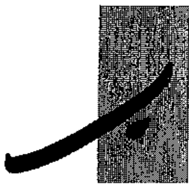


FEDERATION
BANCAIRE
FRANCAISE

Banking supervision
And Accounting issues Unit

The Director

Paris, March 16th 2012

French Banking Federation response to the Joint Forum consultative paper on Principles for supervision of Financial Conglomerates

Dear Sir,

The French Banking Federation (FBF) is the professional body representing the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 450 commercial and cooperative banks. FBF member banks have 40,000 permanent branches in France. They employ 400,000 people, and service 60 million clients.

The FBF appreciates the publication of the Joint Forum consultative paper on Principles for the supervision of financial conglomerates. We fully support the explicit recognition of financial conglomerates and welcome the revision of the 1999 principles. We also welcome the opportunity to comment on the proposed document.

Our main concern relates to the necessity of clarifying and strengthening sectoral supervision by implementing as a first step the Basel 3 framework and, at the European level, Solvency 2. The harmonization between banks and insurance core principles is a pre-requisite to achieve a more comprehensive risk management framework.

Besides, when considering a potential additional capital buffer at the financial conglomerate level, supervisors should take into account the existing risk-sensitive principle of capitalisation under sectoral regulations, the risk of double-counting capital requirements as capital buffers are usually required under sectoral prudential supervisions and regulations, as well as the existence or not of a specific regulation applicable to financial conglomerates in their jurisdiction. Moreover, they should consider the diversification benefits deriving from conglomerate risks aggregation and the financial conglomerate risk profile.

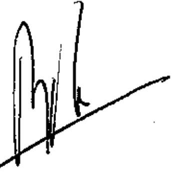
../..

M. Xavier-Yves ZANOTA
Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Our response is divided in two parts: first of all a few general comments and then some more specific remarks.

We thank you for the consideration of our remarks and remain at your disposal for any questions or additional information you might have.

Yours sincerely,



Jean-Paul CAUDAL

p/o Bernard PIERRE

General comments

1. We would like to remind that Europe has already built up a financial conglomerate prudential framework and that many issues raised in the consultative paper have already been addressed under the European directive of 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

2. We also would like to remind that supervision of financial conglomerates is a supplementary supervision, leaning on specific sectoral supervisions. Therefore, the implementation of Basel 3 and, at the European level, Solvency 2 is a top priority. Therefore, you should take care that evolutions in the financial conglomerates supervision do not challenge the implementation of these sectoral frameworks. A step-by-step approach seems to be more adequate.

3. It seems to us that a harmonisation between banks and insurance core principles of supervision would help financial conglomerates to achieve a more comprehensive risk management framework. When establishing these core principles, standard setters should keep in mind the differences of risks between the two areas of activity and preserve sectoral rules when dealing with capital adequacy and solvency issues.
However, it has to be noted that banking and insurance supervision has not yet achieved the same level of internal harmonisation.

4. We back the Basel 3 framework but we recommend proceeding cautiously when expanding banking concepts (such as liquidity, leverage and stress test) to financial conglomerates. These concepts could prove to be irrelevant in this context.

5. We support a global supervisory oversight of financial conglomerates and find relevant in this context to use a "banking Pillar 2" type approach, as suggested in the consultative document. But we think that a possible additional buffer of capital should never jeopardize the current principle of a capitalisation by risk type, based on confidence levels fixed at sectoral levels. Adding new capital charges on top of already existing capital charges can prove to be a hazardous approach if not undertaken very carefully.
Going one step further, we think that it would be difficult to argue that the risk of combined banking and insurance activities is greater than the sum of these two activities' standalone risks. Nothing in recent events supports this statement. On the contrary, the insurance activities have softened the effects of the subprime crisis on the P&L and capital base of the financial conglomerates in our country. Surveys carried out by the industry have also proved that correlations between insurance and banking risks are lower than 100%. Therefore, the diversification benefits deriving from risk aggregation should be recognized in the principles for capital adequacy.

6. We wish that supervision does not create an uneven level playing field. As unregulated entities have rightly been recognized as an important focus by the G-20 and the Joint Forum, we appreciate the emphasis you put on such entities both financial (e.g. special purpose entities, hedge funds, pension fFunds,...) and non-financial (e.g. industrial holdings incorporating some financial subsidiaries) in the context of the supervision of financial conglomerates. But it does not mean that this level playing field issue has necessarily to be fixed by an extension of the existing regulation to all kind of unregulated entities.

Specific remarks

- **Part II - Supervisory responsibility (from §5 to §9)**

§ 5 - Group-level Supervisor

Supervisors are used to work together in their respective colleges, banking supervisors having the advantage of sharing a common supervisory framework. In the financial conglomerates context, it will not be the case anymore due to the possible heterogeneous background of all the participating supervisors. This raises a serious issue, noting at the same time that the specific responsibilities of the Group-level supervisor vis-à-vis the other supervisors are not clearly stated in the document, in case of diverging views among relevant supervisors on various issues pertaining to the supervision of a financial conglomerate.

Same comment for § 7 - Regulators should seek to prevent regulatory arbitrage.

Generally speaking, we think that it is easier for supervisors to work together if they share a common language. The European framework (with Basel 3, CRD IV and Solvency 2) is among the most advanced ones in the world. France, particularly, benefits from its common supervisor and from the more advanced European regulations. This allows a more consistent approach avoiding regulatory arbitrage.

§ 9 – Supervisory tools and enforcement

Paragraph 9.2 states that "*sanctions and corrective actions should be used to address sources of risks or issues of non compliance and may include, but are not limited to, restricting current of future activities, suspending dividend to shareholders of relevant entities within the financial conglomerate and other measures to prevent capital from falling below the required levels*".
It would be worth clarifying that such sanctions or corrective actions should be considered with due regards to the financial conglomerate supervision specifically and should not seek to address any possible sectoral issues.

- **Part III - Corporate governance (from §10 to §14)**

§ 11 - Structure of the financial conglomerate

We support the principle of easily understandable groups' structure. But it seems to us that allowing a supervisor to ask for structural changes in a group, for supervision reasons, is going too far.

We also note that in the expression *"Supervisors should [...] seek restructuring under appropriate circumstances"*, in 11(b), the term "appropriate circumstances" is unclear.
Is it an attempt to include Resolution planning in the scope of supervision and ask for resolution plans at the financial conglomerate level?
Supervisory powers in emergent situations should be addressed in the ongoing bank resolution framework which details the circumstances and tools that the resolution authority may use to ensure that a group structure does not impede its orderly resolution.

Coming to point 11(c), we find questionable the requirement that the board members should be capable of describing and understanding the purpose, structure, strategy, material operations and material risks of the financial conglomerate, including those of unregulated entities that are part of the financial conglomerate. Indeed, members of the board are well aware of the group's main risk factors. Their knowledge should be sufficient to allow them performing their responsibilities and calling upon senior management when needed. Such a requirement is all the more inappropriate as the entire group internal control functions are at their disposal.

However, in order to avoid any misinterpretation, it seems important to us to remind you that in France a board is a non-executive body. As a consequence, in our comments "Board" stands in for "governing body in its supervisory function" and "senior management" for "governing body in its executive function".

- **Part IV - Capital adequacy and liquidity (from §15 to §20)**

§ 15 - Capital management requirements

Unregulated entities and regulated entities' interactions within a financial conglomerate should be taken into account as "environmental" factors as part of the Pillar 2 Supervisory Review and Evaluation Process or its equivalent within the insurance sector (i.e. without strictly extending the regulation to unregulated entities). Unregulated entities should not be regulated differently because they are part of a financial conglomerate in comparison to unregulated entities which are part of other regulated financial groups.

We support the requirements according to which financial conglomerates should manage their capital through a rigorous, board-approved, comprehensive and well documented process. However, it should be noted that the requirements # 15(e) to 15 (l) regarding capital planning of financial conglomerates are far more detailed and prescriptive than those existing under any of the sectoral regulations (eg. Basel 3, Solvency 2 in the EU).

While those requirements may be particularly relevant in certain circumstances (e.g. financial conglomerates significantly involved in various non-life insurance and financial market activities) and in jurisdictions where there are no regulations applicable to financial conglomerates, they may be burdensome in the case of financial conglomerates with a lower risk profile focused on retail customers and already subject to a supplementary supervision as it is already the case in the EU.

Therefore, it would be worth clarifying that:

- the principle of proportionality will apply to requirements in paragraph 15;
- in this respect, the group level supervisor would determine more precisely which requirements are relevant for a financial conglomerate under its supervision, having regard to its risk profile and taking into account the existence or not of a specific regulation applicable to financial conglomerates in its jurisdiction.

§ 16 - Capital adequacy assessment

In our general comments, we already have commented on the capital buffer that supervisors could, as appropriate, require in excess of regulatory minimums and targets (paragraph 16 (d)). The circumstances under which, and the criteria according to which, supervisors could require group-wide capital to exceed regulatory minimums and targets should be clarified. In particular, supervisors should take account of already existing possible buffers at the level of both the banking and insurance activities prior to applying such requirements at the financial

conglomerate level. Therefore, it should be clarified that the circumstances under which, and the criteria according to which, supervisors could require group-wide capital buffers should take into account the risk of double-counting capital requirements, if applied bluntly.

More broadly, the possible existence of a buffer of capital raises the issues of its localisation within the group and of its uniqueness: are we talking about one buffer or about multiple buffers?

The way unregulated entities should be brought into the group-wide capital assessment has also to be clarified (see point 16(a): "via capital proxy or through deduction").

§ 17 – Consideration of double or multiple gearing

As mentioned in point 1 of our general comments and in our specific comment on paragraph 15, the European directive already requires the calculation of the supplementary capital adequacy requirements for financial conglomerates (§ 17 (c) of the consultative document). One of the objectives of the supplementary supervision introduced through this directive was indeed to control potential risks arising from double gearing (i.e. multiple use of capital). Methods provided for in this directive already consider situations of double or multiple use of capital. Therefore, it would be worth clarifying point 17 as follows: "When this is not required in the regulation applicable to financial conglomerates established in their jurisdictions, supervisors should require that capital adequacy assessment and measurement techniques consider double or multiple gearing".

§ 18 - Down streaming and excessive leverage

The example provided in the implementation criteria number 18(c) may be misleading: the payment of dividends by a regulated subsidiary to its parent does not necessarily mean that there is an "undue pressure to service the parent's debt".

§ 20 - Liquidity management

This banking concept may be irrelevant in a financial conglomerate context. Insurers do not rely on short-term debt to a significant degree, nor do they traditionally accept deposits from the public. They are pre-funded by premiums. An insurer would be expected to become insolvent long before it becomes illiquid.

- **Part V - Risk Management (from §21 to §29)**

We note that the principles formulated, notably in § 21 and § 22 are fully consistent with the High level principles for risk management produced by the CEBS (February 2010).

§25 - Outsourcing

See point 25.3: "*There will be certain functions within financial conglomerates which should not be outsourced under any circumstance, while there may be some that may only be outsourced if certain safeguards are put in place. In any event, outsourcing should never result in a delegation of responsibility for a given function.*"

The French regulation on internal control within banks (regulation 97.02) does not prevent them from outsourcing activities but they have to meet some requirements. The outsourcing of essential or important functions is authorized under strict conditions. Indeed, it is required to keep complete responsibility of the operation and there are strict criteria to be respected in risk management (delegation of responsibility is not allowed; audit,

as well as a business continuity plan must be set up). Returning to the in-house execution these operations would generate important costs, and would create important competitive disparities with the groups which are not identified as financial conglomerates.

§ 26 - Stress and scenario testing

We fully support the idea that stress testing and, more generally, scenario analyses are key tools to assess the risk profile of a financial institution and to challenge its risk appetite (by informing senior management about the alignment of the institution's risk profile with the Board's risk appetite, under various circumstances). However, in the context of financial conglomerates these exercises will come across practical limits due to the heterogeneity of the business models and natures of risk of the entities belonging to the conglomerate. As an example, the difference between the time horizons relevant to banks and insurance management will probably lead to add up figures calculated in a traditional silo approach, probably not relevant and far from a real integrated risk process (as it is the case with banks' trading and banking books).

As regards stress tests, we believe it is certainly too early to express such a high level of expectations in the context of financial conglomerates.

§27 - Risk aggregation

CEBS's position paper on the recognition of diversification benefits under Pillar 2 (September 2010) lists criteria as prerequisite to the recognition of diversification in the banking sector. Based on these criteria, we think that insurance activities in financial conglomerates potentially generate intra-group diversification due to their specific business models, risk profiles and operations in various geographies, markets and sectors. This diversification benefits, deriving from the aggregation of risks, should be recognized when considering capital adequacy and solvency purposes (part IV).

We understand the concerns (expressed in paragraph 27.2) about "group risks" (financial contagion, reputational contagion, ratings contagion...) but we think that the reality of these risks needs to be carefully assessed.

§ 28 - Risk concentrations and intra-group transactions and exposures

As regards risk concentrations, we would like to remind that they are already publicly disclosed within Pillar 3 (Basel 3 as well as Solvency 2). With regard to intra-group transactions, we think that such information should be reported to the supervisors but that it might not be useful, and even in some cases prove counter-productive, to disclose it publicly.

Besides, the European directive already plans for a follow-up of the significant cross-sectoral intra-group transactions.

This being said, the concept of "intra-group transactions" is vague and can be confusing. There is no reason to consider senior debts and guarantees in the same manner as other intra-group transactions. And it is important to stress that intra-group transactions have not for exclusive finality to allow regulatory arbitrages as suggested in the document. Intra-group transactions are a useful (and sometimes mandatory) tool for financial management within a group.

§ 29 – Off-balance sheet activities

This point would be dealt with the provision mentioned in §27.