. (2), require an authorization of insurance undertakings having established their head office within the territory of a Member State. Art. 3(1) in connection with Art. 1(6), Investment Services Directive, *supra* note 2 no. (6), states that only investment firms having their registered office or head office in a Member State are subject to authorization. Although Art. 4, Banking Directive, *supra* note 2 no. (8), provides for the authorization of credit institutions prior to commencement of activities in an EU Member State without expressly referring to the origin of that credit institution, it is clear from the context of the Banking Directive and Arts. 23 to 25, Banking Directive (governing relations with third countries) that only credit institutions established under the laws of a Member State are subject to authorization pursuant to Art. 4, Banking Directive.

[38] If a financial conglomerate is headed by a non-EU entity, the EU-regulated entities are subject to supplementary supervision according to Arts. 4(3) & 14, Proposed Directive, *see infra* part IV.E.

[39] Art. 4(5), Proposed Directive.

[40] *See supra* note 35.

[41] Art. 1, Proposed Directive.

[42] According to Art. 2(11), Proposed Directive, a *group* means two or more natural or legal persons between whom there are *close links*. Pursuant to Art. 2(12), Proposed Directive, *close links* mean links within the meaning of Art. 1(l), Third Non-Life Insurance Directive, *supra* note 2 no. (3), Art. 1(m), Third Life Assurance Directive, *supra* note 2 no. (4), Art. 1(15), Investment Services Directive, *supra* note 2 no. (6), or Art. 1(26), Banking Directive, *supra* note 2 no. (8). Such a link is given in a situation in which two or more natural or legal persons are linked by (a) 'participation', which means the ownership direct or by way of control of 20% or more of the voting rights or capital of an undertaking, or (b) 'control', which means the relationship between a parent undertaking and a subsidiary undertaking, in all the cases referred to in Art. 1(1) and (2), Consolidated Accounts Directive, *see supra* note 17, or a similar relationship between any natural or legal person and an undertaking. *Close links* exist also in the following situations:

(a) a situation in which in the opinion of the competent authorities one or more persons effectively exercise a dominant influence over another person;

(b) a situation in which persons are linked by a participation within the meaning of Art. 17, first sentence, Annual Accounts Directive, *supra* note 17. There, *participation* is defined as rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company's activities; or

Bank Holding Company Act concept of control[43] whereby control for purposes of determining a group under the Proposed Directive commences with a 20% capital investment. To qualify as financial conglomerate, such group must meet the following conditions:[44]

(a) its activities mainly consist in providing financial services in the financial sector,

(b) it comprises at least one regulated entity that has obtained an authorization in accordance with one of the sectoral Directives, [45]

(c) it comprises at least one insurance or reinsurance undertaking,[46] and at least one other entity of a different financial sector and

(d) whose cross-sectoral activities in the financial sector referred to in (c) above are significant.

When a group is headed by a regulated entity, it qualifies as a financial conglomerate if it meets clauses (b) to (d), irrespective of the group's ratio set out in clause (a).[47] That means that clause (a) is only applicable to financial conglomerates that are not headed by a regulated entity. Clause (b) requires a regulated entity with an EU license, clause (c) does not require that the insurance undertaking or other entity of a different financial sector has an EU license.

(c) a situation in which persons are linked by a relationship within the meaning of Art. 12(1), Consolidated Accounts Directive. Such a relationship is given if undertakings are (a) managed on a unified basis pursuant to a contract concluded between those undertakings or provisions in the memorandum or articles of association of those undertakings or (b) if the administrative, management or supervisory bodies of those undertakings consist for the major part of the same persons in office during the financial year and until the consolidated accounts are drawn up (such undertakings are not counted if they are connected by a parent-subsidiary-relation as described in Art. 1(1) or (2), Consolidated Accounts Directive.

In order to include all relevant groups, no matter how they are structured, a broad definition is used based on the concept of "close links" as introduced in the past by the so-called post-BCCI Directive (European Parliament and Council Directive 95/26/EC of 29 June 1995 amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non-life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities (Ucits), with a view to reinforcing prudential supervision, O.J. Eur. Comm. No. L 168/7 (1995)). However, the concept of close links has been further elaborated in order to cover other groups of entities among which there are no capital links but that are managed on a unified basis and for which accounting legislation gives Member States the possibility to require consolidated annual accounts. Explanatory Memorandum, *supra* note 3, at 5, *sub* 2, Arts. 2 & 3. Clause (c) above captures so-called "horizontal groups" or "horizontal financial conglomerates" that have no common parent or capital ties.

[43] Section 2, Bank Holding Company Act of 1956, 12 U.S.C § 1841 (1994 & Supp. V, 2000).

[44] Art. 2(13), Proposed Directive.

[45] Art. 6, First Non-Life Insurance Directive, *supra* note 2 no. (1); Art. 6, First Life Assurance Directive, *supra* note 2 no. (2); Art. 3(1), Investment Services Directive, *supra* note 2 no. (6); Art. 4, Banking Directive, *supra* note 2 no. (8). Such authorization is only required for undertakings established under the laws of an EU Member State. S*ee supra* note 37.

[46] According to Art. 2(5), Proposed Directive a *reinsurance undertaking* means a reinsurance undertaking within the meaning of Art. 1(c), Insurance Groups Directive, *supra* note 2 no. (7): an undertaking, other than an insurance undertaking or a non-member-country insurance undertaking, the main business of which consists in accepting risks ceded by an insurance undertaking, a non-member-country insurance undertaking or other reinsurance undertakings.

[47] Art. 3(1), second subparagraph, Proposed Directive.

A financial conglomerate therefore must contain at least one insurance or reinsurance company and one regulated entity from another sector of the financial industry. The above definition of a financial conglomerate contains two measurement criteria:

- Clause (a) above requires that the activities of the group *mainly* consist of providing financial services. This means that the ratio of the consolidated and/or aggregated balance sheet total of the regulated and non-regulated financial sector entities in the group to the consolidated and/or aggregated balance sheet total of the group as a whole, calculated on the basis of the annual accounts, must exceed 50%.[48] This test intends to distinguish between financial and non-financial groups.[49]

- Clause (d) above requires that the cross-sectoral activities in the financial sector are *significant*. This means that (i) the average of the ratio of the balance sheet total of the smallest financial sector to the consolidated and/or aggregated balance sheet total of the financial sector entities in the group, calculated on the basis of the annual accounts, and (ii) the ratio of the solvency requirements of the smallest financial sector to the total solvency requirements of the financial sector entities in the group, must exceed 10%.[50] Generally speaking, the size of the smallest financial sector must amount to 10% of the total of the financial sector entities. This test intends to distinguish between financial groups with homogenous financial activities and financial groups with heterogeneous financial activities.[51] The Proposed Directive intends to cover the latter groups, the former being covered by the existing sectoral directives[52] on a group-wide basis.[53]

The competent authorities[54] of the EU Member States may by common agreement lower the ratios of clauses (a) and (d), in particular in the case of groups that are on the borderline of exclusion from the definition of financial conglomerate.[55] The competent authorities also may, in a particular case, replace the criterion based on balance sheet total with the criterion of income structure or off-balance sheet activities or both or add the criterion of income structure or off-balance activities or both to the

[48] Art. 3(1), first subparagraph, Proposed Directive.

[49] Explanatory Memorandum, *supra* note 3, at 5, *sub* 2, Arts. 2 & 3.

[50] Art. 3(2), first subparagraph, Proposed Directive. According to Art. 3(2), second subparagraph, Proposed Directive, the smallest financial sector in a financial conglomerate is the sector with the smallest average. For the purpose of calculating the average, the banking sector and the investment services sector are considered together. The solvency requirements are to be calculated in accordance with the provisions of the sectoral rules and the Proposed Directive. *Id*.

[51] Explanatory Memorandum, *supra* note 3, at 5, *sub* 2, Arts. 2 & 3.

[52] *See supra* note 2.

[53] Explanatory Memorandum, *supra* note 3, at 5, *sub* 2, Arts. 2 & 3.

[54] Art. 2(15), Proposed Directive defines *competent authorities* as the national authorities of the EU Member State which are empowered by law or regulation to supervise credit institutions, and/or insurance undertakings and/or investment firms. Thus, the Proposed Directive does not introduce a new authority but provides cooperation between the existing national supervising authorities, *see infra* part IV.D.

[55] Art. 3(3)(b), Proposed Directive.

criterion based on balance sheet total, if the competent authorities are of the opinion that these parameters are of particular relevance.[56]

The Proposed Directive introduces and defines the term *mixed financial holding company*[57] to cover financial conglomerates headed by a non-regulated entity holding company. The definition does not require that mixed financial holding companies must have their head office in the EU. However, if a financial conglomerate headed by a mixed financial holding company is to be covered directly by the Proposed Directive, the mixed financial holding company must be located in the EU.[58]

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[56] Art. 3(3)(c), Proposed Directive. According to Art. 3(3)(a), Proposed Directive, the competent authority may exclude a particular entity from the calculation of ratios under the same conditions under which a competent authority responsible for exercising supplemental supervision may exclude an entity from supplemental supervision pursuant to Art. 5(4), Proposed Directive. *See infra* part IV.A.

[57] Art. 2(14), Proposed Directive defines *mixed financial holding company* as a parent undertaking, other than a regulated entity, which, together with its subsidiaries, of which at least one is a regulated entity having its head office in the EU, and other entities, constitutes a financial conglomerate.

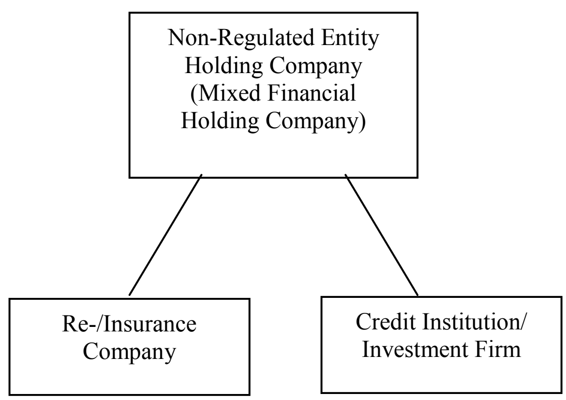
[58] *See* Art. 4(2)(b), Proposed Directive. Financial conglomerates that are headed by a non-EU company (a regulated entity or a mixed financial holding company) are covered by Arts. 4(3) & 14, Proposed Directive, *see infra* part IV.E.

Financial Conglomerates:

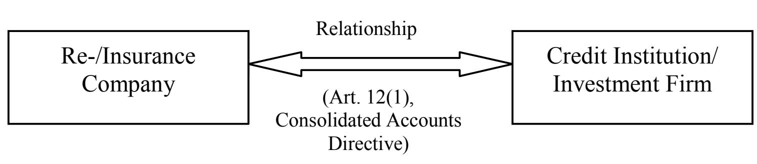
Group must be mainly engaged in financial activities.

1. Regulated Entity Holding Company

2. Non-Regulated Entity Holding Company



3. Horizontal Conglomerate



It is noteworthy that a financial conglomerate does not exist if a group is composed only of credit institutions and investment firms. However, the permitted activities of an investment firm are substantially overlapping with the permitted activities of a financial institution. Thus, in most – if not all – cases, an investment firm owning 20% or more of a credit institution or a credit institution owning more than 20% of an investment firm is covered by the current rules on consolidated supervision of credit institutions and financial institutions. For instance, the rules on consolidated supervision of the German banking law apply to financial institutions and investment firms.[59] Consolidated supervision always requires the existence of a deposit-taking institution in the group.

From the U.S. experience, it is surprising that conglomerates that are headed by a non-regulated entity holding company are subject to supplementary supervision only if the group is mainly engaged in financial services in the financial sector, *i.e.*, banking, insurance or investment services. However, the Proposed Directive goes further than current rules on consolidated supervision. The current rules require consolidated supervision for credit institutions that are subsidiaries of a credit institution or of a financial holding company, *i.e.*, a company the subsidiaries of which are exclusively or mainly credit institutions or financial institutions and that has at least one credit institution subsidiary.[60] Consolidated supervision does not extend to a "mixed-activity holding company", which is defined as a parent company other than a financial holding company or a credit institution, the subsidiaries of which include at least one credit institution.[61] Thus, the proverbial steel company that acquires a bank is not subject to consolidated supervision under current EU law because it is not a financial holding company.[62] However, the steel company that acquires a bank and an insurance company, both together being larger than the steel company, would be a mixed financial holding company of a financial conglomerate and be subject to supplementary supervision under the Proposed Directive. A holding company without its *own* business activities whose principal activity consists of acquiring holdings in industrial and financial companies is a financial institution[63] and if the subsidiaries of such financial institution *mainly* consist of credit institutions or financial institutions,[64] it is a financial holding company and subject to consolidated supervision.[65] If the subsidiaries do not *mainly* consist of credit or financial institutions, it is not a financial holding company subject to consolidated supervision. If the above holding company holds a credit institution and an insurance company *and* if its activities *mainly* consist of providing financial services, it is a mixed financial holding company and is also subject to supplementary supervision. If its activities do not consist mainly of providing financial services, *it is* neither subject to consolidated nor to supplementary supervision.

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[59] *See* the discussion of consolidated supervision in Germany in Michael Gruson, *Banking Regulation and Treatment of Foreign Banks in Germany*, Chapter 8, §§ 8.20-8.25 in 2 REGULATION OF FOREIGN BANKS, UNITED STATES AND INTERNATIONAL (Michael Gruson & Ralph Reisner eds., 3d ed. 2000), at 425-446. Investment firms in the meaning of the Investment Services Directive, *supra* note 2 no. (6), may be covered by consolidated supervision as part of a banking group (*Institutsgruppe)* (§ 10a(2), KWG, *supra* note 16, because they are financial service institutions (*Finanzdienstleistungsinstitute,* defined in § 1(1a), KWG) or they may be part of a financial holding group (*Finanzholding Gruppe*) (§ 10a(3), first sentence, KWG) because they are financial enterprises (*Finanzunternehmen*, defined in § 1(3), KWG).

[60] Art. 52(2), Banking Directive, *supra* note 2 no. (8). *See supra* note 19.

[61] Art. 1(22), Banking Directive, *supra* note 2 no. (8).

[62] *See supra* note 20.

[63] *See supra* note 16.

[64] *See supra* note 20.

[65] *Id*.

The non-regulated entity holding company that is the parent of a financial conglomerate must always be a *mixed financial holding company*, *i.e.*, it must have at least one EU-regulated entity subsidiary that has its head office in the EU.[66]

C. Undertakings in the Financial Conglomerates that are Subject to Supplementary Supervision

The Proposed Directive does not envision that the whole financial conglomerate or all companies in the financial conglomerate are subject to supplementary supervision. It requires that only the following undertakings that are part of a financial conglomerate are subject to supplementary supervision in addition to the supervision pursuant to the applicable sectoral rules:[67]

(a) every EU-regulated entity which is at the head of a financial conglomerate,

(b) every EU-regulated entity, the parent undertaking[68] of which is a mixed financial holding company having its head office in the EU, and

(c) every EU-regulated entity in a financial conglomerate linked to another entity by a relationship within the meaning of Art. 12(1), Consolidated Accounts Directive,[69] *i.e.*, every regulated entity in a horizontal financial conglomerate.[70]

As stated above,[71] each regulated entity subject to supplementary supervision must have its head office in the EU and the mixed financial holding company heading a financial conglomerate must have its head office in the EU and such financial conglomerate must have at least one subsidiary that is a regulated entity with its head office in the EU.[72] However, even in the case of a mixed financial holding

[66] Arts. 1(14) & 4(2)(b), Proposed Directive. If the parent were not a mixed financial holding company, its regulated entity subsidiaries would not be subject to supplementary supervision. *Id.*

Note that the Tripartite Report, *supra* note 5, at 36, *sub* no. 97, defines *mixed conglomerates* quite differently as those groups which are predominantly commercially or industrially oriented, but contain at least one regulated financial entity (which is more than merely a "captive" entity doing business only on behalf of the group) in some part of their corporate structure. Typically, mixed conglomerates would be headed by a commercial or industrial company (or by an unregulated non-financial holding company) with the regulated entities embedded downstream in the group structure. The Proposed Directive does not address the issue of such mixed conglomerates. *See* Tripartite Report at 36-38, *sub* nos. 97-103.

[67] Art. 4(1) & (2), Proposed Directive. It follows from Art. 4(2), Proposed Directive in connection with Art. 4(1) Proposed Directive ("regulated entities referred to in Article 1") and in connection with Art. 1, Proposed Directive ("… regulated entities which have obtained an authorization pursuant to …") that the regulated entities referred to in (a) to (c) are regulated entities which have their registered office or head office in the EU. *See supra* note 37.

[68] According to Art. 2(8), Proposed Directive, a *parent undertaking* means a parent undertaking within the meaning of Art. 1, Consolidated Accounts Directive, *see supra* note 17, and, in addition, any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking.

[69] *Supra* note 17.

[70] *See supra* note 42, *sub* (c). Such a relationship between two entities exists when the entities are managed on a unified basis pursuant to a contract or when the administrative, management or supervisory bodies of such entities consist for the major part of the same persons in office.

[71] *See supra* notes 37 & 67.

[72] Art. 2(14), Proposed Directive.

company having its head office in the EU, not the mixed financial holding company but the EU regulated entity subsidiaries are subject to supplementary supervision. If the parent undertaking of an EU-regulated entity is a regulated entity having its head office outside the EU or a mixed financial holding company having its head office outside the EU, Art. 14, Proposed Directive applies.[73]

Where a financial conglomerate is a subgroup of another financial conglomerate (the main financial conglomerate), Member States may apply the provisions of Arts. 5 to 13, Proposed Directive (supplementary supervision) only to the main financial conglomerate and not to the subgroup.[74] It appears that the non-financial activities of a mixed financial holding company could have the effect that the group headed by the mixed financial holding company does not meet the financial conglomerate tests. In that case, one has to determine whether the non-qualifying group comprises subgroups that qualify as financial conglomerates.[75]

The Proposed Directive gives the competent authorities discretion to enlarge the group of entities subject to supplementary supervision beyond the entities described in Art. 4(2) and (3), Proposed Directive:[76] where persons hold participations or capital ties in one or more regulated entities or exercise significant influence over such entities without holding a participation or capital ties, although the conditions of Art. 4(2) or (3) are not met, the competent authorities shall determine whether and to what extent these entities together with other entities constitute a financial conglomerate and supplementary supervision is to be carried out to the regulated entities.[77]

It is somewhat confusing that the existence of a financial conglomerate is determined by the existence of financial and other control relationships (*close links*) and that the determination of those regulated entities in a financial conglomerate that are subject to supplementary supervision is also determined by the existence of (other) financial and capital relationships. The Commission did not choose to use a uniform concept to determine the relation between entities that would subject such entities to supplementary supervision, such as the use of the simple but flexible concept of *control* of the U.S. Bank Holding Company Act of 1956.[78]

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[73] Art. 4(3), Proposed Directive. *See* Art. 14, Proposed Directive discussed *infra* part IV.E.

[74] Art. 4(2), second subparagraph, Proposed Directive.

[75] The prohibition of separate regulation of subgroups set forth in Art. 4(2), second subparagraph, Proposed Directive does not apply in that case because the subgroup is not a subgroup of another financial conglomerate.

[76] Art. 4(3), Proposed Directive is discussed *infra* part IV.E.

[77] Art. 4(4), Proposed Directive. The Explanatory Memorandum, *supra* note 3, at 6, *sub* 2, Art. 4, states:

> As some groups are not covered by the definitions under Art. 2, but do have financial entities with substantial activities in the financial markets the supervision of which would respond to the objectives of the Directive, the Directive introduces a basis for competent authorities to submit also these special group structures to supplementary supervision, on the condition that well defined conditions are met.

[78] *See* Section 2(a), Bank Holding Company Act of 1956, 12 U.S.C. § 1841(a) (1999); Michael Gruson, *Nonbanking and Financial Activities of Foreign Banks Operating in the United States*, Chapter 10, §§ 10.05, 10.06, *in* 1 REGULATION OF FOREIGN BANKS, UNITED STATES AND INTERNATIONAL (Michael Gruson and Ralph Reisner eds., 3d ed. 2000), at 688-736.

In order to avoid possible moral hazards, the Proposed Directive states that the inclusion of unregulated entities or third-country regulated entities in the group-wide supplementary supervision does not mean that these entities are subject to supervision on a stand-alone basis.[79]

IV. Supplementary Supervision

The Proposed Directive introduces a series of rules with regard to the supplementary supervision of regulated entities in a financial conglomerate. They relate in particular to capital adequacy,[80] intra-group transactions and risk concentration,[81] and to the management.[82] The Proposed Directive also requires Member States of the EU to ensure that for each financial conglomerate the competent authority of one Member State is designated to coordinate between the supervisors involved in the group-wide supervision. The competent authorities are also required to cooperate and exchange information.[83]

It must be emphasized that supplementary supervision does not mean supervision on a consolidated basis like the supervision provided by the sectoral rules. The Proposed Directive follows a so-called "solo-plus" approach to supervision. The basis of supervision is the supervision of individual group entities on a solo basis by their respective regulators. The solo supervision of individual entities is complemented by a general quantitative assessment of the group as a whole and, usually, by a quantitative group-wide assessment of the adequacy of capital.[84] The Proposed Directive does not require any additional consolidation of the accounts of the financial conglomerate as a whole if such consolidation is not imposed by existing EU Directives.

A. Capital Adequacy

One of the most important issues of the supervision of financial conglomerates is the supervision of the financial condition of the group. Therefore, the competent authorities are required to exercise a supplementary supervision on the capital adequacy of the regulated entities in a financial conglomerate in accordance with Annex I of the Proposed Directive.[85] The major goal of such supplementary group-wide capital adequacy requirements is to eliminate any inappropriate intra-group creation of own funds such as *double or multiple gearing*[86] or *excessive leverage*.[87] In such situations the

[79] Art. 4(5), Proposed Directive. *See* Explanatory Memorandum, *supra* note 3, at 6, *sub* 2, Art. 4, and Tripartite Report, *supra* note 5, at 36, *sub* no. 96 (the impression that the activities of unregulated entities in the financial conglomerate are in some way being monitored or supervised, even if only informally, creates a moral hazard).

[80] Art. 5, Proposed Directive.

[81] Art. 6, Proposed Directive.

[82] Arts. 18(1), 19(1), 23(1) and 25(2), Proposed Directive.

[83] Arts. 7 to 13, Proposed Directive.

[84] Tripartite Report, *supra* note 5, at 17, *sub* no. 43.

[85] Art. 5(1), Proposed Directive.

[86] According to the Joint Forum Report, *supra* note 5, at 8, Capital Adequacy Principles Paper, *sub* no. 18, *double gearing* occurs whenever one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet; *multiple gearing* occurs when the dependant in the previous instance itself downstreams regulatory capital to a third-tier entity, and the parent's externally generated capital is geared up a third time.

[87] Annex I, *sub* I, 2(i), Proposed Directive. *See* Explanatory Memorandum, *supra* note 3, at 4, *sub* 1(b). The Joint Forum Report, *supra* note 5, at 9, Capital Adequacy Principles Paper, *sub* no. 23, defines *excessive leverage* as situations where a parent

same own funds are used simultaneously as a buffer more than once, *i.e.*, to cover the capital requirements of the parent company as well as those of a subsidiary (and possibly also those of a subsidiary of a subsidiary).[88] Thus, the competent authorities must require regulated entities in a financial conglomerate to provide own funds at the level of the financial conglomerate that are always at least equal to the capital adequacy requirements as calculated in accordance with Annex I.[89] In addition, certain entities in the financial conglomerate that on a stand-alone basis may not be subject to capital adequacy requirements must be included for its purpose of calculating capital adequacy at the level of the financial conglomerate.[90]

The solvency requirements for each separate financial sector represented in a financial conglomerate continues to be covered by own funds elements in accordance with the corresponding sectoral rules.[91] Only own funds elements that are eligible according to each of the sectoral rules (*cross-*

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issues debt (or other instruments not acceptable as regulatory capital in the downstream entity) and downstreams the proceeds as equity or other forms of regulatory capital to its regular subsidiaries.

[88] Tripartite Report, *supra* note 5, at 17, *sub* no. 44.

[89] Art. 5(2), first subparagraph, Proposed Directive.

[90] Art. 5(3), Proposed Directive states that "[f]or the purpose of calculating the capital adequacy requirements…, the following entities shall be included in the scope of supervision":

(a) *financial holding companies* within the meaning of Art. 7(3), first indent, Capital Adequacy Directive, as amended by Art. 22, first indent, Proposed Directive, *i.e.*, financial institutions the subsidiary undertakings of which are either exclusively or mainly investment firms or other financial institutions at least one of which is an investment firm and which is not a mixed financial holding company within the meaning of the Proposed Directive;

(b) *mixed activity holding companies* within the meaning of Art. 7(3), second indent, Capital Adequacy Directive, as amended by Art. 22, second indent, Proposed Directive, *i.e.*, parent undertakings, other than financial holding companies or investment firms or mixed financial holding companies within the meaning of the Proposed Directive, the subsidiaries of which include at least one investment firm;

(c) *related undertakings of an insurance undertaking* within the meaning of Art. 3(2), first indent, in connection with Art. 1(h), Insurance Groups Directive, *supra* note 2 no. (7), *i.e.*, subsidiaries of insurance undertakings or other undertakings in which a participation is held by insurance undertakings;

(d) *participating undertakings in insurance undertakings* within the meaning of Art. 3(2), second indent, in connection with Art. 1(g), Insurance Groups Directive, *i.e.*, parent undertakings of insurance undertakings or other undertakings holding a participation in insurance undertakings;

(e) *related undertakings of a participating undertaking in an insurance undertaking* within the meaning of Arts. 3(2), third indent, 5, 6, 8, 9 & 10, Insurance Groups Directive, *i.e.*, "sister undertakings" of an insurance undertaking;

(f) *credit institutions* within the meaning of Art. 1(1), second subparagraph, Banking Directive, *supra* note 2 no. (8), *i.e.*, any private or public undertakings which correspond to the definition in Art. 1(1), first paragraph, Banking Directive, and which have been authorized in a third country (*see supra* note 15);

(g) *financial institutions* within the meaning of Art. 1(5), Banking Directive (s*ee supra* note 16); and

(h) *ancillary banking services undertakings* within the meaning of Art. 1(23), Banking Directive, *i.e.*, undertakings the principal activity of which consists in owning or managing property, managing data-processing services, or any other similar activity which is ancillary to the principal activity of one or more credit institutions.

The solvency requirements for non-regulated financial sector entities that are not included in the sectoral solvency requirement computation are computed on a notational basis. *Notional solvency requirement* means the capital requirement such an entity would have to comply with according to the relevant sectoral rules if it were a regulated entity of that particular financial sector; a mixed financial holding company shall be treated according to the sectoral rules of the most important financial sector in the financial conglomerate. Annex I, *sub* I, 2(ii), last paragraph, Proposed Directive.

[91] Annex I, *sub* I, 2(ii), Proposed Directive.

sector capital) shall qualify for the verification of the compliance with additional solvency requirements at the financial conglomerate level.[92]

Annex I sets forth three different methods for calculating the solvency position on the level of a financial conglomerate. Although the Proposed Directive is not clear in this respect, it is intended that the competent authorities have the choice as to which method they apply to a financial conglomerate and they may also apply a combination of the three methods.[93] These methods are:

1. Method 1: "Accounting Consolidation" Method

Method 1 uses the consolidated accounts as a basis for calculating the supplementary capital adequacy. Thus, it is only applicable for consolidated groups. According to this method, the supplementary capital adequacy shall be calculated as the difference between:

(i) the own funds of the financial conglomerate calculated on the basis of the consolidated position of the group;[94]

and

(ii) the sum of the solvency requirements for each different financial sector represented in the group.[95]

Formula for calculating the supplementary capital adequacy according to method 1:

$$\text{Supp.CA} = \text{OF}_{\text{Consolidated}} - (\text{S}_{\text{Bank}} + \text{S}_{\text{Insurance}} + \text{S}_{\text{Investment}} + \text{S}_{\text{Non-Regulated}})$$ [96]

The difference shall not be negative.[97]

Because of the fact that this method takes as its starting point and basis the fully consolidated accounts of the financial conglomerate, by definition, all intra-group on- and off-balance sheet accounts or exposures have been eliminated and the effects of double or multiple gearing and

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[92] *Id*.

[93] Annex I, sub II, Method 4, Proposed Directive. *See also* Opinion of the Economic and Social Committee, *supra* note 13, at 2, *sub* 2.5 and at 4, *sub* 3.9; Report of the European Parliament's Committee on Economic and Monetary Affairs, *supra* note 12, at 34.

[94] The elements eligible are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub* II, Method 1(i), Proposed Directive.

[95] The solvency requirements for each different financial sector are calculated in accordance with the relevant sectoral rules, Annex I, *sub* II, Method 1(ii), Proposed Directive. In the case of non-regulated financial sector entities that are not included in the sectoral solvency requirement calculations, a notional solvency requirement shall be calculated. *Id*. *See supra* note 90.

[96] *Supp.CA* shall mean the supplementary capital adequacy, *i.e.*, the surplus or deficit of the group-wide capital, *OF* shall mean own funds, and *S* shall mean the solvency requirements of a financial sector.

[97] Annex I, *sub* II, Method 1, ultimate paragraph, Proposed Directive. If the difference is negative, the group faces a capital deficit.

excessive leverage are equated. Thus, calculating the group-wide capital adequacy simply consists in the deduction of the solvency requirements of the group's sectors from the consolidated own funds.

2. Method 2: "Deduction and Aggregation" Method

The calculation of the supplementary capital adequacy pursuant to method 2 is carried out on the basis of the single accounts of each entity in the group. According to this method, the supplementary capital adequacy shall be calculated on the basis of the accounts of each of the entities in the group as the difference between:

(i) the sum of the own funds of each regulated and non-regulated entity in the financial conglomerate;[98]

and

(ii) the sum of:

- the solvency requirements for each regulated and non-regulated entity in the group[99]; and
- the book value of the participations in other entities of the group.[100]

Formula for calculating the supplementary capital adequacy according to method 2:

$$\text{Supp.CA} = (OF_1 + OF_2 + OF_3 + \ldots) - [(S_1 + S_2 + S_3 + \ldots) + (BV_1 + BV_2 + BV_3 \ldots)]$$ [101]

The difference shall not be negative.[102]

The effect of this method is to pretend the situation of consolidated accounts and therefore to eliminate multiple gearing, excessive leverage and the misuse of accounting margins relating to the book value of participations by deducting those participations.

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98 The elements eligible are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub* II, Method 2(i), Proposed Directive.

99 The solvency requirements shall be calculated in accordance with the relevant sectoral rules, Annex I, *sub* II, Method 2(ii), Proposed Directive. In the case of non-regulated entities, a notional solvency requirement shall be calculated, *Id*. *See supra* note 90.

100 Although the wording in this point is not very clear, *participations in other entities of the group* means any participation that is held within the group, *e.g.*, participations of the parent in its subsidiaries or cross-participations of the subsidiaries. *See* Joint Forum Report, *supra* note 5, at 9, Capital Adequacy Principles Paper, *sub* no. 20.

101 *Supp.CA* shall mean the supplementary capital adequacy, *i.e.*, the surplus or deficit of the group-wide capital, *OF* shall mean own funds, *S* shall mean the solvency requirements of an entity of the group and *BV* shall mean the book value of a participation.

102 Annex I, *sub* II, Method 2, ultimate paragraph, Proposed Directive. If the difference is negative, the group faces a capital deficit.

3. Method 3: "Requirement Deduction" Method

Method 3 is based on the balance sheet of each company within the group. According to this method, the calculation of the supplementary capital adequacy shall be carried out on the basis of the accounts of each of the entities in the group as the difference between:

(i) the own funds of the parent undertaking or the entity at the head of the financial conglomerate;[103]

and

(ii) the sum of

- the solvency requirement of the parent undertaking or the head referred to in clause (i); and
- the higher of the book value of the parent undertaking's participation in other entities in the group and these entities' solvency requirement.[104]

Formula for calculating the supplementary capital adequacy according to method 3:

$$\text{Supp.CA} = OF_{\text{Parent}} - [S_{\text{Parent}} + (BV_1 \text{ or } S_1 + BV_2 \text{ or } S_2 + BV_3 \text{ or } S_3 + \ldots)]$$[105]

The difference shall not be negative.[106]

The competent authorities shall require regulated entities to have in place adequate capital adequacy policies at the level of the financial conglomerate, as well as appropriate internal control mechanisms as regards capital adequacy.[107] For the purpose of calculating the capital adequacy requirements, the competent authorities responsible for exercising supplementary supervision may decide not to include a particular entity in the following cases:[108]

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[103] The elements eligible are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub* II, Method 3(i), Proposed Directive.

[104] The solvency requirements of the parent undertaking shall be taken into account for their proportional share in accordance with Annex I, *sub* I, Proposed Directive. Annex I, *sub* II, Method 3(ii), Proposed Directive. In the case of non-regulated entities, a notional solvency requirement shall be calculated. *Id. See supra* note 90.

[105] *Supp.CA* shall mean the supplementary capital adequacy, *i.e.,* the surplus or deficit of the group-wide capital, *OF* shall mean the own funds of the parent undertaking on the basis of the single account, *S* shall mean the solvency requirements and *BV* shall mean the book value of the parent's participation.

[106] Annex I, *sub* II, Method 3, ultimate paragraph, Proposed Directive. If the difference is negative, the group faces a capital deficit.

[107] Art. 5(2), second subparagraph, Proposed Directive.

[108] Art. 5(4), Proposed Directive.

(a) if the entity is situated in a third country where there are legal impediments to the transfer of the necessary information;[109]

(b) if the entity is of negligible interest with respect to the objective of the supplementary supervision of regulated entities in a financial conglomerate;[110] or

(c) if the inclusion of the entity would be inappropriate or misleading with respect to the objectives of supplementary supervision.

If the capital adequacy position at the level of the financial conglomerate falls below the requirements, if the capital adequacy policies are not adequate, if the internal control mechanisms are not appropriate, or where the requirements are met but the solvency may nevertheless be jeopardized,[111] the competent authorities responsible for the supervision of the regulated entities in the financial conglomerate must ensure that the necessary measures to rectify the situation are taken by the entities in the group as soon as possible.[112]

B. Intra-Group Transactions and Risk Concentration

Another core regulation of the Proposed Directive is the requirement of supplementary supervision on *intra-group transactions*[113] and *risk concentration*[114] of regulated entities in a financial conglomerate.[115]

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[109] This exception must be without prejudice to the sectoral rules regarding the obligation of competent authorities to refuse authorization where the effective exercise of their supervisory functions is prevented. Art. 5(4)(a), Proposed Directive.

[110] If several entities are intended to be excluded because of such negligible interest, they must be nevertheless included when collectively they are of non-negligible interest. Art. 5(4), second subparagraph, Proposed Directive.

[111] The requirements are set forth in Art. 5(2), first subparagraph, Proposed Directive.

[112] Art. 5(5), Proposed Directive.

[113] According to Art. 2(16), Proposed Directive, *intra-group transactions* mean all transactions by which regulated entities within a financial conglomerate rely either directly or indirectly upon other entities within the same group for the fulfillment of an obligation, whether or not contractual, whether or not for payment.

According to the Joint Forum, *supra* note 5, in its *Report on Intra-Group Transaction and Exposure Principles* (Basle, Dec. 1999), amending the Report on Supervision of Financial Conglomerates, at 2, *sub* no. 4, *intra-group transactions and exposures* take the form of direct and indirect claims between entities within a financial conglomerate. They can originate in a variety of ways, for example, through: (a) cross shareholdings, (b) trading operations whereby one group company deals with, or on behalf of, another group company, (c) central management of short-term liquidity within the conglomerate, (d) guarantees, loans and commitments provided to, or received from, other companies in the group, (e) the provision of management and other service arrangements, *e.g.*, pension arrangements or back office services, (f) exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees), (g) exposures arising through the placement of client assets with other group companies, (h) purchase or sales of assets with other group companies, (i) transfer of risk through reinsurance, and (j) transactions to shift third party-related risk exposures between entities within the conglomerate.

[114] According to Art. 2(17), Proposed Directive, *risk concentration* means all exposures with a loss potential borne by entities within a financial conglomerate, which are large enough to threaten the solvency or the financial position in general of the regulated entities in the financial conglomerate, and which exposures may be caused by counterparty risk/credit risk, investment risk, insurance risk, market risk, other risks, or a combination or interaction of these risks.

Pursuant to the Joint Forum, *supra* note 5, in its *Report on Risk Concentrations Principles* (Basle, Dec. 1999), amending the Report on Supervision of Financial Conglomerates, at 2, *sub* no. 4, risk concentration can take many forms, including exposures to: (a) individual counterparties, (b) groups of individual counterparties or related entities, (c) counterparties in

Intra-group transactions may cause supervisory concerns when they (i) result in capital or income being inappropriately transferred from the regulated entity, (ii) are on terms or under circumstances which parties operating at arm's length would not allow and may be disadvantageous to a regulated entity, (iii) can adversely affect the solvency, the liquidity and the profitability of individual entities within a group, or (iv) are used as a means of supervisory arbitrage, thereby evading capital or other regulatory requirements altogether.[116] Monitoring intra-group transactions is also an important factor in dealing with the risk of contagion within a financial conglomerate. Contagion entails the risk that, if certain parts of a conglomerate are experiencing financial difficulties, they may infect other healthy parts of the conglomerate as a result of which the operation of the healthy parts may be hampered or even made impossible.[117] Therefore, intra-group transactions can significantly exacerbate problems for a regulated entity once contagion spreads.[118]

As to the problem of risk concentration, supervisors of the different financial sectors use various approaches to monitor large exposures, due to the different risks they are facing.[119] In all three sectors, financial institutions face an increased risk of loss when their assets, liabilities or business activities are not diversified.[120] As not all risk concentrations are inherently bad (a certain degree of concentration is the inevitable result of a well-articulated business strategy as well as product specialization, the targeting of a customer base or a sound strategy of outsourcing data processing activities), supervisors need to balance the benefits against the risks of concentrations at the conglomerate level.[121] In identifying risks, the competent authorities have to take into account the different ways in which large losses can develop in a conglomerate as a result of risk concentration.[122]

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specific geographical locations, (d) industry sectors, (e) specific products, (f) service providers, *e.g.*, back office services, and (g) natural disasters or catastrophes.

[115] Art. 6(1), in connection with Annex II, Proposed Directive.

[116] Joint Forum Report on Intra-Group Transactions and Exposure Principles, *supra* note 113, at 6, *sub* no. 12. *See also* Tripartite Report, *supra* note 5, at 21, *sub* no. 55.

[117] Tripartite Report, *supra* note 5, at 18, *sub* no. 47.

[118] Tripartite Report, *supra* note 5, at 19, *sub* no. 50.

[119] *See* Joint Forum Report on Risk Concentrations Principles, *supra* note 114, at 4 & 5, *sub* nos. 8–10.

[120] Joint Forum Report on Risk Concentrations Principles, *supra* note 114, at 5, *sub* no. 11.

[121] Joint Forum Report on Risk Concentrations Principles, *supra* note 4, at 7, *sub* nos. 22 & 23.

[122] Joint Forum Report on Risk Concentrations Principles, *supra* note 114, at 7, *sub* no. 23. The Report addresses some of them as follows:

- Losses at the conglomerate level can reflect the aggregate of losses on similar types of exposures (*e.g.,* bonds, loans and investments with the same obligor) across the sectors.
- Losses could reflect risk factors that have consequences for different types of exposures in different entities (*e.g.*, a natural disaster could cause insurance loses in a conglomerate's insurance operation and credit losses in its banking operation if both offered products in the affected region).
- Losses could reflect the interaction of risk factors (*e.g.*, the loss potential in a derivative or exchange rate contract resulting from an exchange rate depreciation may be intensified if the same price movement adversely affects the repayment ability of a counterparty or the financial stability of the counterparty's country of residence).
- Losses could also reflect the breakdown of previously observed correlations, such as occurs in a flight to quality in which all risky assets decline in value, where previously many of them were measured to be uncorrelated.

To avoid the risks resulting from intra-group transactions and risk concentration, the EU Member States or the competent authorities shall require regulated entities to have in place within the financial conglomerate adequate risk management processes and internal control mechanisms, including sound reporting and accounting procedures, in order to identify, measure, monitor and control the intra-group transactions within a financial conglomerate and the risk concentration at the level of the financial conglomerate.[123] However, the Proposed Directive does not provide for quantitative limits or standards with regard to intra-group transactions within a financial conglomerate and risk concentration at the level of the financial conglomerate. The introduction of such limits or the introduction of other supervisory measures that would achieve similar objectives is left to the EU Member States.[124]

In addition, the Member States or the competent authorities shall require regulated entities or mixed financial holding companies to report on a regular basis and at least annually to the competent authority responsible for the supplementary supervision all significant intra-group transactions within the financial conglomerate as well as any significant risk concentration at the level of the financial conglomerate.[125] The intra-group transactions and risk concentrations shall be subject to supervisory overview by the competent authorities responsible for supplementary supervision.[126] Therefore, the co-ordinator[127] and the competent authorities responsible for sectoral group-wide supervision of the regulated entities in a financial conglomerate shall identify and agree with each other on the type of transactions and risks regulated entities in a particular financial conglomerate shall report in accordance with the provisions on reporting of intra-group transactions and risk concentration.[128] Thus, the Proposed Directive provides for the development of reporting requirements that are specific for each financial conglomerate.

When a financial conglomerate is headed by a mixed financial holding company, the sectoral rules regarding intra-group transactions and risk concentration of the largest financial sector in the financial conglomerate shall apply to the financial conglomerate as a whole, including the mixed financial holding company.[129]

The Proposed Directive gives the competent authorities responsible for the supervision of the regulated entities in the financial conglomerate the authority to enforce compliance with the rules on intra-group transactions and risk concentration against such regulated entities and, where appropriate, against other entities in the group.[130] Where the intra-group transactions or risk concentrations are a

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[123] Art. 6(2), Proposed Directive. According to the second paragraph of Annex II, Proposed Directive, the competent authorities responsible for supplementary supervision shall in particular monitor the possible risk of contagion in the financial conglomerate, the risk of a conflict of interests, the risk of circumvention of sectoral rules, and the level of volume of risks.

[124] Art. 6(4), Proposed Directive.

[125] Art. 6(3), Proposed Directive, in connection with Annex II, Proposed Directive.

[126] *Id.*

[127] *See infra* IV D for a discussion of the co-ordinator.

[128] Annex II, first paragraph, Proposed Directive referring to the reporting provision of Art. 6(3), Proposed Directive. When defining the type of transactions and risks, the relevant competent authorities shall take into account the specific group and risk management structure of the financial conglomerate. In particular, the relevant competent authorities shall define appropriate thresholds based on regulatory own funds and/or technical provisions. *Id.*

[129] Art. 6(5), Proposed Directive. According to the wording of Art. 6(5), Proposed Directive the sectoral rules of the largest sector in the financial conglomerate shall apply "to that [largest] sector". However, that does not seem to make sense. Art. 6(5) probably means that the sectoral rules of the largest sector shall apply to the whole group.

[130] Art. 6(6), first subparagraph, Proposed Directive.

threat to the regulated entities' financial position, the competent authorities shall take appropriate measures.[131]

In the banking sector, the Proposed Directive proposes some amendments concerning intra-group transactions. The Proposed Directive would amend the Banking Directive[132] to provide that, where the parent undertaking of one or more credit institutions is a mixed-activity holding company, the competent authorities responsible for the supervision of these credit institutions shall exercise general supervision over transactions between the credit institution and the mixed-activity holding company and its subsidiaries.[133] In addition, the competent authorities must require credit institutions to have in place adequate risk management processes and internal control mechanisms, including sound reporting and accounting procedures, in order to identify, measure, monitor and control transactions with their parent mixed-activity holding company and its subsidiaries appropriately.[134] The proposed amendment to the Banking Directive does not establish objective standards for the permissibility of intra-group transactions.[135]

C. Management Qualifications

The Proposed Directive provides that, in the case where the business of an insurance undertaking, life insurance undertaking, investment firm or a credit institution is co-directed by persons appointed in a different legal entity or where persons appointed in a different legal entity have a material influence on the direction of the insurance undertaking, life insurance undertaking, investment firm or credit institution, those persons have to prove sufficient good repute and appropriate professional qualifications or experience to perform their duties.[136] These provisions are intended to ensure that a manager or co-director of a non-regulated entity having a dominant influence on the performance of a regulated entity is reliable like a manager of the regulated entity. This provision responds to the recent tendency to manage financial conglomerates along the different business lines of conglomerates instead of the traditional legal entity based approaches.[137]

D. Measures to Facilitate Supplementary Supervision

As mentioned above, one of the principal objectives of the Proposed Directive is the introduction of measures to facilitate supplementary supervision.[138] Supplementary supervision requires

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[131] Art. 6(6), second subparagraph, Proposed Directive.

[132] *Supra* note 2 no. (8).

[133] Art. 25(7), Proposed Directive, proposing to add a new Art. 55a to the Banking Directive, *supra* note 2 no. (8).

[134] *Id*.

[135] *See, e.g.*, . . 23A & 23B, Federal Reserve Act, 12 U.S.C, 371c & 371c-1 (1994 & Supp. V 2000). New Art. 55a, Banking Directive, *supra* note 2 no. (8), proposed to be added by Art. 25(7), Proposed Directive, provides that where the intra-group transactions are a threat to a credit institution's financial position, the competent authority responsible for the supervision of the institution shall take appropriate measures.

[136] Art. 18(1), Proposed Directive amending the First Non-Life Insurance Directive, *supra* note 2 no. (1); Art. 19(1), Proposed Directive amending the First Life Assurance Directive, *supra* note 2 no. (2); Art. 23(1), Proposed Directive amending the Investment Services Directive, *supra* note 2 no. (6); and Art. 25(2), Proposed Directive amending the Banking Directive, *supra* note 2 no. (8).

[137] Explanatory Memorandum, *supra* note 3, at 7, *sub* 2, Arts. 5 & 6.

[138] Arts. 7 to 13, Proposed Directive.

the exchange of information among the entities in the financial conglomerate and exchange of information and cooperation among the competent authorities involved in the supervision of regulated entities in a particular financial conglomerate.[139]

The Proposed Directive introduces the so-called *co-ordinator*. The competent authorities of the Member States concerned shall appoint amongst them a co-ordinator responsible for the coordination and exercise of the supplementary supervision of the regulated entities in a financial conglomerate.[140] The co-ordinator functions merely as a *primus inter pares* of the competent authorities of the Member States involved with the regulated entities of a financial conglomerate.[141] A co-ordinator must be nominated not only for cross-border financial conglomerates but also for financial conglomerates that have several regulated entities in one Member State and at least two supervisory authorities are involved.[142] In the absence of an agreement among the competent authorities about the selection of a co-ordinator, the co-ordinator is identified on the basis of criteria set forth in the Proposed Directive.[143]

The tasks of the co-ordinator with regard to supplementary supervision are:[144] (i) the coordination of gathering and disseminating of relevant or essential information in going concern and emergency situations, (ii) the assessment of the financial situation, and the overview and monitoring of the compliance with the rules on capital adequacy, risk concentration and intra-group transactions,[145] (iii) the assessment of the financial conglomerate's structure, organization and internal control systems, and (iv) the planning and coordination of supervisory activities in going concern as well as in emergency situations, in cooperation with the relevant competent authorities involved.

The co-ordinator has no decision-making or enforcement authority to impose measures and sanctions.[146] The presence of a co-ordinator entrusted with specific tasks on the supplementary supervision does not affect the tasks and responsibilities of the competent authorities responsible for the regulated entities in a financial conglomerate as provided by the sectoral rules.[147]

To ensure proper supplementary supervision, the competent authorities responsible for the supervision of regulated entities in a financial conglomerate are required to cooperate closely.[148] They shall provide each other with any information that is essential or relevant for the exercise of the other

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[139] Explanatory Memorandum, *supra* note 3, at 7 *sub* 2, Arts. 7 to 13.

[140] Arts. 7(1) & (2), Proposed Directive. The co-ordinator may be composed of more than one competent authority. Art. 7(1), Proposed Directive. The competent authorities of the Member State in which a mixed financial holding company is set up participate in the selection of the co-ordinator. Art. 7(2), Proposed Directive.

[141] *See* Economic and Financial Committee, *Report on Financial Stability* (Brussels Apr. 2000), EFC/ECFIN/240/00–Final, available at http://europa.eu.int/comm/economy_finance/publications/economic_papers/2001/ecp143en.pdf (last visited Mar. 25, 2002) [*herein* Brouwer Report], at 17, *sub* V.1.

[142] Although the language of the Proposed Directive is not clear, it follows from Art. 7(2)(b)(ii), third subparagraph, Proposed Directive, that the competent authorities that appoint a co-ordinator may all be located in one Member State.

[143] Art. 7(2), Proposed Directive.

[144] Art. 8(1), Proposed Directive.

[145] *See* Arts. 5 & 6, Proposed Directive.

[146] *See* Report of the Presidency of the Council of the European Union, *supra* note 13, at 4, *sub* 2.

[147] Art. 8(2), Proposed Directive.

[148] Art. 9(1), Proposed Directive.

competent authorities' supervisory tasks, and provide the co-ordinator with any information that is relevant for the exercise of his task.[149] The competent authorities shall communicate on request all relevant information and shall communicate on their own initiative all essential information.[150] The competent authorities shall consult with each other with regard to the following decisions, where these decisions are important for the supervisory tasks of other competent authorities: (i) changes in shareholder, organizational or management structure of regulated entities in a financial conglomerate, that require the approval or authorization of competent authorities and (ii) major sanctions or exceptional measures taken by the competent authorities.[151]

E. Parent Undertakings Outside the European Union

If the parent undertaking of a financial conglomerate is a regulated entity or a mixed financial holding company having its head office outside the EU, the regulated entities in the EU belonging to such a "non-EU group" cannot be subject to the same rules on supplementary supervision as regulated entities in an "EU group", however, the Proposed Directive attempts to apply as much supplementary supervision as possible.[152] The competent authority of the EU Member State must verify whether the regulated entities in the EU, the parent undertaking of which has its head office outside the EU, are subject to supervision by a third country competent authority that is equivalent to the supplementary supervision of regulated entities of the Proposed Directive.[153] The verification shall be done by the authority that would be responsible for the supplementary supervision in the absence of equivalent supervision by the third country.[154] The Member State of such authority must then notify the Commission and the other Member States of each case of equivalent supervision it has recognized or intends to recognize. If within two months of such notice an objection is raised by a Member State or the Commission regarding the equivalence of such supervision, the Commission must subject the matter to a regulatory procedure.[155]

Whereas the U.S. rules on comprehensive supervision on a consolidated basis[156] ask whether the foreign bank having an establishment in the United States is properly supervised by its home country, the Proposed Directive asks whether the EU affiliates of the foreign entity are subject to (supplementary) supervision by the non-EU regulation of the non-EU parent company.

[149] *Id.*

[150] *Id.* Art. 9(1), Proposed Directive enumerates eight categories of information that shall be gathered and exchanged. Member States shall authorize the exchange of information between the competent authorities and between the competent authorities and other authorities as referred to in Art. 9(1) & (2), Proposed Directive.

[151] Art. 9(1), fourth subparagraph, Proposed Directive.

[152] Arts. 4(3) & 14, Proposed Directive. *See* Explanatory Memorandum, *supra* note 3, at 7, *sub* 2, Art. 14.

[153] Art. 14(1), Proposed Directive, referring to the provisions on supplementary supervision in Art. 4(2), Proposed Directive.

[154] Art. 14(1), Proposed Directive. *See* Art. 14(2), Proposed Directive.

[155] Art. 14(1), in connection with Art. 17(2), Proposed Directive. The regulatory procedure is laid down in Art. 5 of Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, O.J. Eur. Comm. No. L 184/23 (1999). *See* Arts. 14(1) & 17(2), Proposed Directive. Art. 9(3), Proposed Directive.

[156] *See* 12 C.F.R. § 225.92(e)(1) & (2) (2002) (Regulation Y); 12 C.F.R. § 211.24(c)(1)(i)(A) (2002) (Regulation K); 12 C.F.R. § 225.13(a)(4) (2002) (Regulation Y).

In the absence of such equivalent supervision, EU Member States shall apply to the regulated entity, by analogy, the provision with regard to supplementary supervision of regulated entities set forth in the Proposed Directive.[157] As an alternative to the application of the supplementary supervision rules by analogy, the Member States may allow their competent authorities to apply other methods that ensure an appropriate supplementary supervision of the regulated entities in a financial conglomerate.[158] The competent authorities may in particular require the creation of a sub-holding company (which would be a mixed financial holding company) that has its head office in the EU, and apply the supplementary supervision to the regulated entities in the financial conglomerate headed by the European sub-holding company.[159] In any case, the methods selected by the competent authorities to ensure an appropriate supplementary supervision must achieve the objectives set out in the Proposed Directive and must be notified to the other Member States and the Commission.[160] This notice triggers the procedure set forth above: if within two months of such notice an objection is raised by a Member State or the Commission regarding the equivalence of supplementary supervision, the Commission must subject the matter to a regulatory procedure.[161]

The Proposed Directive - different from the US Bank Holding Company Act - does not attempt to regulate non-EU holding companies that control regulated entities in the EU. The Member States together with the Commission, may assess the equivalence of the supplementary supervisions by the non-EU home state of parent companies with a head office outside the EU over EU-regulated entities. In the absence of a finding of equivalence, the Member States may require the formation of an EU sub-financial conglomerate. This subgroup would not be insulated against acts by the non-EU holding company. The Proposed Directive states however, that the creation of an EU sub-financial conglomerate "must achieve the objectives of the supplementary supervision as defined in this Directive".[162]

V. Conclusion

The growing consolidation process in the financial industry created a number of new prudential risks, which must be faced. The Proposed Directive marks an important step in keeping up supervisory instruments with the development of an integrated world financial market. It is a significant step in the right direction. However, there are some weaknesses in the Proposed Directive that should be pointed out.

The high degree of discretion given to the Member States and their supervisory authorities could possibly lead to enormous differences in the definition of financial conglomerates and in national supervisory rules and practices relating to financial conglomerates throughout the EU. This

[157] Art. 14(2), Proposed Directive. The provision referred to in Art. 14(2), Proposed Directive is Art. 4(2), Proposed Directive. *See supra* part III.C. It is not clear what application "by analogy" means. Presumably, it means "to the extent possible."

[158] Art. 14(3), Proposed Directive. According to Art. 14(3), second sentence, Proposed Directive. Those methods must be agreed upon at least by the competent authorities responsible for the sectoral group-wide supervision of the regulated entities in the financial conglomerate and where relevant by other competent authorities concerned. *Id*.

[159] Art. 14(3), third sentence, Proposed Directive.

[160] Art. 14(3), ultimate sentence, Proposed Directive.

[161] Art. 14(3), ultimate sentence, in connection with Art. 14(1), penultimate sentence, Proposed Directive. *See supra* note 155.

[162] Art. 14(3), ultimate sentence, Proposed Directive.

would not only create legal uncertainties but could also cause competitive distortions.[163] Generally speaking, it would be preferable to reduce the national options in the Directive.

Under the current version of the Proposed Directive, it is extremely difficult to determine which groups are financial conglomerates and to determine the undertakings that should be subject to supplementary supervision. Especially the definition of a *group* is extremely complicated and hard to understand. In addition, the Member States have much discretion in that regard. Therefore, the Finnish Delegation and the European Parliament's Committee on Economic and Monetary Affairs proposed different approaches to define a group by simplifying and narrowing the definition.[164] It has also been suggested to establish a procedure for identifying a financial conglomerate.[165]

Some commentators have expressed the view that the 50% threshold in Art. 3(1), Proposed Directive, defining whether the activities of a group consist mainly in providing financial services[166] should be lowered. Otherwise large industrial groups with significant financial activities would not be covered by the Directive and consequently escape any form of supervision.[167] The question should be raised why the relative size of financial services as compared to non-financial services in a conglomerate is a relevant consideration. All credit institutions that are subsidiaries of principally non-financial conglomerates are exposed to the dangers from which the Proposed Directive is intended to protect the credit institution and the public.

The Proposed Directive provides that the competent supervisory authority decides which of the methods for the calculation of the supplementary capital adequacy should be applied.[168] It would be desirable to leave the choice of the calculation method to the financial conglomerate in order to give companies more flexibility.[169]

Finally, it is quite astonishing to note that the Proposed Directive hesitates to regulate non-EU holding companies directly.[170] The United States banking legislation does not show such hesitation with respect to foreign holding companies. For example, the U.S. Bank Holding Company Act applies not only to U.S. banks but also to foreign banks that have a U.S. bank subsidiary[171] and foreign banks that maintain a branch, agency or commercial lending company in the United States.[172]

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[163] *See* Opinion of the Economic and Social Committee, *supra* note 13, at 4, *sub* 3.7.

[164] *See* Note of the Finnish Delegation, *supra* note 13, at 3; Report of the European Parliament's Committee on Economic and Monetary Affairs, supra note 13, at 7.

[165] *See* Opinion of the European Central Bank, *supra* note 13, at 11, *sub* 5; Note of the Finnish Delegation, *supra* note 13, at 5.

[166] Art. 3(1), Proposed Directive is discussed *supra* part III.B.

[167] *See* Report of the European Parliament's Committee on Economic and Monetary Affairs, *supra* note 13, at 33; Position Paper of the Banking Federation of the European Union, *supra* note 13, at 6.

[168] *See* Annex I, *sub* II, Method 4, Proposed Directive discussed *supra* part IV.A.

[169] *See* Report of the European Parliament's Committee on Economic and Monetary Affairs, *supra* note 13, at 28 & 34; Position Paper of the Banking Federation of the European Union, *supra* note 13, at 11.

[170] *See* Arts. 4(3) & 14, Proposed Directive as discussed *supra* part IV.E.

[171] The Bank Holding Company Act applies directly to such foreign banks.

[172] Section 8(a), International Banking Act of 1978, 12 U.S.C. § 3106(a) (1994). For a further discussion of supervision of foreign banks in the United States *see* Michael Gruson, 1 REGULATION OF FOREIGN BANKS, UNITED STATES AND INTERNATIONAL (Michael Gruson & Ralph Reisner eds., 3d ed. 2000).

Annex:
Overview of the Cited Directives

No.	Official Name	Nickname	Introduced in Footnote
Directive 73/239/EEC	First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance, O.J. Eur. Comm. No. L 228/3 (1973)	First Non-Life Insurance Directive	Note 2 no. (1)
Directive 79/267/EEC	First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance, O.J. Eur. Comm. No. L 63/1 (1979)	First Life Assurance Directive	Note 2 no. (2)
Directive 92/49/EEC	Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC (third non-life insurance Directive), O.J. Eur. Comm. No. L 228/1 (1992)	Third Non-Life Insurance Directive	Note 2 no. (3)
Directive 92/96/EEC	Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directive 79/267/EEC and 90/619/EEC (third life assurance Directive), O.J. Eur. Comm. No. L 360/1 (1992)	Third Life Assurance Directive	Note 2 no. (4)
Directive 93/6/EEC	Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions, O.J. Eur. Comm. No. L 141/1 (1993)	Capital Adequacy Directive	Note 2 no. (5)
Directive 93/22/EEC	Council Directive 93/22/EEC of 10 May 1993 on the investment services in the securities field, O.J. Eur. Comm. No. L 141/27 (1993)	Investment Services Directive	Note 2 no. (6)
Directive 98/78/EC	Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group, O.J. Eur. Comm. No. L 330/1 (1998)	Insurance Groups Directive	Note 2 no. (7)
Directive 2000/12/EC	Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, O.J. Eur. Comm. No. L 126/1 (2000)	Banking Directive	Note 2 no. (8)
Directive 92/30/EEC	Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis, O.J. Eur. Comm. No. L 141/27 (1993)		Note 14
Directive 2000/28/EC	Directive 2000/28/EC of the European Parliament and of the Council of 18 September 2000 amending the Banking Directive relating to the taking up and pursuit of the business of credit institutions, O.J. Eur. Comm. No. L 275/37 (2000)		Note 14
Directive 2000/46/EC	Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, O.J. Eur. Comm. No. L 275/39 (2000)		Note 14
Directive 83/349/EEC	Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts, O.J. Eur. Comm. No. L 193/1 (1983)	Consolidated Accounts Directive	Note 17
Directive 78/660/EEC	Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, O.J. Eur. Comm. No. L 222/11 (1978)	Annual Accounts Directive	Note 17
Directive 95/26/EC	European Parliament and Council Directive 95/26/EC of 29 June 1995 amending Directives 77/780/EEC and 89/646/EEC in the field of credit institutions, Directives 73/239/EEC and 92/49/EEC in the field of non-life insurance, Directives 79/267/EEC and 92/96/EEC in the field of life assurance, Directive 93/22/EEC in the field of investment firms and Directive 85/611/EEC in the field of undertakings for collective investment in transferable securities (Ucits), with a view to reinforcing prudential supervision, O.J. Eur. Comm. No. L 168/7 (1995)	Post-BCCI Directive	Note 42

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