

Interim Working Committee on Financial Conglomerates	IWCFC/DOC/07/04
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**Report on the impact
of the differences in sectoral rules
on the calculation of own funds
of financial conglomerates**

August 2007

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Executive summary

1. In January 2007, the IWCFC, in a joint effort between the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), published¹ a comparison of the capital instruments ('the Comparison Report') that are eligible for prudential purposes in the application of the European banking, insurance and securities regulations.
2. At that time, the Consultative Panels of the two Committees flagged four main differences that should be addressed: the treatment of hybrids (including the limits), the different approaches to deductions, the treatment of unrealised profits and revaluation reserves and the differences in consolidation approaches and methods.
3. As a follow up to that report, CEBS and CEIOPS have carried out a quantitative analysis of the impact of the differences that were flagged by the industry on the capital of financial conglomerates, based on fictitious numerical examples.
4. The quantitative analysis has been based on cases that necessarily simplified the complex reality of financial conglomerates applying the three methods of calculation laid down in the Financial Conglomerates Directive. The exercise did not take into account differences in transposition at national level. During the exercise the IWCFC has benefited from the input and practical experience provided on an informal basis by experts from conglomerates.
5. The analysis has been carried out on the basis of the current sectoral Directives and the Financial Conglomerates Directive 2002/87/EC. For the banking sector, these are Directives 2006/48/EC and 2006/49/EC. For the insurance sector the relevant Directives are the Recast Life Directive 2002/83/EC, the First Council Directive on the taking-up and pursuit of the business of direct insurance other than life assurance 73/239/EEC, as amended, and the Directive on supplementary supervision of insurance undertakings in an insurance group 1998/78/EC. It must be noted that the new risk-sensitive regime of Solvency II will

¹ Report available at www.c-ebs.org and www.ceiops.org

significantly impact the calculation of the capital requirements and the availability of capital in the insurance sector.

6. It needs to be underlined at this stage that the IWCFC does not attempt to set out recommendations. The aim of this report is to provide objective figures and conclusions pointing out the potential impact of the sectoral rules on the capital requirements of financial conglomerates.

Key findings of the report

7. First, the quantitative analysis confirmed that the key differences identified in the Comparison report can have an impact on the composition and amount of regulatory capital of a financial conglomerate. The Financial Conglomerates Directive (FCD) does not increase, alleviate nor eliminate the differences in capital which are driven by the sectoral differences. This is common across the three² methods of consolidation allowed by the FCD.
8. The differences in the types of capital elements eligible in each sector and the differences in the limits on the inclusion of eligible items may create distortions and influence the placing of certain assets or transactions within a conglomerate. Some market participants however pointed out that management decisions are not driven only by the prudential regulation and that there is no strong evidence that financial conglomerates take advantage of these differences. The differences that have been identified are:
 - Issuance of financing instruments: innovative instruments are recognised as eligible original own funds for banks in some countries up to 15% in accordance with the Sydney press release; innovative instruments are not explicitly recognised in the insurance sector. Subordinated loans are recognized up to 100% of Tier 1 in the banking sector: up to 50% of the required or available solvency margin in the insurance sector³; This would allow for a higher amount of hybrids and subordinated loans to be eligible in the banking sector.

² The fourth method is a combination of the three methods set out in Annex I of the FCD, on the basis of national discretion.

³ The report does not distinguish between securities of indeterminate duration and (fixed term) subordinated loan capital: the limit in the banking sector of 100% of Tier 1 applies to the total amount of additional own funds. For more details on the treatment of these elements in the insurance and banking sector, see the Comparison Report, p. 38-40 and 47-48.

- unrealised gains on assets (e.g. latent gains on real estate) are not recognised as eligible in the banking sector or only to a limited extent whereas they are recognised as eligible without limit (but subject to prior supervisory approval) under the insurance regulations: revaluation reserves are recognised as eligible without limit under the insurance regulations;
 - under Method 1, if common cross-sectoral own funds which exceed the more restrictive sectoral limit but remain within the less restrictive one are taken into account as non-cross-sectoral own funds, a conglomerate may benefit from placing these elements in the sector where the limit is less stringent. Under Method 2, the calculation is based on the solo situation of each sector, so the sectoral differences in the composition of own funds and the calculation of limits are mechanically reflected in the own funds of the conglomerates. Method 3 has proved not to be a very useful basis for the analysis;
 - holdings in other financial institutions within the conglomerate: a holding in a bank of more than 10% but less than 20% is not automatically deducted if it is held by an insurance undertaking, whereas it would be deducted if it were to be held by the banking part of the conglomerate.
9. Second, the exercise found out that whether the parent of the conglomerate is an insurance undertaking or a bank does not have an impact on the amount of the regulatory capital of the financial conglomerate under the first two methods of the FCD. It only matters under Method 3 as the capital is calculated on the basis of the rules applicable to the parent.
10. The aim of the exercise was not to make a comparison between the calculation methods. However the calculations show a different outcome.
11. The IWCFC has submitted the preliminary findings of this exercise to a panel of experts designated by the consultative panels of CEBS and CEIOPS.
12. Among the key preliminary messages flagged to the CEBS and CEIOPS experts, industry participants advocated:
- a more consistent approach within sectors as the differences in the national implementation of the sectoral Directives

themselves may be greater than the differences between the sectoral Directives;

- while the participants recognised the sectoral differences, they did not consider them at first sight to be paramount drivers for capital management;
- the participants did not have a strong opinion on the priorities for harmonisation. According to them, the cross-sectoral differences are not so important that they require cross-sectoral harmonisation. One participant indicated that harmonisation could nevertheless realise efficiencies at an operational level.

General methodology

13. There are a number of considerations to bear in mind when reading the key findings of this report.
14. Consistent with the Comparison Report, the IWCFC assessed the impact of the differences in the rules as laid down by the European sectoral Directives. The report therefore does not make an impact assessment of the differences between the regimes as transposed in each Member State taking into account different interpretations of the FCD.
15. An overview of the use across the EU of the Calculation Methods permitted by Annex I of the FCD across the EU has been carried out. The answers provided by Member States to a quick stocktake are annexed to the report (Annex II: Overview of the implementation and the use of the Methods of consolidation laid down in the FCD across the EU).
16. The IWCFC aimed at assessing in an empirical fashion the extent to which the differences highlighted in its Comparison Report were significant for the supervision of FC. Special attention was paid to the differences that, from a market participant's perspective, were considered as being the most important to address. These consist primarily of the differences in the treatment of hybrids, the different thresholds for deductions, the treatment of unrealised profits and revaluation reserves, and the different consolidation approaches and methods of consolidation.⁴ The differences in limits applied to the inclusion of eligible subordinated loans have

⁴ Comparison report, para 43.

also been identified as relevant by some market participants and have been tested in this report.

17. The exercise covers the three methods of calculation set out in Annex I of the FCD: Method 1 (Accounting consolidation method), Method 2 (Deduction and aggregation method) and Method 3 (Book value/Requirement deduction method) (see Annex I: The methods of calculation laid down in the Financial Conglomerates Directive.) The fourth method of calculation which allows competent authorities to apply a combination of Methods 1, 2, and 3 as a national discretion has not been covered, because the objective of the analysis was not to assess the differences in national rules and options.
18. Method 3 is a simplified methodology which compares the available capital of the parent undertaking with the required capital of the parent plus the higher of the parent's holdings in group undertakings and the latter's required capital. The method does not recognise surplus value held in other group undertakings. Therefore, this method has proved not to be a very useful basis for analysis. Method 3 of the FCD is similar to Method 3 of the Insurance Groups Directive. In its recommendations on the possible need for amendments to the IGD, CEIOPS suggested deleting this method.⁵
19. The exercise consists of applying to a simplified balance sheet the rules of the Banking Directives and the rules of the Insurance Directives in order to identify the differences.
20. The exercise aims to cover the potential basic structures of a conglomerate. To capture these relationships, two simple building blocks have been designed:
 - a. The first building block is constructed to address the 'mother– daughter' relationship, and basically aims to test to what extent the situation differs when there is a bank at the top of the conglomerate and when there is an insurance entity at the top.
 - b. The second building block is meant to investigate how participations are accounted for in the 'step mother' relationship. Taking into account the different thresholds in the insurance and banking sector for deducting participations (10 % for banks and 20 % for insurance companies), this building block aims to test the situation where a participation in a bank jointly held by an insurance entity and another

⁵ CEIOPS Doc 04/05 Recommendations on possible need for amendments to the Insurance Groups Directive, http://www.ceiops.org/media/files/publications/standardsandmore/guidelines/recommendations_DOC0504.pdf, para 7.3.1.

bank falls between the 10 and 20 % limits. For a participation under 10 %, there will be no deduction, as it exceeds neither of the limits. For participations over 20 %, the participation will be deducted under both sectoral rules. Different scenarios have been tested to assess the potential impact of these different thresholds on the financial conglomerate.

21. The detailed calculations and conclusions of the building blocks can be found later in the report.
22. The IWCFC based its analysis on a set of simple numerical examples which would demonstrate whether and if so to what extent, the calculation of the capital adequacy of a conglomerate may differ because of the differences between the sectoral rules.
23. The numerical examples are hypothetical but illustrative, in particular, of how the limits on the inclusion of eligible capital items interact.

The building block approach has been constructed independently of the various consolidation methods and approaches available under the banking and insurance regulations, highlighted in the Comparison Report⁶. This neutral approach was decided on for the sake of clarity in order to focus on sectoral differences in the definition of eligible capital elements from a conglomerates perspective.

24. The IWCFC has had informal contacts with industry representatives in order to assess the preliminary conclusions of the hypothetical exercise against the differences encountered in practice by market participants (See part B of the report: The reality check).
25. The analysis refers to the rules contained in **Annex 1, I, 2 of the FCD** as well as on the **detailed guidance** on the implementation of the requirements of the FCD published by the EC.⁷ The rules and the interpretation of the rules are attached to this report (Annex III: Definition of the rules laid down in the FCD).
26. Furthermore, in order to base the analysis on comparable outcomes, each set of examples has used the same overarching assumptions (see infra). These assumptions have been made for the purpose of this empirical exercise. As mentioned before, in reality the assumptions underlying the calculations and the

⁶ See para. 365 ff.

⁷ Mixed technical group, Implementation and interpretation of Directive 2002/87/EC, Issues schedule, November 2005, http://ec.europa.eu/internal_market/financial-conglomerates/docs/20051114_issues_en.pdf

interpretations of the FCD may vary across Member States (for more detail, see Annex III).

Assumptions made for the sake of clarity and simplicity of the calculations

27. The calculations were made under the assumption that the conglomerate would apply IAS/IFRS
28. The calculations did not include specific calculations related to prudential filters on the assumption that they apply in accordance with the relevant CEBS and CEIOPS guidelines.⁸ Nevertheless, it should be underlined that there are relevant differences in the definition and application of the prudential filters between the two sectors and within each sector that could affect the calculation of the capital adequacy of the FC.⁹
29. When devising the examples, the IWCFC found it key to ensure that to the maximum extent possible the conclusions would only be driven by the rules applied and not by the example or the numbers used.
30. The hypothetical balance sheets of the insurance company and the bank were the same, regardless of whether the entity was a parent or a subsidiary, across the three Methods.
31. The amount of the capital requirements of the bank and the insurance company was also kept constant for Methods 1, 2 and 3.
32. No assumption has been made on banking Tier 3 capital as in practice this element is present only in a limited number of countries.
33. In the calculations, the insurance companies have been considered solvent; that is the available solvency margin (after the deduction of intangibles) is higher than the required solvency margin. Therefore, in the exercises the 50% limit has been applied to the required solvency margin.

⁸ CEIOPS, Recommendations regarding the Implications of the IAS/IFRS Introduction for the Prudential Supervision of Insurance Undertakings, September 2005, http://www.ceiops.org/media/files/publications/standardsandmore/guidelines/recommendations_DOC0505.pdf and <http://www.c-ebs.org/Advice/advice.htm> for CEBS guidelines on prudential filters

⁹ See IWCFC, Comparison report, p 75 ff.

Assumptions with regard to capital elements

34. As indicated in the Comparison Report, there are three main categories of difference between the banking and insurance sectors:

- differences in the types of eligible capital elements;
- differences in the methods used to calculate their eligible amount; and
- differences in the limits applied to those eligible elements.

35. Taking these differences into consideration, the IWCFC has made some assumptions for its calculations across the three methods in the FCD. In reality, these calculations may differ as Member States may have transposed the sectoral Directives and the FCD in different ways.

36. These differences are summarized in the table below :

Items	Differences	Assumptions used by the IWCFC in the calculations
Unrealised latent gains on assets	Not recognised as eligible in the banking sector or eligible in a limited way, (e.g. latent gains on real estate or on equity instruments) - only in additional own funds having applied a haircut (45% of the value). Included as eligible own funds without limit, and subject to prior supervisory approval in insurance regulation	Unrealised latent gains of insurance company are fully (i.e. without haircut) included in own funds
Unpaid capital	Not authorised in banking regulation 50 % of the unpaid capital may be included in the own funds of insurance companies subject to prior approval of the supervisor, up to 50 % of the available or required solvency margin, whichever is	Unpaid capital is subscribed by third parties. This also applies to hybrids and subordinated loans¹⁰. - 50 % unpaid capital of insurance companies is included in own funds, up to 50 % of the available or

¹⁰ In reality, it will frequently be that the unpaid capital, like these other items, is subscribed from within a group by the parent undertaking. However, in this case, these elements are totally excluded from the solvency calculation at insurance group level (see IGD, Annex I, 1. C.2)

	lower	required solvency margin, whichever is lower
Hybrids	- authorized as Tier 1 for banks up to a certain limit; - eventually authorized in insurance, depending on the interpretation of the local supervisor, as subordinated debt with no specified maturity date but limit applies (=up to 50 % of the available or required solvency margin, whichever is lower).	- for the banking sector : innovative capital instruments¹¹ are included in original own funds up to 15%. The excess compared to this limit may be included in additional own funds (tier 2) - for the insurance sector : innovative capital instruments are not explicitly mentioned in the Insurance Directives and are therefore treated as subordinated debt and so, subject to the limit (up to 50 % of the available or required solvency margin, whichever is lower)
Revaluation reserves	- Included in additional own funds (Tier 2) in the banking sector. Additional own funds may not exceed 100 % of original own funds (Tier 1) - May be included without limit in the insurance sector For both sectors, prudential filters may apply differently	- For the banking sector: revaluation reserves are included in additional own funds subject to the Tier 2 limit - For the insurance sector: revaluation reserves are included in own funds without any limit. The full amount of the revaluation reserve is taken into consideration (no haircut)
Subordinated loans (dated and undated)	- Included in additional own funds (Tier 2) in the banking sector. Additional own funds may not exceed 100 % of original own funds (Tier 1). - Included in own funds in the insurance sector but subject to a specific limit (=max 50 % of the available or required solvency margin, whichever	- No specific assumption.

¹¹ For simplicity, the calculations are based upon the limit generally applied to one of the three categories of eligible hybrids in the banking sector - innovative instruments. For further details on these categories, please refer to the CEBS report on hybrids published in March 2007 and available at www.c-ebs.org

	is lower, for undated subordinated loans and 25 % of the available or required solvency margin, whichever is lower, for dated subordinated loans; cumulative limit is 50 %).	
Participation in insurance company > 20 % ¹²	- Deduction of the participation for banks, at the pro-rata share of the capital requirement for insurance	- No example in the report.
Participation in bank	- Threshold of 10 % for banks; threshold of 20 % for insurance companies	- The IFWC has tested different simplified assumptions (see building block 2 and Annex X)
Holding of shares (investment portfolio) in financial institutions	- Deduction for banks (if more than 10 % of own funds)	- No example in the report.

37. In addition to those assumptions, with regard to Method 1, the IWCFC has made the assumption that the cross-sectoral own fund items that exceed the most stringent sectoral limit, but remain within the less stringent sectoral limit, may be included in non-cross-sectoral own funds.

¹² As an alternative to the deduction, Members States may allow their insurance undertakings or credit institutions to apply methods 1, 2, or 3 of Annex I of the Financial Conglomerates Directive 2002/87.

A. Detailed calculations

To what level do the differences in sectoral rules impact the level of own funds of a conglomerate?

38. The conclusions set out below are based on the simplified and hypothetical balance sheets of a parent entity on both solo and consolidated bases and of a subsidiary on a solo basis (see Annex IV: balance sheets)

39. In order to illustrate the differences between the sectoral rules, the following calculations of own funds have been made:

1. applying the insurance rules to the consolidated balance sheet (see Annex V: Table 1 Differences between the sectoral rules), third column (hereafter calculation 1); and
2. applying the banking rules to the consolidated balance sheet (Annex V: Table 1 Differences between the sectoral rules), fourth column (hereafter calculation 2).

40. The composition of eligible own funds can be divided into three categories :

- **Common (or cross-sectoral) own funds without limits:** they abide by the rules of both sectors and are not subject to any limit. They can be used to cover a deficit at conglomerate level not allocated to a specific sector. These are capital, reserves, retained earnings and profit for the year. In both sectors, goodwill and intangible assets are to be deducted.
- **Common (or cross-sectoral) own funds with limits:** these are common to both sectors but their eligibility is subject to some limits. As with other common own funds, they can be used to cover a deficit at conglomerate level not allocated to a specific sector. They relate to revaluation reserves, Tier 1 hybrids and subordinated loans or securities. The Commission has indicated that the most stringent limits apply.¹³
- **Non-cross-sectoral own funds:** they follow the rules of one sector and therefore can only cover the capital requirements of this sector. Non-cross-sectoral own funds may not cover the capital requirements

¹³ Two possible alternative interpretations of this statement can be found in Annex III, para.8, a and b.

of another sector, and consequently they must be located and accepted as eligible own funds in the appropriate sector.

Results of calculations 1 and 2

41. On the basis of hypothetical balance sheets, calculations 1 and 2, detailed in Annex VI (Annex VI: Table 2 Global results of building block 1) show the following results:

- a. total own funds are higher (39,100) when the insurance rules apply than when the banking rules apply (32,941);
- b. own funds common to the two sectors and not subject to limits are the same in terms of individual elements and in terms of amount (14,000),
- c. the causes of the “surplus” mentioned under a) between the two sectors are related to (i) Own funds common to the two sectors and subject to limits and (ii) Own funds that are not common to the two sectors (Annex V: Table 1 Differences between the sectoral rules).

42. **On (i), the numerical example shows that “Common own funds with limits”** are higher when the banking rules apply (18,941) than the own funds calculated on the basis of the insurance rules (14,155). This can be explained by the different limit structures of the two sectors.

43. **First, the level of the limits differs:** In practice, the 50% of capital requirements limit in the insurance sector is generally more stringent than the Tier 2 limit of the banking sector. The latter is limited to 100% of Tier 1 Capital. In insurance, the limit is the lower of 50% of the required solvency margin (capital requirements) or of the available solvency margin (own funds). 50% of the required solvency margin is generally more stringent as it applies whenever there is a surplus of own funds, which is normally the case. In the example, the difference between the amount of common own funds subject to limits is 6,316, meaning that the banking sector may recognize more common own funds with limits, notably Tier 1 hybrids and Tier 2 subordinated loans, than the insurance sector.

44. It should be underlined that limits work differently in the two sectors:

- a. in the insurance sector, under the condition that the available solvency margin is higher than the required

solvency margin, if the capital requirement of an insurance entity increases by 1 euro, the limit increases mechanically by 0.50 euro. In the banking sector, if the capital requirement of a bank increases by 1 Euro, the bank has to issue 1 Euro of new capital;

- b. in the banking sector, if the amount of Tier 1 decreases by 1 euro (e.g. due to losses), the amount of Tier 2 decreases mechanically by 1 euro. In the insurance sector, if unlimited own funds decrease by 1 euro, there is no further decrease in the limits on other elements¹⁴.

45.**Second, what is limited differs.** The fact that a portion of hybrids may be included in Tier 1 in the banking sector increases the amount of Tier 2 capital. In the example, this enables the bank to have more common own funds subject to the limit, in an amount of 2,471 corresponding to the portion of hybrids included in Tier 1. In the insurance sector, hybrids are treated as subordinated loans and are subject to the limit of 50% of the required/available solvency margin.

46.Revaluation reserves are accepted without limit in the insurance sector but they are included within the Tier 2 limit in the banking sector.

47.**On (ii), non-cross-sectoral own funds which relate to latent gains on assets and unpaid capital.** In the example, they are recognized in the insurance sector, for an amount of 10,945, but not in the banking sector.

48.On the basis of the numerical example set out in Table 1, it can be concluded that the insurance sector could have an advantage with regard to:

- a. unrealized latent gains on assets (not included in the banking sector)
- b. revaluation reserves (included only in Tier 2 in the banking sector); and
- c. unpaid capital (not included in the banking sector).

49.The banking sector could have an advantage with regard to:

- a. hybrid instruments (Can qualify as Tier 1 instruments in the banking sector);

¹⁴ Except when the insurer's available solvency margin is lower than its required solvency margin (but this is not generally the case).

- b. subordinated loans. (The difference between the Tier 2 limit of 100% of original own funds and the insurance limit of 50% of required/available solvency margin normally allows for a higher amount of hybrids and subordinated loans to be eligible in the banking sector. This is not the case though when the available solvency margin is lower than the required solvency margin.)
50. This leads to the fact that issuing hybrids or subordinated securities from the banking sector is normally more advantageous from a regulatory own funds perspective. Having unrealized latent gains and revaluation reserves in the insurance sector is also more advantageous.
51. The advantages of the insurance sector identified are mainly driven by the health of the financial market, which influences the levels of the revaluation reserves or unrealized gains on assets. These can also be influenced by management decisions relating to investment strategies. The advantages of the banking sector identified in paragraph 49.b. and the insurance sector in paragraph 48c. will depend mainly on management decisions.

Building block 1: Do sectoral differences change if the parent is a bank or an insurance company?

52. The purpose of the exercise is to test whether the fact that the head of a conglomerate is a bank or an insurance company makes any differences/impact on the differences highlighted above.
53. Two situations are analysed in this report:
- a bank owns 100% of an insurance subsidiary;
 - an insurance company owns 100% of a bank.
54. The IWCFC has made similar calculations when the percentage of ownership is 75% and 30%. Their results confirmed the findings identified for 100% ownership. The amount of total own funds decreased due to the decrease in the participation.
55. The three methods of calculation included in the FCD have been tested:
- o applying Method 1 (consolidation) (Annex VII: Table 3 : Results of Method 1);
 - o applying Method 2 (aggregation/deduction) (Annex VIII: Table 4: Results of Method 2);
 - o applying Method 3 (book value/requirement deduction method) (Annex IX: Table 5: Results of method 3).

Result of calculation 3: Method 1 - consolidation

56. When calculating the supplementary capital adequacy of a conglomerate, Method 1 compares the consolidated own funds of the FC with the sum of the capital requirements of the different sectors. The IWCFC chose to base the calculation of cross-sectoral and non-cross-sectoral own funds on their consolidated amount (One of the two possible interpretations of rule 3, see Annex III, paragraph 8, a and Annex VII: Table 3 : Results of Method 1).
57. **Common own funds without limits** relate to capital, reserves, retained earnings and profit, less deduction of goodwill and intangible assets. They are the same whether the parent is a bank or an insurance company (14,000).
58. **Common own funds with limits** relate to revaluation reserves, hybrids and subordinated loans (with indeterminate duration and with fixed term). When the limit is different between the two sectors, only the amount within the lower limit may be considered as cross-sectoral (see para 40, second bullet)
59. Taking the numerical example, the amount of eligible own funds subject to limit and as calculated on the basis of the insurance rules is 14,155 (4,000 without limit for the revaluation reserves and 50% of the capital requirement = 10,155 for hybrids and subordinated loans). The amount of eligible own funds subject to limit and as calculated on the basis of the banking rules is 18,942 for these elements (2,471 of hybrids included in Tier 1 and the Tier 2 limit of 16,471).
60. In application of the principle that the most stringent rules apply, only a maximum amount of 14,155 can be counted as cross-sectoral own funds. This amount does not change, if the parent is a bank or an insurance company.
61. **Non-cross-sectoral own funds** are:
- latent unrealized gains on assets (5,070) and unpaid capital of the insurance company (250) are taken into account in the calculation up to the capital requirement of the insurance company;
 - o 4,787 (difference between 18,942 and 14,155) may be accepted as non-cross-sectoral own funds in the banking sector if the relevant items (in this case subordinated loans and hybrids) are booked and are eligible as own funds in the banking sector, in the application of paragraph 40 above.¹⁵
62. As a conclusion, the calculations for Method 1 show that:

¹⁵ This is an interpretation made by the IWCFC.

- o the difference between the sectoral limits has an influence on the level of cross-sectoral own funds and non-cross-sectoral own funds. If the amount of one or several elements subject to a limit exceeds the lower limit, it is important for a FC, in order to recognize these elements as non-cross-sectoral own funds, to place them in the appropriate sector (where they have a greater chance of being recognized). Intra-group transactions may be used to place the own funds in the appropriate sector. In the examples, these elements are mainly hybrids;
- o the non-cross-sectoral own funds, such as unrealized latent gains and unpaid capital, are also recognized at conglomerate level but only, in this example, for the part covering the insurance requirements;
- o it makes no difference to the amount of non-cross-sectoral own funds (4,786) whether the bank or the insurance company is the parent.

Result of calculation 4: Method 2 - aggregation/deduction

63. When calculating the supplementary capital adequacy of a conglomerate, Method 2 adds up the own funds of each entity within the group and deducts their capital requirements and the book values of the participations. There is no consolidation. The capital requirements of the subsidiary are pro-rated according to the size of the participation of the parent.

64. This can be expressed as follows:

$SCA = (OF1 + OF2 \dots) - [(S1 + S2 \dots) + (BV1 + BV2 + \dots)]$

Where:

- SCA = Supplementary Capital Adequacy
- OF = Own Funds of the entity
- S = Solvency requirement of the entity
- BV = Book Value of the parent's participation.

65. The calculation (Annex VIII: Table 4: Results of Method 2) is based on the solo situation of each sector, hence:

- o the sectoral differences in the composition of own funds and in the calculation of limits are automatically reflected in the own funds of the conglomerate;
- o it makes no difference whether the bank or the insurance company is the parent.

Result of calculation 5: Method 3 –Book value/requirement deduction method

66. When calculating the supplementary capital adequacy of a conglomerate, Method 3 compares the regulatory capital resources of the parent with the capital requirement of the parent and the higher of the participation in and the capital requirement of the subsidiary. There is no consolidation. The capital requirements of the subsidiary are pro-rated according to the size of the participation of the parent. As it stems from IGD, Annex I, the prerequisite for the use of this method is that participations are valued by the equity method.

67. This can be expressed as follows:

$$SCA = POF - PCR - (\max(PP; SubCR))$$

Where:

- SCA = Supplementary Capital Adequacy
- POF = Parent own funds before participation
- PCR = Parent capital requirement
- PP = Participation of parent in subsidiary
- SubCR = capital requirement of subsidiary.

68. It is assumed that the deductions are made in sequence for each subsidiary (i.e. one subsidiary after the other; there is a cumulative deduction). The alternative method of computation would have been to add up all the capital requirements of all subsidiaries and then deduct. This would have led to the excess capital offsetting the deficits, which was not considered to be prudent. (Annex IX: Table 5: Results of method 3)

69. Differences in results between a bank and an insurance parent are driven by limits on eligible capital at the parent level only. Different outcomes generated by method 3 are driven by the following differences in sectoral rules:

- a. calculations of the appropriate limits for supplementary own funds (where there will be a benefit if the parent is a bank);
- b. treatment of hybrid capital instruments (where there will be a benefit if the parent is a bank);
- c. treatment of unrealized profits (where there will be a benefit if the parent is an insurer);
- d. treatment of revaluation reserves (where there will be a benefit if the parent is an insurer).

70. The differences identified at (a) and (b) above are structural, inasmuch as they are a function of the position of banks and insurers within the group.
71. The differences identified at (c) and (d) above are driven by the health of the financial market.
72. Intra-group transactions have no impact, as method 3 does not consider the capital resources of the subsidiaries.

General conclusions of building block 1 (see Annex VI)

73. Sectoral differences have an impact on the level of the own funds of a conglomerate.

74. For Method 1, non-cross-sectoral own funds are recognized only if they are booked in the sector in which they are eligible, subject to the limit for the sector in question. Therefore it could be more useful to have unrealized latent gains or unpaid capital in the insurance side of a FC.
75. For common own funds subject to limits, the difference in limits between the two sectors has an influence on the qualification of cross- and non-cross-sectoral own funds. If some elements, such as revaluation reserves, hybrids or subordinated loans, exceed the lower limit between the two, they are considered non-cross-sectoral own funds and treated as such. Therefore a FC may in theory profit from locating these items in the sector where they may be used to cover a capital requirement or, in general, where the limit is less stringent.
76. In Method 2, the calculation is based on the solo position of each company, so the sectoral differences in the composition of own funds and in the calculation of limits are mechanically reflected in the own funds of the conglomerates.
77. In Method 3, the calculation is based on the solo position of the parent. Therefore, whether the parent is an insurance company or a bank, the differences in the definition of own funds between the two sectors are still important elements.

78. The results of the 3 FCD methods are different.

79. The difference in the results between Methods 1 and 2 is due to the fact that the limits applicable to “common own funds with limits” are calculated at **solo** level and before eliminating intra-group creation of own funds in Method 2, and at **consolidated** level in Method 1. So, in general, Method 2 will make it possible to recognize more ‘common own funds with limits’ than Method 1. However, starting from this “automatic” result of Method 2,

additional amendments were made in order to eliminate the effects of intra-group transactions.

80. The level of own funds and surplus in Method 3 is influenced by the nature of the parent (insurance company or bank). This method is not comparable to Methods 1 and 2.

81. Whether the parent is a bank or an insurance company is only important in Method 3.

82. As regards FCD Methods 1 and 2, whether a conglomerate has a bank or an insurance company as its ultimate parent does not impact the calculation of regulatory capital. This conclusion is different for Method 3, because the own funds are calculated on the basis of the rule applicable to the parent.

Building block 2: The impact of having different thresholds for deductions

83. As indicated in the Comparison report, there are differences in the threshold for deductions:

	Holdings in credit institutions	Participations in insurance undertakings
Insurance company (parent)	Deduction if > 20% or, if less, in case of strict link	Deduction if > 20% or, if less, in case of strict link
Bank (parent)	Deduction if > 10% or, if less, the total amount exceeds 10% of own funds	Deduction if > 20% or, if less, in case of strict link ¹⁶

84. This building block aims to test the impact of having different thresholds. It may be that Member States have a different understanding of the definition of a participation or a holding (notably in the interpretation of durable links). These differences have not been explored for the sake of simplification.

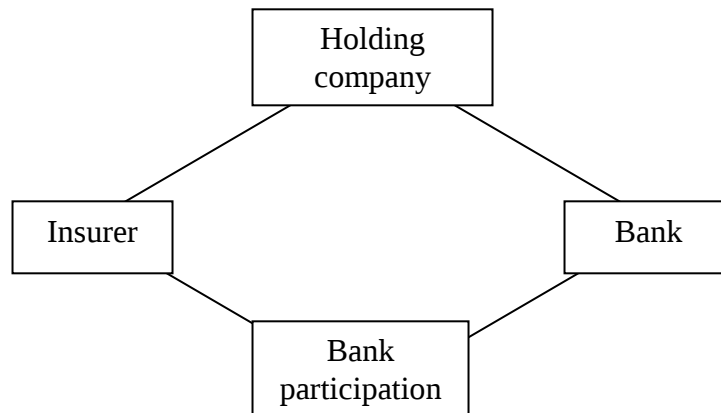
85. The test addresses the situation where a holding in a bank falls between the 10 and 20 % limit.

¹⁶ As an alternative to the deduction, Member States may allow their insurance undertakings or credit institutions to apply methods 1, 2, or 3 of Annex I to the Financial Conglomerates Directive 2002/87.

86. For participations under 10 %¹⁷, there will be no deduction, as they exceed none of the limits.

87. Holdings over 20 % are deducted under both sectoral rules.

88. The numeric example has been structured as follows:



The insurance entity and the bank in the conglomerate own the same bank (up to 19% in total):

- a. Respectively at 10% and 9%,
- b. Respectively at 9% and 10%,
- c. Respectively at 0% and 19%,
- d. Respectively at 19% and 0%.

89. Different possible options for Method 1 have been considered. It is not clear which of these three options is applied in practice.

90. For Method 2 the sectoral rules at sectoral level are applied.

91. For Method 3 the issue is not relevant.

92. The calculations are detailed in Annex X: Table 6 : Deductions.

General conclusions on building block 2 (see Annex X)

93. In Methods 1 and 2, the holder of the participation is relevant. Depending on the method used, it could be more advantageous if holdings of more than 10% and less than 20% are held by an insurance undertaking rather than by a bank in order to avoid a deduction.

¹⁷ In the banking sector, it is assumed that holdings in banks below 10% do not exceed 10% of the participating bank's own funds before deductions.

94. However, the insurance 20% deduction limit is a simplification – actually all holdings in relevant undertakings qualifying as participations have to be deducted but only holdings of at least 20% are automatically treated as participations.
95. Additionally, it can be pointed out that Articles 22, 23, 28 and 29 of the FCD give the Member States the option not to deduct at solo level (sectoral or cross-sectoral) participations which are consolidated under sectoral rules or treated under one of the FCD methods. Hence, in those Member States that have used the option not to deduct, cases where these deductions could apply and consequently where a difference could be found between both sectors, would be rare.
96. Differences in sectoral rules regarding the treatment of deductions do not have an impact on the supplementary capital adequacy requirement calculated using Method 3. This is because only the capital resources of the parent are considered. As a result, deductions made from the capital resources of a subsidiary will not flow through to the final calculation of the supplementary capital adequacy of the conglomerate

B. Reality check on the conclusions

97. Bearing in mind the inherent shortcomings of any quantitative exercise based on fictitious numerical examples, the IWCFC has had two informal meetings with experts from conglomerates and with experts designated by the CEBS and CEIOPS Consultative Panels to check whether the conclusions of the numerical examples were identifying the correct issues and were experienced in practice by market participants.
98. The IWCFC experts benefited from their constructive input.
99. During a first informal meeting, two industry representatives, one expert from a conglomerate applying method 1 of the FCD and one expert from a conglomerate applying method 2 of the FCD, were invited to present the reality and the complexity of the calculation in a real conglomerate.
100. Annex XI indicates that the sectoral differences (based on national rules) that have the most relevant impact in practice are those highlighted by the IWCFC.
101. Annex XII gives a breakdown of eligible own funds of one real conglomerate, showing the differences between the structure of the own funds of the banking activities, those of the insurance activities and of those of the conglomerate (after recalculations).
102. The expert from the conglomerate applying Method 1 highlighted that if more cross-sectoral consistency would bring anything at all, it would be to ease the rather complex computations that differences in regulations create at an operational level, and different reporting of capital requirements.
103. The expert from the conglomerate applying Method 2 indicated that it can be expected that the bank would become the financing vehicle of the group because of the better rating Basel II is likely to give to this specific entity, allowing for a cheaper cost of capital (company specific comment).
104. The expert from the conglomerate applying Method 1 proposed some potential improvements to the current calculation:
- introduction of different 'Tiers' of capital, with clear limits for insurance and as currently used in the bank sector. For example, currently the guidance with regard to limits on hybrid capital is unclear;
 - more guidance with regard to non-innovative issues and preferred shares is needed.

- regional harmonisation of prudential filters for the sector insurance sector, such as for example on unrealised capital gains (due to national differences) or deductions of catastrophe provision for insurance (country specific remark).
105. Another inconsistency is the difference in reporting rules at the group level and at national level.
106. In a second meeting, the IWCFC met with experts designated by the Consultative Panels of CEIOPS and CEBS.
107. One expert underlined that one needs to consider that the basis on which the limits are being calculated is different in both sectors. In the insurance sector, limits apply to the amount of the lower of required or available capital whereas in banking the limits apply to the tiers.
108. Representatives of (mainly) insurance companies stressed the need for a balanced view, where some apparent advantages in the insurance sector were either differences 'justified' by the differences in the businesses, for instance for unrealised gains/revaluation reserves, or not in fact of any significant benefit to this sector, such as for example unpaid capital. The industry did not elaborate thoroughly on the precise justification for these differences. Another participant from the banking sector indicated that differences in the businesses across sectors should not be a reason to support differences in the regulatory definition of capital.
109. The view was also expressed that in reality, differences between the sectoral rules did not have a considerable impact on the decision making regarding corporate structure or capital allocation, i.e. they would not restructure a conglomerate just to benefit from regulatory arbitrage. To a larger extent, other considerations are taken into account in business strategies such as the health of the financial market (unrealised gains), return on equity, tax, costs of capital and management decisions on investment strategies.
110. Participants in the meeting also underlined that harmonisation should not necessarily be the main objective and should not be pushed forward towards the lowest common denominator. They indicated that harmonisation could have serious drawbacks in the case of 'justified' differences.

Annex I: The methods of calculation laid down in the Financial Conglomerates Directive.

Method 1: Accounting consolidation method is described in the FDC as follows:

The calculation of the supplementary capital adequacy requirements of the regulated entities in a financial conglomerate shall be carried out on the basis of the consolidated accounts.

The supplementary capital adequacy requirements 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; the elements eligible are those that qualify in accordance with the relevant sectoral rules;

and

(ii) the sum of the solvency requirements for each different financial sector represented in the group; the solvency requirements for each different financial sector are calculated in accordance with the corresponding sectoral rules.

The sectoral rules referred to are in particular Directives 2000/12/EC, Title V, Chapter 3, as regards credit institutions, 98/78/EC as regards insurance undertakings, and 93/6/EEC as regards credit institutions and investment firms. In the case of non-regulated financial sector entities which are not included in the aforementioned sectoral solvency requirement calculations, a notional solvency requirement shall be calculated. The difference shall not be negative.

Method 2: Deduction and aggregation method is described in the FCD as follows:

Calculates the supplementary capital adequacy requirements on the basis of the accounts of each of the entities in the group.

The supplementary capital adequacy requirements shall be calculated as the difference between:

(i) the sum of the own funds of each regulated and non-regulated financial sector entity in the financial conglomerate; the elements eligible are those which qualify in accordance with the relevant sectoral rules;

and

(ii) the sum of

- the solvency requirements for each regulated and non-regulated financial sector entity in the group; the solvency requirements shall be calculated in accordance with the relevant sectoral rules, and

- the book value of the participations in other entities of the group.

In the case of non-regulated financial sector entities, a notional solvency requirement shall be calculated. Own funds and solvency requirements shall be taken into account for their proportional share as provided for in Article 6(4) and in accordance with Section I of this Annex.

The difference shall not be negative.

Method 3: Book value/Requirement deduction method.

The calculation of the supplementary capital adequacy requirements of the regulated entities in a financial conglomerate shall be carried out on the basis of the accounts of each of the entities in the group

The supplementary capital adequacy requirements shall be calculated as the difference between:

(i) the own funds of the parent undertaking or the entity at the head of the financial conglomerate; the elements eligible are those which qualify in accordance with the relevant sectoral rules; and

(ii) the sum of the solvency requirement of the parent undertaking or the head referred to in (i), and the higher of the book value of the former's participation in other entities in the group and these entities' solvency requirements; the solvency requirements of the latter shall be taken into account for their proportional share as provided for in Article 6(4) and in accordance with Section I of this Annex

In the case of non-regulated financial sector entities, a notional solvency requirement shall be calculated. When valuing the elements eligible for the calculation of the supplementary capital adequacy requirements, participations may be valued by the equity method in accordance with the option set out in Article 59(2)(b) of Directive 78/660/EEC.

The difference shall not be negative.

Annex II: Overview of the implementation and the use of the Methods of consolidation laid down in the FCD across the EU

In 2006, the IWCFC conducted a stock take among its members on the implementation the FCD rules. The stock take included questions on the most common capital calculation methods applied for financial conglomerates in the various jurisdictions. Hereunder you can find a summary of the answers to these questions of the stock take. The answers were updated in the course of 2007.

Which methods for calculating the capital requirements are most common in your country: method 1, method 2, method 3 or a combination of methods?

BG	The Bulgarian Law on Financial Conglomerates has entered into force on January 1, 2007 and its provisions allow the application of one of the three methods or of a combination of them, as the calculation method is decided by the coordinator after consultation with the other competent authorities concerned and with the financial conglomerate. Since the Law is in force as of the beginning of 2007, the methods for calculating the capital requirements should be applied for the first time for the financial year 2007. At present it is too early to provide concrete answers to the specific questions hereunder.
DE	The most commonly used method is a combination of methods 1 and 2.
FR	The only method currently in practice is the consolidation method
HU	The financial conglomerate coordinated by HFSA applies method 1. HFSA approves the method following a consultation with both the financial conglomerate and and the relevant competent authorities.
IT	The coordination agreement on Italian financial conglomerates [available on Italian Authorities websites (www.isvap.it , www.bancaditalia.it , www.consob.it)] identified Method 1 as the reference method for the calculation of Italian based conglomerates' own funds. The other methods are nevertheless allowed.
LU	The law of 5 November 2006 on financial conglomerates provides that the CSSF and the Commissariat aux Assurances shall set up the terms of capital requirements to be respected by a financial conglomerate. The CSSF circular 06/268 does not prescribe a calculation method but allows all the methods described in the annex I of the Directive or a combination thereof.
NL	No reporting yet (FCD has been implemented early 2007). The reference method is method 1, so we presume that method 1 will be most common.

	The Portuguese legislation implementing FCD foresees all the methods laid down in Annex I. Nonetheless the general rules of that legislation are the following: 1) method 1 (accounting consolidation) should be used if the FC is headed by a Portuguese regulated entity or if it is headed by a non-regulated entity but all relevant competent authorities are Portuguese; 2) a combination of methods 1 (accounting consolidation) and 2 (deduction and aggregation) should be used, instead of method 1, in the absence of consolidated accounts for banking and insurance sector as a whole (at the prudential supervision level); 3) in the remaining cases, the calculation method is decided by the coordinator after consultation with the other relevant competent authorities and with the financial conglomerate.
PT	
	In practice the combination of methods 1 and 2 is applied.
RO	The Romanian legal framework allows the application of any of the three methods (or of a combination of those), upon the decision taken by the coordinator. Since there are no financial conglomerates yet identified in Romania, no specific answers can be given for the time being.
SI	In accordance with the Financial Conglomerates Act (FCA), the Ministry of Finance in cooperation with all three financial supervisory authorities shall prepare and adopt a by-law (till May 2007), prescribing the methods of capital adequacy calculation. Irrespective of the method to be prescribed, the supervised entity containing a FC is obliged to assure that in calculation of FC capital adequacy the following principles will be considered: (i) elimination of double or multiple capital application and; (ii) assurance of adequacy of capital components for coverage supplement capital requirements, taking account possible restrictions of capital transfer inside the group..
SE	No reporting yet, preliminary study indicates that method 2 will be most common. Discussions are ongoing on possible combinations of methods 1 and 2 (to use consolidated figures for different groups in the sectors, in Method 2)
UK	Method 4 (combination of methods) is the most common method. In some cases, we can decide to require another method but we have not generally done so.

Method 1 in Annex I, accounting consolidation,

AT	This is the most common method. For not consolidated entities – Method 2. Depending on the availability of consolidated accounts on group level, accounts were aggregated on a conglomerate-level using method 2.
BE	The accounting consolidation is the general rule.
CZ	No.
DE	The method is implemented in law.
DK	Partly used.
ES	No.
FI	Yes.
FR	This method is the general rule. Nevertheless we adopted the 3 methods in our French regulation. In specific circumstances and after consulting the other relevant competent authorities, the Commission bancaire or the ACAM can allow the application of the other FCD methods (article 14 of our regulation n°2000-03 relative to prudential supervision on a consolidated basis and to supplementary supervision and article R 334-50 of insurance code).
GR	We do not intend (for the moment) to apply Method 1 due to the difficulty of consolidating the insurance companies of the groups.
HU	Method 1 (accounting consolidation) is implemented in the legislation.
IR	Yes.
IT	Reference method (see above).
LU	See above.

NL	All 4 methods allowed in regulation based on law. However, the consolidation method Method 1 is implemented by the supervisor as the reference method (and also previously used in our country).
NO	Yes.
PL	No FC's identified, all four methods allowed
SK	Methods 1 – 3 are allowed.
UK	In some cases, we can decide to require Method 1 but we have not generally done so.

Method 2 in Annex I, deduction and aggregation,

AT	No.
BE	No, unless approval of the CBFA.
BU	All three methods allowed.
CZ	No.
DE	The method is implemented in law.
DK	Partly used.
ES	No.
FR	Not applied yet, but may be applied after a formal approval of the Commission bancaire or ACAM.
GR	We propose to apply this method for its simplicity, to avoid double gearing and because consolidated accounts are not available for the financial conglomerate under supervision.
HU	Yes, method 2 (deduction and aggregation) is implemented in the legislation.
IT	Method allowed (see above).
LU	See above.
NL	Only allowed after supervisory approval.
NO	Not in use.
PL	No financial conglomerates identified, all four methods allowed.
SK	Methods 1 – 3 allowed.
SE	See above
UK	In some cases, we can decide to require Method 2 but we have not generally done so.

Method 3 in Annex I, book value/requirement deduction

AT	No.
BE	No, unless approval of the CBFA.
BU	All three methods allowed.
CZ	No.
DE	The method is implemented in law but only used in one case.
DK	Not used.
ES	No.
FR	Not applied yet, but may be applied after a formal approval of the Commission bancaire or ACAM.
GR	We also propose to apply this method, but not in the case of the financial conglomerate under supervision, because there is not a parent company at the head of the group.
HU	The method 3 (value requirement deduction) is implemented in the legislation.
IT	Method allowed (see above).
LU	See above.
NL	Only allowed after supervisory approval.
NO	Not in use as a separate method.
PL	No FC's identified, all four methods allowed.
SK	Methods 1 – 3 allowed.

UK In some cases, we can decide to require Method 3 but we have not generally done so.

Or a combinations of those method, and if so which combination?

AT No.
 BE No, unless approval of the CBFA.
 CY Combination of methods 1,2 and 3 or a combination of two of these methods.
 CZ Yes.
 DE The combination of method 1 and 2 is allowed. This is the most common method in our country.
 DK Used.
 ES Yes. A combination of 1 and 2
 FR Not applied yet, but may be applied after a formal approval of the Commission bancaire or ACAM.
 GR No.
 HU Combination of methods 1,2 and 3 or a combination of two of these methods might be allowed by the coordinator.
 IT Method allowed (see above).
 LU See above.
 NL Only allowed after supervisory approval.
 NO Accounting consolidation and deduction and aggregation methods are used in combination for some groups.
 PL No financial conglomerates identified, all four methods allowed.
 PT Combination between the accounting consolidation method and deduction and aggregation.
 SK N/A
 SE See above.
 UK Method 4 (combination of methods) is our default method. For banking-led conglomerates, it is a combination of Methods 1 and 3; for insurance-led conglomerates, it is a combination of Methods 2 and 3.

What are the main arguments for your choice of calculation method?

AT Simple to calculate for the conglomerates; Easy to understand; Low costs of implementation on a conglomerate level.
 BE Consolidation method is used for the general accounting.
 BG The wish to give flexibility to financial conglomerates to calculate their capital requirements.
 CY The widest choice of calculation methods is available, in order to give the coordinator and the regulated entities the flexibility for choosing the most appropriate method.
 CZ The structure of the group.
 DE At the moment credit institutions/investment firms are still not allowed to use the accounting consolidation for supervisory reporting.
 DK Method 1 is currently used in the banking sector and Method 2 in the insurance sector.
 ES Simplicity, effectiveness and a continuity with the system that has been in force in Spain from 1997 (Spanish banking institutions with significant stakes in insurance companies have had to comply with capital requirements at the so called mixed group level –broadly equal to the conglomerate- from that date on, applying a methodology which is very similar to the aggregation / deduction method set out in the directive)
 FI Consolidation method is used in accounting.

FR	The Commission bancaire and ACAM's aims were: (i) to apply a similar method for all the financial conglomerates to maintain a level-playing field; (ii) (even though we introduce a flexibility possibility); (iii) to get a clear-cut view on the capital adequacy of the group, consequently we kept an accounting approach (less discrepancies between the prudential and accounting approaches).
GR	See above.
HU	By including all the three methods the Hungarian legislation intends to provide flexibility in the field of calculation. Method 1 (i.e. consolidation method) has been chosen in respect of the financial conglomerate coordinated by HFSA as it is simple to calculate for the conglomerate and this is the one that has been proposed by the conglomerate itself.
IR	Proposed by the FC's concerned and proved to be easier to work through. While agreeing on Method 1, one of the FC's will report to us under all 3 Methods.
IT	Method 1 is the most common method already used in Italy at sectoral level, both in insurance and banking sector.
LU	N/A since currently no financial conglomerate has been identified in Luxembourg.
NL	Method 1 has been used for years to calculate the capital adequacy of financial conglomerates, and would therefore continue current practice. Method 1 is viewed as most consistent with consolidated banking supervision and supplementary insurance supervision + consistent with accounting. Methods 2, 3 and 4 however, are also allowed after preliminary approval by the supervisor.
NO	Accounting consolidation is the fall-back method. Combination of Accounting consolidation and Deduction aggregation methods are used where holdings are deemed insignificant to the overall risk of the group i.e. a deduction is applied rather than consolidating those participations deemed insignificant, and only after the FSA's approval.
PL	Data availability necessary for correctly applying methods 1, 2, 3 or 4 – decision is discretionally made by the potential coordinator based on availability of financial data (consolidated accounts, aggregated data, book value financial data)
PT	In the absence of consolidated accounts for banking and insurance sector as a whole (at the prudential supervision level), we aggregate the consolidated own funds and capital requirements for each sector and deduct the intra group transactions and the common elements of own funds.
SK	Data availability is necessary for correctly applying methods 1, 2, 3. A decision is made discretionally, based on availability of financial data (consolidated accounts, aggregated data, book value financial data)
UK	We decided to implement the FCD with as little change to the capital requirements as possible and, as far as possible, to maintain a level playing field between a banking group and a banking-led conglomerate (and the same for insurance). So we made the small changes needed to bring our pre-existing rules for banking groups and insurance groups into line with Method 4 (Methods 1&3 or 2&3 as noted above) under the FCD.

Annex III: Definition of the rules laid down in the FCD

1. The IWCFC based its analysis on both the technical principles of Annex 1, I. 2 of the FCD and its commonly agreed interpretation published on the Commission's website. This interpretation does not exclude other possible interpretations of the FCD, as explained in detail in para. 40.
2. The rules below apply regardless of the method used for the calculation of the supplementary capital adequacy requirements of conglomerates.
3. For the sake of its analysis, the IWCFC has made few assumptions.
4. **Rule 1:** "The multiple use of elements eligible for the calculation of own funds at the level of the financial conglomerate (multiple gearing) as well as any inappropriate intra-group creation of own funds must be eliminated; in order to ensure the elimination of multiple gearing and the intra-group creation of own funds, competent authorities shall apply by analogy the relevant principles laid down in the relevant sectoral rules".
 - a. In its calculations, for the sake of simplicity the IWCFC assumed that there was no 'intra-group' lending or creation of capital from the start.
 - b. Double gearing: For Method 1, different options for deductions from total own funds have been investigated. For Method 2, the book value of the subsidiaries was deducted so that any double gearing was eliminated. For Method 3 double gearing is eliminated because only own funds of the parent undertaking are taken into account and the higher of the parent's investment in the subsidiary and the subsidiary's capital requirement is deducted.
5. **Rule 2:** "Pending further harmonisation of sectoral rules, the solvency requirements for each different financial sector represented in a financial conglomerate shall be covered by own funds elements in accordance with the corresponding sectoral rules; when there is a deficit of own funds at the financial conglomerate level, only own funds elements which are eligible according to each of the sectoral rules (cross-sector capital) shall qualify for verification of compliance with the additional solvency requirements".
 - a. For Method 1, this implies that cross-sectoral own funds first cover the solvency requirements at the conglomerate level.

- b. On the other hand, since the supervision of financial conglomerates is “supplementary”, the solvency requirements (both at a group and solo level) for each financial sector must be covered by own funds/eligible elements of the same sector. If this condition is respected, a different interpretation of the rule implies that to be eligible at the conglomerate level each element has to fulfill the requirement of the relevant sector. In a case where a deficit arises at the conglomerate level, only cross-sectoral elements would be eligible to cover it.
6. **Rule 3:** “Where sectoral rules provide for limits on the eligibility of certain own funds instruments, which would qualify as cross-sector capital, these limits would apply mutatis mutandis when calculating own funds at the level of the financial conglomerate”.
7. As indicated by the Commission¹⁸, this means that to count as cross-sectoral capital, the own funds elements must meet each of the sectoral rules. Therefore, if there is a limit in one sector and a higher limit in another sector, then only amounts within the lower/most restrictive limit can count as cross-sectoral capital.
8. This rule can bear different possible interpretations:
 - a. One possible interpretation is that it is the consolidated position of the conglomerate (including those situations where the parent undertaking is a mixed financial holding company) that is the most important factor. Therefore the limits that are to be applied are those based on the consolidated accounts.
 - b. According to another interpretation, taking into account that the FCD also states that when calculating capital adequacy “the elements eligible are those that qualify in accordance with the relevant sectoral rules”, eligible elements at conglomerate level are the sum of the amounts eligible at sectoral level. In addition, in the insurance sector the situation varies between MS and in some cases eligible elements are not recalculated at the consolidated level of the group, but are subject to the limits applied at solo level (typically subordinated debt, life assurance funds, subscribed but not paid-up capital). In this case, in order to fulfil the relevant sectoral rules, eligible own funds may only be included in the calculation in so far as they are eligible to cover the solvency margin requirement of that related undertaking.

¹⁸ See question 58 in http://ec.europa.eu/internal_market/financial-conglomerates/docs/20051114_issues_en.pdf

9. **Rule 4:** “When calculating own funds at the level of the financial conglomerate, competent authorities shall also take into account the effectiveness of the transferability and availability of the own funds across the different legal entities in the group, given the objectives of the capital adequacy rules”.
- a. The IWCFC is of the view that by construction the consolidation method (Method 1) assumes that the underlying principles of transferability and availability of own funds across legal entities are respected.
 - b. Method 2 considers own funds and the solvency requirements at each single entity level, transferability is therefore not an issue.
 - c. Method 3 considers own funds at the parent level and not at subsidiary level. Only the requirements of subsidiaries are included in the calculation of the supplementary capital adequacy. Transferability is therefore not an issue.

Annex IV: balance sheets

Building block 1: Mother bank with 100 % insurance subsidiary

Solo balance sheet of the mother bank

Assets (MEUR)		Liabilities (MEUR)	
Intangible assets	2000	subscribed capital	10500
Other assets	187500	(Unpaid Capital)	-500
Participation in the entity 100 % (an insurance if the balance sheet is of a bank; a bank if the balance sheet is of an insurance)	11000	Statutory reserves	5500
		Profit and loss	250
		Hybrids (this is the gross value- the limit is not applied)	7000
		Revaluation reserves	2000
		Securities of indeterminate duration/cumulative preference shares (this is the gross value- the limit is not applied)	15000
		Fixed-term securities/ Cumulative preference shares (this is the gross value- the limit is not applied)	15000
		Other liabilities	145750
Total	200500	Total	200500

Capital requirement 15000

unrealized gains on assets 5625

Solo balance sheet of the insurance subsidiary

Assets (MEUR)		Liabilities (MEUR)	
Intangible assets	2000	subscribed capital	10500
Other assets	169000	(Unpaid Capital)	-500
		Statutory reserves	3000
		Profit and loss	250
		Hybrids (this is the gross value- the limit is not applied)	3000
		Revaluation reserves	2000
		Securities of indeterminate duration/cumulative preference shares (this is the gross value- the limit is not applied)	10000
		Fixed-term securities/ Cumulative preference shares (this is the gross value- the limit is not applied)	10000
Total	171000	technical provisions	132750
		Total	171000

capital requirement 5310

unrealized gains on assets 5070

Consolidated balance sheet

Assets (MEUR)		Liabilities (MEUR)	
Intangible assets	4000	subscribed capital	10500
Other assets	356500	(Unpaid Capital)	-500
goodwill	1000	consolidated reserves	8500
		Profit and loss part of the group	500
		third party interest	
		Hybrids (this is the gross value- the limit is not applied)	10000
		Revaluation reserves	4000
		Securities of indeterminate duration/cumulative preference shares (this is the gross value- the limit is not applied)	25000
		Fixed-term securities/ Cumulative preference shares (this is the gross value- the limit is not applied)	25000
		Other liabilities (technical provisions if insurance)	278500
	361500		
			361500

Capital requirement 20310

unrealized gains on assets 10695

Building block 1: Mother with insurance with 100 % bank subsidiary

Solo balance sheet for the mother insurance company

Assets (MEUR)		Liabilities (MEUR)	
Intangible assets	2000	subscribed capital	10500
Other assets	169000	(Unpaid Capital)	-500
Participation in the entity 100 % (an insurance if the balance sheet is of a bank; a bank if the balance sheet is of an insurance)	11000	Statutory reserves	3000
		Profit and loss	250
		Hybrids (this is the gross value- the limit is not applied)	3000
		Revaluation reserves	2000
		Securities of indeterminate duration/cumulative preference shares (this is the gross value- the limit is not applied)	10000
		Fixed-term securities/ Cumulative preference shares (this is the gross value- the limit is not applied)	10000
		technical provisions	132,750
		other debt	11,000
Total	182000	Total	182000

capital requirement 5310

unrealized gains on assets 5070

Solo balance sheet for the subsidiary bank

Assets (MEUR)		Liabilities (MEUR)	
Intangible assets	2000	subscribed capital	10500
Other assets (at book value)	187500	(Unpaid Capital)	-500
	0	Statutory reserves	5500
		Profit and loss	250
		Hybrids (this is the gross value- the limit is not applied)	7000
		Revaluation reserves	2000
		Securities of indeterminate duration/cumulative preference shares (this is the gross value- the limit is not applied)	15000
		Fixed-term securities/ Cumulative preference shares (this is the gross value- the limit is not applied)	15000
Total	189500	Other liabilities	134750
		Total	189500

Capital requirement	15000
unrealized gains on assets	5625

Annex V: Table 1 Differences between the sectoral rules

Table 2 : insurance versus banking rules	Amounts (consolidated)	Insurance	Bank	differences	explanation
Common own funds without limit		14000	14000		
Paid-up capital	10000	10000	10000		
Consolidated reserves	8500	8500	8500		
Profit and loss, group share	500	500	500		
Less : Intangible assets	-4000	-4000	-4000		
Goodwill	-1000	-1000	-1000		
					Difference arises due to :
Common own funds with limits		14155	18941	-4786	- difference in the level of the limits (50% of MCR for insurance = 10115 compared to 100% of Tier 1 for banks = 16471*)
Revaluation reserves	4000	4000	For these 4 elements, 2.471 of hybrids may be included in Tier 1. The excess hybrids and the other 3 may be included up to 16471 (limit Tier 2)		(Positive impact on banks = 6316)
Hybrids	10000	These 3 elements may be included in own funds up to 50 % of capital requirements (10.155)			- difference in the items subject to limits:
Non-fixed-term securities	25000				+ revaluation reserves: no specific limit in insurance, included in Tier 2 in banks (positive impact on insurance = 4000)
Fixed-term securities	25000				+ hybrid instruments : for banks included in Tier 1 up to 15% and in Tier 2, for insurance: limit of 50% of MCR (positive impact on banks = 2470)
					Total impact = 6316 + 2470 - 4000 = 4786
Non-cross sectoral own funds	11195	10945	0	10945	Differences arise due to:
Unpaid capital	500	250	0		- unpaid capital not recognized in banks (positive impact on insurance: 250)
Unrealized gains on assets	10695	10695	0		- latent gains not recognized in banks (positive impact on insurance: 10695)
TOTAL OWN FUNDS		39100	32941	6159	
Capital requirements	20310	20310	20310		
SURPLUS/DEFICIT		18790	12631		

Annex VI: Table 2 Global results of building block 1

Table 1 : global results	Amount on consol. basis	calculation 1	calculation 2	FCD method 1 (bank mother) (see table 3)	FCD method 2 (bank mother) (see table 4)	FCD Method 3 (see table 5)	
		Insurance (see table 1)	Bank (see table 1)			Bank mother	Insur. Mother
Common own funds without limit		14000	14000	14000	25000	13750	13750
paid up capital	10000	10000	10000	10000	20000	10000	10000
consolidated reserves	8500	8500	8500	8500	8500	5500	5500
Profit and loss part of the group	500	500	500	500	500	250	250
Less							
intangible assets	-4000	-4000	-4000	-4000	-4000	2000	2000
Goodwill	-1000	-1000	-1000	-1000			
Common own funds with limits		14155	18942	14155	23258	18602	9500
revaluation reserves	4000	4000 (rev. res.)		4000 (rev. res.)		2.426 hybrids in tier I and 16.176 of tier II items	2000 (rev. res.)
Hybrids	10000	+ 10155 (50 % of cap. requ.) for hybrids and sub.)	2.471 hybrids in tier I and 16.471 of tier II items	+ 10155 (50 % of cap. requ. for hybrids and sub.)			7500 of hybrids and sub. (50% cap.requ.)
securities with indeterminate duration	25000						
Fixed term securities	25000						
Non cross sectoral own funds	11195	10945	0	10106	5070		5875
unpaid capital	500	250	0	250	0		5625
unrealized gains on assets	10695	10695	0	5070	5070		250
<i>Excess compared to the lower limit (for method 1)</i>				4786			
TOTAL OWN FUNDS		39100	32942	38261	53328	32352	25375
capital requirements	20310	20310	20310	20310	20.310	15000	15000
<i>Deduction book value of participation (method 2 and 3)</i>					11.000	11000	11000
Surplus/deficit		18790	12632	17951	22018	6352	3125

Annex VII: Table 3 : Results of Method 1

Table 3 : method 1 consolidation method	Parent bank with 100% insurance subsidiary				Parent insurance co. with 100% bank subsidiary	
	Amount (consolidated)	limit for banks	limit for insur.	eligible amount	amount	Eligible amount
Total cross-sectoral own funds without limits	14000			14000	14000	14000
Revaluation reserves	4000	2471 hybrids in Tier 1 and 16471 m for the excess hybrids and the other 3 elements	no limit for rev. reserves		4000	
Hybrids	10000		Hybrids and subord. may be included up to 50% of Cap. Requir. = 10155		10000	
Non-fixed-term securities	25000				25000	
Fixed-term securities	25000				25000	0
Total cross-sectoral own funds with limits	64000	Total eligible elements = 2471 +16471 = 18942	Total eligible elements = 4000 +10155 = 14155	14155	64000	14155
Non-cross-sectoral own funds covering insurance requirements						
Unpaid capital	500		250	250	500	250
Unrealized gains on assets	5070			5070	5070	5070
Non-cross-sectoral own funds covering banking requirements						
Excess compared to the lower limit of cross-sectoral own funds with limits	18941-14155 = 4786	9603		4786	4786	4786
TOTAL				38261		38261
Capital requirements				20310		20310
Surplus/deficit				17951		17951

Annex VIII: Table 4: Results of Method 2

Table 4 : method 2 - aggregation/deduction	Amounts on solo basis : bank (1)	Eligible own funds : bank (2)	Amounts on solo basis : insurance (3)	Eligible own funds : Insurance (4)	Total if bank Mother (5) = (2)+(4)	Total if insurance Mother (6) = (4) + (2)
Common own funds without limit		13750		11250	25000	25000
paid up capital	10000	10000	10000	10000	20000	20000
reserves	5500	5500	3000	3000	8500	8500
profit	250	250	250	250	500	500
less						
intangible assets	2000	2000	2000	2000	4000	4000
Common own funds with different limits		18603		4655	23258	23258
revaluation reserves	2000	2.426 hybrids in tier I and 16.176 m in tier II for the excess hybrids and the other 3 elements	2000	no limit for rev. reserves (2000) Hybrids and subord. may be included up to 50 % of Cap. Requis. = 2655		
hybrids	7000		3000			
securities with indeterminate duration	15000		10000			
Fixed term securities	15000		10000			
Non cross sectoral own funds				5320	5320	5320
Unpaid capital	500	0	500	250	250	250
unrealized gains on assets	5.625	0	5070	5070	5070	5070
TOTAL OWN FUNDS		32353		21225	53578	53578
capital requirements		15000		5310	20310	20310
deduction (book value of intra group participation)					11000	11000
Margin					22268	22268

Annex IX: Table 5: Results of method 3

	Amount (on solo basis of the mother)	Bank mother	Insurance mother
Table 5 : method 3			
Common own funds without limit		13750	13750
paid up capital	10000	10000	10000
Reserves	5500	5500	5500
Profit	250	250	250
Less			
intangible assets	2000	2000	2000
Common own funds with different limits		18603	9500
revaluation reserves	2000	2.426 of hybrids included in tier I + 16.176 for the other items	2000 (rev. reserves without limits)
Hybrids	7000		7500 of other items (50 % of the cap. requir.)
securities with indeterminate duration	15000		
Fixed term securities	15000		
Non cross sectoral own funds covering insurance requirements			
unrealized gains on assets	5625		5625
securities with indeterminate duration	500		250
TOTAL OWN FUNDS		32353	29125
capital requirements		15000	15000
deduction (higher of the book value of the capital requirements of the subsidiary)		11000	11000
Surplus/deficit		6353	3125

Annex X: Table 6 : Deductions

Table 6 Deductions	Method 1			Method 2
	Option 1 = applying the rule of the mother (or the main sector)	Option 2 = applying the rule of the booking entity	Option 3 = applying the most stringent rule	
if mother (main sector) is a bank				
19 % in the bank	1900	1900	1900	1900
19 % in the insurance	1900	0	1900	0
10 % in bank and 9 % in insurance	1900	1000	1900	1000
9 % in bank and 10 % in insurance	1900	900	1900	0
if mother (main sector) is an insurance				
19 % in the bank	0	1900	1900	1900
19 % in the insurance	0	0	1900	0
10 % in bank and 9 % in insurance	0	1000	1900	1000
9 % in bank and 10 % in insurance	0	900	1900	0

Annex XI: Reality check: Differences, based on the rules of a national jurisdiction, in the capital elements of a FC applying FCD method 1

Own funds elements	Bank	Insurance	General
Capital & Reserves excluding revals	Included	Included	Included
Result of the year	Included after expected dividend	Included after expected dividend	Included after expected dividend
Minority Interests	Included	Included	Included
Hybrid Tier 1 Capital	Max 15% of Tier 1 capital as Hybrid Tier1	No definition of Tier 1 / Tier2 concept	No clear guidance
Hybrid Tier 2 / Tier 3 capital	Additional max 100% of Tier1 as Tier 2 (of which max 50% Lower Tier 2)	Max 50% of RMM as subordinated debt (of which maximum 25% on RMM with maturity date)	No clear guidance
Unrealised capital gains on AFS investments net of shadow accounting	90% included on Equities as Tier 2	90% included on Equities 90% included on Debt Securities	90% included on Equities 90% included on Debt Securities
Unrealised capital gains on Real Estate	Excluded	100% included FIN, 90% included FIB	N/A
Deductions made for :			
Goodwill	Yes, from Tier 1	Yes	Yes
Translation differences	Yes, from Tier 1	Yes	Yes
Other intangibles	Yes, from Tier 1	Yes	Yes
Participating interests (stakes in financial institutions > 10%)	Yes, 50/50 from Tier1/Tier2	Yes	N/A
Catastrophe risk	N/A	Yes, for FIB	N/A
Degression dated subordinate loans	Yes	No	No

Annex XII: Reality check: Structure of capital elements of a FC applying Method 1

31-Dec-06	Banking	Insurance	General including eliminations	Total
Share capital and reserves	47%	40%	-90%	39%
Net profit attributable to share holders	12%	14%	-5%	14%
Unrealised gains and losses	3%	29%	+4%	13%
Shareholders' equity	63%	84%	-91%	65%
Non Innovative instruments	0%	0%	+23%	0%
Minority interests	1%	7%	+1%	3%
Revaluation of real estate to fair value (latent gains)	0%	15%	0%	5%
Revaluation of debt securities, net of shadow accounting (prud.filters)	-1%	-5%	0%	-2%
Revaluation of equity securities, net of shadow accounting (prud.filters)	-3%	-2%	0%	-3%
Goodwill	-3%	-3%	0%	-3%
Expected dividend	-1%	-5%	-7%	-3%
Other	-2%	-4%	0%	-3%
Core equity	54%	87%	-74%	61%
Innovative Tier 1 Capital	9%	6%	+10%	11%
Tier 1 Capital	64%	93%	-64%	73%
Subordinated loans	44%	8%	-36%	34%
Other prudential filters and deductions on total capital	-7%	-1%	0%	-6%
Total capital	100%	100%	-100%	100%