

Consolidated supervision – more problems for groups

December 2003

The FSA has issued new consolidated supervision requirements and proposals that will impact many firms of all types in the UK. These will result (and in some cases are already resulting) in firms and groups needing more capital, enhanced reporting systems, and improved documentation of systems and controls at group level. They will also impact acquisition and restructuring decisions. All firms (whether they are banks, investment firms or insurance companies) should study the proposals, understand the likely impact on their business and capital structure, lobby where appropriate, and plan for implementation. Key to the proposals for most firms is the FSA's Consultation Paper (CP204). This implements the Financial Groups Directive (FGD) in the UK from financial years beginning in 2005 and amends key Directives already in place, such as the Insurance Groups Directive, the Capital Adequacy Directive and the Banking Consolidation Directive. One sector of the industry does not have a free ride until then though, since asset managers already have to comply with a tighter consolidation regime laid out in October in the FSA's Policy Statement (PS173). This brings them closer to the existing regime for the rest of the industry and may result in greater capital needs for firms in the sector.

Asset management groups – the first to be impacted

The FSA and its predecessors have had rules on consolidated supervision for investment firms in general for many years, but commonly granted a waiver to asset managers so that they often have not had to apply them. However, the FSA is now seeking to implement a tighter policy for these firms as part of its wider regime. The new (PS173) rules affect all Investment Services Directive (ISD) firms that are part of a group, except for:

- Firms that are already subject to consolidated supervision by a banking or investment firm regulator in the EEA (e.g. subsidiaries of banks, but not insurance companies)
- Those few ISD firms that are not subject to the Capital Adequacy Directive (CAD), i.e. those that only give advice, or receive or transmit orders, and do not hold client assets.
- UCITS managers that do not carry out any ISD activity.
- Occupational pension scheme firms.
- Venture capital firms.

From 1 December 2003 asset management firms caught by the new regime will have to prepare group financial resource calculations and make returns in addition to the existing solo returns. This means that, unless they have a 'CAD waiver' (see below) they must have a surplus of group financial resources over their group regulatory requirements and comply with the large exposure requirements at a group level.

It is expected that a number of asset management groups will not meet the financial resources test at consolidated level. This may be because of additional regulatory-equivalent requirements arising from unregulated entities or because the group has significant goodwill financed by debt capital.

A group regulatory capital deficit may not be a problem if the firm can take advantage of the 'CAD waiver' (see below); if it cannot all may not be lost as the FSA may be prepared to exercise 'regulatory forbearance'. FSA has not spelt out the detailed parameters of its "regulatory forbearance", however it has said that it may allow the breach to continue, but only if the firm has a credible plan to remedy it. Plans and timing will be discussed by the FSA on a case by case basis.

The 'CAD waiver' (which is really a notification/undertaking by the firm to the FSA) will allow some firms to 'forgo' the quantitative test required by consolidated supervision at least until 2006 (see below). They will not have to meet the financial resources and large exposure requirements at consolidated level, **but will still have to submit the calculations (which could show a capital deficit)**. To get the waiver they will also have to meet the requirements listed below and any others that the FSA may impose on them.

The **CAD waiver** is available to firms if each CAD firm in the group:

- Is subject to a liquid capital requirement
- Complies with the solo financial resources and large exposure rules
- Has controls to monitor capital and funding of other group financial institutions

The waiver is not available if:

- The firm deals as principal; or
- There is a credit institution in the group.

Further, firms using it need to give certain undertakings to the FSA relating to:

- Ring fencing of group risk, i.e. deducting from capital contingent liabilities such as group guarantees and including in the expenditure base requirement all expenses of the firm even if borne by other group members
- Robust controls over client assets (the FSA may call for a Section 166 report to confirm the robustness of these controls)
- Notifying the FSA of any risk that could undermine the financial stability of the group
- Reporting group large exposures quarterly
- Disclosing in the statutory financial statements that the firm is not subject to consolidated capital requirements.

The FSA has also taken the opportunity to clarify the methodology that all investment firms should follow in preparing consolidated returns. In the future only the "Accounting Consolidation" method will be available. Many firms currently prepare returns using the "Aggregation and Deduction" method instead. Whilst in theory both methods create the same result, the complexity of Aggregation and Deduction can lead, as the FSA has said, to unintentional errors. The FSA has announced transitional arrangements for those using Aggregation and Deduction to transfer to Accounting Consolidation.

For asset management firms then, CP173 is already here. They also face the impact of CP204 from 2005 as explained below. Such firms may have significant problems: they might be happier when they hear that others in the industry will then face a similar issue.

CP204 – coming down the track

CP204 will impact institutions across the financial sector. Its prime focus is with regulating the new category of conglomerates, but it tightens existing consolidation regimes as well.

At the first level, additional prudential supervision will be applied to groups which have a significant presence in both insurance and banking/investment business. The groups affected are called **financial conglomerates** in the FGD. The FSA expects to have between ten and thirty such UK groups, depending on how their regulatory discretion is applied.

These groups will be subject to extra prudential requirements at the mixed financial group level (i.e. the level in the group at which over 40% of the total balance sheet comprises financial activities). The requirements will cover the quality of their systems and controls, the adequacy of capital across the conglomerate and limitations on intra-group transactions and exposures (ITE), and risk concentrations (RC).

- In the capital area one key issue will be the need to deduct goodwill arising on consolidation from the group's regulatory capital, resulting in a greater need to fund acquisitions, particularly of asset-light organisations, with equity rather than debt. The consolidation net could also drag in businesses that were previously not subject to regulatory capital requirements.
- In the ITE and RC area the FSA proposes to base the new requirements on the best of the existing regime, by:
 - Retaining the definitions of significance in current sectoral requirements.
 - Requiring financial conglomerates to provide an additional annual summary report developed using internal management information systems.
- CP204 also contains 'near-final' rules and guidance on group systems and controls. The FSA consulted on an earlier version of this in CP97 (June 2001).

The **insurance** EEA group-wide capital adequacy calculation will become a 'hard' test to be passed as a matter of regulatory obligation rather than a reporting requirement only (as now). This step is likely to have significant cost implications for some groups and it may take time for them to change debt and equity structures.

To allow for this, the FSA proposes a phased approach which does not include in the group requirement the Enhanced Capital Requirement (ECR) proposed for non-life insurers in the FSA's CP190 (Enhanced capital requirements and individual capital assessments for non-life insurers). This is permitted only so long as this remains a reporting requirement only for these firms. In other respects these proposals are complementary to those set out in CP190 and CP195 (Enhanced capital requirements and individual capital assessments for life insurers).

The FGD also amends the existing insurance regime (Insurance Groups Directive) and the first life and non-life insurance directives, to prevent double counting of capital arising from insurance companies investing in banking and investment firms. These changes are required from financial years beginning in 2005.

Financial services bulletin

PwC's UK Financial Services Regulatory Practice comprises 120 partners, directors, managers, and staff dedicated to providing pro-active regulatory advice to authorised firms and other financial institutions within the UK, Europe, and elsewhere. Our team blends the experience of former senior regulators, compliance managers, industry personnel and staff with an assurance/client facing background, to provide clients with an unparalleled knowledge of the regulatory rules, codes of conduct and the prudential supervisory framework

This bulletin is produced periodically to address important issues, affecting the financial services industry. If you wish to receive it by e-mail or if any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to

Jackie Dowsett
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY

Or send an email to:
jackie.m.dowsett@uk.pwc.com

PricewaterhouseCoopers (www.uk.pwc.com) is the world's largest professional services organisation. Drawing on the knowledge and skills of more than 124,000 people in 142 countries, we build relationships by providing services based on quality and integrity.

("PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

The current mish-mash of consolidated supervision requirements for different kinds of **investment firms** will be presented as a single set of rules. The changes in methodology this involves may impact the capital needs of these groups (in addition to the PS173 effects described above). This is in some respects just a holding move, since the EU's review of its capital regime (via the Risk Based Capital Directive (RBCD) is likely to amend the framework, and limit the current exemptions from end 2006. (The RBCD is, in addition, the EU vehicle for the implementation of the new Basel capital framework).

New prudential supervision arrangements will also be applied to financial groups (including financial conglomerates as described above) which have their top parent outside the EEA ("**third country groups**"). The existing insurance regime applies this approach already, but this framework now applies to banking and investment groups even where they are not categorised as conglomerates.

If a third country conglomerate or banking/investment group is subject to equivalent group-wide supervision in its home country then the need for FSA group-wide supervision is waived. However, where this doesn't happen (and this will be the case for many groups) the FSA does not believe it can practically implement full worldwide group supervision itself. Instead it is likely to require the establishment of a European holding company with the relevant governance arrangements and restriction of exposures between the European sub-group and the worldwide group ("ring-fencing"). Strangely the FSA does apply such full worldwide group supervision itself for insurance groups (although the result of that calculation is a reporting requirement rather than a "hard" capital test).

Conclusion

Firms and groups across the sector face a period of challenge as a result of the new requirements. All firms should study the proposals, understand the likely impact on their business, lobby where appropriate, and plan for implementation. Firms need to think broadly – including considering the impact of future business expansion/acquisition plans and their capital structure.

PricewaterhouseCoopers LLP

If you would like to discuss any of the issues arising from the proposals, please speak to your usual contact at PricewaterhouseCoopers, or one of the people listed below.

Banking and Capital Markets	Patrick Fell	020 7212 5273	patrick.w.fell@uk.pwc.com
	Neil Hatton	020 7212 4165	neil.j.hatton@uk.pwc.com
Investment Management	Stephen Burke	020 7804 3318	stephen.j.burke@uk.pwc.com
	Peter Milroy	020 7212 5282	peter.d.milroy@uk.pwc.com
Insurance	Melanie McLaren	020 7212 3505	melanie.e.mclaren@uk.pwc.com
	Jonathan Miles	020 7213 3760	jonathan.miles@uk.pwc.com