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*Company groups in the face of prudential supervision*

*Eddy WYMEERSCH*

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# *Company groups in the face of prudential supervision*

*Eddy WYMEERSCH*

**Abstract**

*Groups of companies that are engaged in financial services raise specific issues, especially in terms of supervision. Traditionally supervision is based on different types of activities: banking insurance, investment services. The borderlines between these activities are increasingly blurred, while supervision is not integrated. Recently, some major financial services groups have been formed, spanning numerous jurisdictions, and engaging a wide range of financial activities, often referred to as Bank-Insurance groups. The future European directive on "financial conglomerates" will introduce more adequate mechanisms for the supervision of these groups on an aggregate basis.*

Comments to the Author:

eddy.wymeersch@rug.ac.be

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**Eddy Wymeersch**
Professor at Ghent University

# Company groups in the face of prudential supervision

## 1. General aspects of group law and financial services groups

**1.** Company groups are complex organisations presenting a great variety of structural features.

Often groups stand for the legal form in which substantially one single enterprise is being run, structured over a series of domestic but more significantly foreign subsidiaries. In this case the firm's business is usually an integrated industrial activity.

Other groups are more heterogeneous, including a more or less diversified range of businesses: these were called "conglomerates" in the 1970s when several of these conglomerates were assembled as the result of the merger wave of that era. Today, many of these conglomerates have disappeared, the remaining entities concentrating on one or two core activities. However new types of "conglomerates" are emerging, engaging in a whole range of activities related to the financial services business. These are called "financial conglomerates" according to a proposed directive[1], provided the majority of their business takes place in relation to regulated financial business.[2] Some find this terminology misleading and prefer to refer to these groups as "financial services groups". This phenomenon often also is referred to as relating to the formation of bank and insurance groups (bancassurance, Allfinanz). These groups are frequently found in the Scandinavian countries and in the Benelux, although also in Germany and in Spain some recent take-overs illustrate the importance of the development. Business wise, these groups offer a wide range of financial services, that previously were considered unrelated: banking, insurance, but also specialised securities services, asset management, leasing, real estate financing, structured finance, etc. Apart from the significance of using both banking and insurance channels as often powerful distribution instruments, these bank-insurance groups also may function on an integrated basis, although not as a single economic entity. From the regulatory point of view, banking and insurance business have to be kept separate, in the sense that the two businesses cannot be located in the same legal entity. This does not prevent common, or cross holdings at the level of the company's capital, nor

[1] See proposal for a directive the European parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council directives 73/ 239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC ands 93/22/EC, and directives 87/78/EC and 2000/1/EC of the European Parliament and the Council, OJEC, C. 213 E/227 of 31 July 2001.

[2] See art. 3(1) of the proposed directive.

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business lines being increasingly integrated. Two models can be found: according to a first one, the top banking - or the top insurance company - holds shares in the insurance or banking subholding company. An equally common pattern is the one in which a holding company, that is not itself engaged in banking nor insurance business, nor offers any financial service on the market, holds the shares in both the 100% owned top holding companies that head the banking and insurance subsidiaries, standing for the wider range of operational units. This two legged approach offers the advantage of presenting both sides of the business as being equal partners while integrating overall group strategy at the level of the holding company. Strategic decisions, such as mergers or acquisitions, but also the allocation of capital group wise are decided by the top group management. Moreover, common group functions will be introduced at the level of the top holding company, such as capital allocation, group audit, group compliance, IT, and other fields of group interest. In some cases at least, the group is being managed on the basis of an integrated strategy, whereby the command structure follows the business lines, cutting across the legal structures. Matrix structures are increasingly being introduced: management at the subsidiary level is reporting not only to the subsidiary's legal organs, but also to the business line managers acting for the whole subgroup, and simultaneously to horizontally structured regional management. The tension between the legal structure and the management structure become an interesting central feature of this business model.

Some of these groups have a mixed nature, in the sense that they are engaged in quite heterogeneous activities, including non-financial ones. If a large part of the group's business relates to financial services, additional prudential safeguards have to be introduced. These groups are referred to by the proposed directive as "mixed financial holding companies" [3]. If the regulated financial activity does not represent at least half of the group's business, each financial entity will be supervised according to its own provisions. Additional issues will arise, e.g. in accounting terms (full consolidation v. proportional consolidation, or equity method), but also in terms of prudential supervision.

**2**. Apart from issues traditionally encountered in groups with heterogeneous activities - transfer pricing, interlocking directorates and conflicts of interest - these groups raise a number of regulatory issues that offer interesting additional perspectives from the overall angle of the law of groups of companies. As far as regulation and supervision is concerned, bank-insurance groups usually are composed of a string of strictly regulated firms, the regulatory regime of which may present significant differences and even conflicts but also lacunae. Moreover, in most jurisdictions, supervision has been put in the hands of different authorities: only recently have some states merged banking and insurance supervision[4], but in most jurisdictions

[3] See art. 1(14) of the proposed directive.

[4] This is the case in the United Kingdom, and in the Nordic States (Sweden, Denmark, Finland); also in Austria, and according to published proposals in Germany. In the Netherlands, the prudential

especially supervision of insurance companies continues to be exercised by a clearly different government agency with some weak co-ordination with the bank supervisor. Further complexity flows from the cross border nature of these groups: especially in the Benelux states, due to their small size, large bank-insurance groups necessarily have to expand outside their jurisdictional boundaries, and therefore are confronted with numerous regulators and supervisors. The persistence of this diversity constitutes not only a burden on their business efficiency, but also may lead to divergences in practices and conflicting views on the part of their supervisors. Ultimately, important risks may result from the absence of a comprehensive supervisory scheme. Therefore, new forms of supervisory streamlining are being developed. In this sense the proposed directive on "supplementary supervision of ... financial conglomerates" offers interesting new perspectives, which will have to be further refined and adapted in line with market developments. It does not prejudge on the future structure of the supervisory framework, but deals only with the integration of some supervisory techniques at the level of the supervised entities.

These market developments, management techniques and supervisory issues also offer new insights and challenges for the scholar of the law of groups of companies.

**3.** The fundamental dilemma - in group law in general, but in prudential supervision relating to company groups in particular - relates to whether the issues should be solved on an integrated or unitary basis, or rather whether - and to what extent - one should take into account each entity individually, with some or even ample corrections for the group effect. This tension often also corresponds to the opposition between the legal analysis of groups on the one hand, and how they are dealt with in business or management terms on the other.

If, as is the case in most industrial groups, the group is largely integrated and constitutes one single enterprise, spread over numerous legal entities, there is a tendency to deal with the group as one single entity. The single entity approach is underpinning the concept of full consolidation of annual accounts. However, in legal terms it is generally accepted that consolidation of annual accounts as such does not allow the group to be dealt with as a single entity, nor to attribute liabilities of one entity to the others, or even less to the group as a whole. However, industrial policies developed in different fields - antitrust, or prudential supervision, to name but two - prefer to deal with the group as a single entity, as a single entry point for policy directives addressed to the management of the entire group. The strongest opposite view is taken by insolvency law, where the existence of separate legal persons is considered a bar to extending the reach of the creditors of one entity to the assets of the others.

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supervision has been located at the Nederlandse Bank, while the insurance supervisor, or "Pensioen en Verzekeringskamer- maintains certain competences as to the prudential supervision. The rules of conduct supervision on banking, securities and insurance transactions will be exercised by the Stichting toezicht effectenwezen, the securities regulator.

This tendency is less clear, or not at all visible in more heterogeneous groups: for accounting purposes, e.g. diversity of business activities will normally not allow full consolidation, subsidiaries having to be dealt with according to the equity method[5]. Although synergies between group members exist, these synergies will not allow an integrated treatment[6].

However, for purposes of non-regulatory legal practice, there is widespread resistance to abandon the idea that each of the group entities is to be considered a separate legal person, with its own corporate organs, its own assets and liabilities, its own contractual obligations and privileges. This does not mean that group's influence is not recognised: in many jurisdictions, the group's influence is dealt with on an "ad hoc" basis, limiting itself to the specific consequences of the relationship at hand, but without treating parent and subsidiary as one single unit for all legal purposes. This approach allows to recognise the influence of the parent on the subsidiary: although de facto the subsidiary often could not subsist - even has no raison d'être - except as being fully embedded in the network of business relations that stand for its group membership, the legal system allows in a variable degree to take account of the group's interference. Save for exceptional circumstances, these arguments do not suffice to consider the subsidiary as legally being part of the parent, or belonging to the same legal entity.

**4.** While starting from the principle of separation of each legal entity functioning within the group context, many legal systems utilise a series of techniques to mitigate this principle: an impressive range of legal techniques has been devised that allow decisions relating to group components to take account not only of the presence of a dominant, often an exclusive shareholder, but also of the consequences of decision making at the group level, including of pervasive group policies

Examples are numerous: parents, or group companies have been declared liable for the subsidiaries debts on the basis of representation, of deficient capitalisation, of de facto directorship, of tortuous or negligent acts, etc. A whole panoply of legal instruments has been developed that all recognise the existence of a separate legal entity, while at the same time derive specific legal consequences from the occurrence of certain group behaviour. The sheer fact of belonging to a group is not a valid reason, while the mere existence of a separate legal personality is equally unconvincing. One could refer to the excellent work of Druey and Vogel

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5 See art. 33 of the Seventh Company Law Directive; to the extent that these subsidiaries are not omitted altogether: art 33, § 9.

6 One could refer to competition policy and the substantial difference between the American and the European approach, the former refusing to consider the sheer size of the group as a significant factor, while the EU commission is still considering the issue.

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for an overview of techniques used in Swiss law[7]. Most of these techniques have been identified in several other legal systems[8].

These techniques should not be described as exceptions to the single company doctrine as they confirm the separate existence of the companies involved: they rather stand for the interference of other legal principles mitigating the said doctrine by taking into account other conflicting interests.

This dichotomy between the legal and the business approach has incited some legal scholars to claim that the group should be considered a separate legal person, extending the application of the rules to all group components, and thereby dissolving the existence of separate legal entities. This view usually is rejected both in case law and in legal writing: cases adopting genuine "lifting of the corporate veil" have been very rare, and controversial, at least outside the United States.

**5** In the field of prudential supervision, the ultimate aim of which is to protect creditors from the insolvency of the supervised entity, a theoretical lawyer would image that considering each entity individually would offer the strongest protection: the limited liability principle would prevent insolvency of one group entity to affect the other groups entities. Creditors of each entity would be best protected by reserving the company's assets and liabilities to its own creditors. Subsidiaries should be managed exclusively on the basis of their own interest, with no or the least interference of the parent, or of other group entities. Hence prudential regulation should be aimed at safeguarding the individual existence of each entity, while supervision would restrict its analysis to the company under review (so-called "solo supervision"). Support for this approach could be found in a comparison with insolvency laws, according to which the effect of insolvency of a group as a rule is limited to each of the constituent entities.

For prudential purposes, which are aimed at the avoidance of insolvency, this theoretical view would be utterly fallacious, and has proved in history to be clearly detrimental to the

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7 DRUEY, J.N. and VOGEL, A., Das Schweizerische Konzernrecht in der Praxis der Gerichte, 1999.

8 See for an overview: LUTTER, M (ed.) Konzernrecht im Ausland, ZGR Sonderheft, 11, 1993, HOPT, K.J. (Ed), Groups of companies in European laws, Berlin, 1982, WYMEERSCH (Ed), Groups of companies the EEC, 1993, 279; CL.SCHMITTHOFF and FR. WOOLDRIDGE (Ed), Groups of companies, London, 1991; for the US, see BLUMBERG, PH., The law of corporate groups: problems of parent and subsidiary corporations under statutory law of general applications, Boston, 1989; The law of corporate groups: problems in the bankruptcy or reorganisation of parent and subsidiary corporations, including the law of corporate guaranties : 1987 supplement, Boston, 1987; The law of corporate groups : tort, contract, and other common law problems in the substantive law of parent and subsidiary corporations, Boston, 1987; The law of corporate groups : problems in the bankruptcy or reorganization of parent and subsidiary corporations, including the law of corporate guaranties, Boston, 1985; The law of corporate groups : procedural problems in the law of parent and subsidiary corporations, Boston, 1983; for Dutch law e.g. LENNARTS, M.L., Groepsaansprakelijlkheid, 1999, 412 p.; P. BALZARINI, G. CARCANO and G. MUCCIARELLI, I Gruppi di Società: atti del convegno internazionale di studi, 3 vol., Milan, 1996.

interests of both creditors and of the financial system as a whole. Major financial crises in the second half of the twentieth century can be attributed to the insufficient taking into account of the interdependence of the group aspect of the financial activity.

Different from groups in general, financial groups are more sensitive to reputation issues: damage to the reputation of one group member reverberates on all group members. Parents in financial groups are supposed not to be able to raise the company law based limitation of liability for the debts of their subsidiaries, if the company belongs to the same group, has the same name or is holding itself out as part of the group. It is a point of discussion to what extent these rules - purportedly based on third party reliance on the parent's liability - are proper to financial groups[9]. The lack of confidence that markets display v.à.v. one of the entities of the group quickly reverberates on all group companies (contagion risk). Although non-financial groups may also have difficulties shedding one of their components, this would clearly be unacceptable in banking groups who largely rely on the confidence on the markets. Therefore parents de facto will not be able to resist supporting their ailing subsidiaries. As has been evidenced in several cases, once the markets start to withdraw their confidence from one of the group entities, the entire group will soon afterwards collapse, unless the parent would be able to immediately stop the movement by backing up the failing subsidiary with additional assets, or guarantees. Banking groups therefore have a stronger tendency than groups of industrial companies to present a high degree of interdependency of the companies involved, not only in terms of reputation, but also in terms of management, organisation, risk distribution, and so on.

Regulators have tried to formulate adequate responses, by imposing "supervision on a consolidated basis", or other provisions that take account of this group phenomenon. Up to now, these techniques have mainly been limited to banking groups.

**6.** Prudential supervision, according to present requirements, is based on a two-tier regime: on the one hand it is based on "solo supervision": according to its own rules and requirements each entity being supervised by its own supervisor. For specific items, supervision is being exercised on the group as a whole, as a "single entity", and this according to the requirements formulated by the supervisor of the top company. The latter is often called

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[9] See on the liability for apparent identification, the Swissair decision of the Swiss supreme court, and the later Motor Columbus decision, referred to in DRUEY and VOGEL, note 8, at 119 e.s.; also: M. LUTTER, "Haftung aus Konzernvertrauen?" in SCHÖN (ed.) *Gedächtnisschrift für Brigitte Knobbe-Keuk*, 1997, 29. But this line of reasoning has also been developed in French group law, relating both to parent and to sister companies: Cass. comm. fr., 4 March 1997, JCP, Ed. G., 1997, IV, 910; Bull. Joly, 1997, 567, nt. Daigre; a quo: Paris, 19 October 1994, Revue des sociétés, 1995, 85, note M. Pariente; in the same sense: Cass. comm. fr., 5 February 1991, D., 27, note Y. Chartier; Cass. comm. fr., 18 October 1994, Bull. Joly, 1994, 1317, note Couret; Cass. comm. fr., 5 February 1991. But the sole fact of belonging to a group is not sufficient: Cass. comm. fr., 24 May 1982, Revue Pratique des Sociétés, 1990, nr. 6224.

"supervision on a consolidated basis". According to this approach, the group will not be considered as a single entity, nor will supervision be limited to each individual entity in the group, but above and beyond individual supervision, some form of adapted supervision will be exercised at the level of the group. The group related supervision therefore reinforces individual supervision to ensure its all-encompassing character, while supervisory loopholes are being avoided and regulatory arbitrage or other negative effects of inclusion in integrated group management are prevented. If the group is headed by a regulated firm – a bank, an investment firm, an insurance company – group supervision will more readily deal with the group on an integrated basis: the top bank, investment firm, etc will be the addressee of the regulation. A further complication then arises when the top company is not subject to any form of supervision, being a non-financial (holding) company.

In actual regulation and in supervisory practice, the issue presents itself in somewhat more difficult terms: most of the time, the supervisor for the parent and for the subsidiary are located in different jurisdictions, so that on top of the question of allocating supervisory competencies within one jurisdiction, one also comes across issues of allocating supervisory powers over different jurisdictions. As mentioned above, in bank-insurance groups, the issue is even more complex as, apart from specific forms of supervision on the banking and insurance activities, both supervisory lines have to converge at the level of the ultimate group supervision. Interesting schemes are being developed in the European directives: it is useful to outline some of the principles that have been followed in present and future European regulation.

## 2. EU rules on supervision of financial services groups.

**7 .** The EU directives have established an important series of guiding principles relating to the supervision of financial groups. These may be analysed as constituting several superimposed layers of prudential provisions.

The first regime, flowing from the 1989 Second directive [10] is based on the requirement that prudential supervision on each credit institution established in each of the EU member states should be organised by this state. This type of supervision applies to both credit institutions with their main business localisation in the member states, and credit institutions organised by way of subsidiaries of credit institutions established in other member states. More importantly, branches of foreign credit institutions will remain subject, as a rule, to the supervision of the state where their headquarters are located (or home state). The rule aims at avoiding double supervision, at least for branches as these belong to the same legal entity as the main bank. The first directives clearly affirm the principle of supervision on a solo basis. On

[10] Directive 89/646 of 19 December 1989.

the contrary, these early directives also affirm that, even foreign owned, banking subsidiaries primarily remain under the supervision of the "host" state. This is a clearly legal approach, as in business terms there often is no difference between a branch and a subsidiary. To decide otherwise would however have raised very difficult issues of public law, of group law and of enforcement.

**8.** The second layer of supervision derives from the 1992 directive dealing with prudential supervision of credit institutions on a consolidated basis[11], now co-ordinated in the 2000/12/EC directive. Here the group is already and increasingly - but not fully - taken into account and for certain, although limited objectives, prudential provisions are enacted that deal with the group as a whole.

This 1992 directive, the ambit of which was later supplemented by the so-called BCCI-directive[12], only deals with defined areas of prudential supervision, leaving it to the member states to add other fields of integrated supervision. The core items on which, according to the directive, supervision should be exercised on a consolidated basis are:

- solvency ratios
- own fund adequacy to cover market risks
- controls of large exposures
- limits on the holding of share participations in non-financial firms[13].

In addition, there should be developed a system for collecting data and information relevant for the purposes of supervision on a consolidated basis[14].

This scheme applies to groups composed of banks and investment firms. Insurance companies remained outside the ambit. As far as capital adequacy requirements are concerned, the group phenomenon is taken into account in the directive 93/6 EC; some of its provisions are proposed for further amendment, as will be detailed later.

In terms of group law, this directive establishes a regime of supervision whereby subsidiaries are included in the group supervisory framework, but only for specific purposes, also thereby avoiding loopholes and distortions within the supervised group. The directive's concept is not based on regulating the group as a single, integrated entity, but on the one hand

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11 Directive 92/30/EEC of 6 April 1992, incorporated in directive 2000/12 of 20 March 2000, art 56 e.s.

12 Though not formally modifying the Consolidated Supervision Directive, the BCCI-Directive obliged the national authorities responsible for licensing of credit institutions to ascertain whether the existence of 'close links' between the applicant and other natural of legal persons do not prevent the effective exercise of prudential supervision; see art. 2 BCCI-directive (Directive 1995/26/EC of 29 June 1995, *OJ*, L 168, of 18 July 1995, p. 7). On the proposal for a directive see: Carton de Tournai, G. La proposition de nouvelle directive sur la surveillance des établissements de crédit sur une base consolidée, Rev dr. bancaire et de la bourse, 1991, nr. 24; Gualandari, E. and Vella, F., The Post-BCCI EC directive, Revue de la banque, (belge), 1995, 202.

13 Art. 3(5) of the 92 /30/ EEC directive of 6 April 1992.

14 Art. 3(6) of the 92 /30/ EEC directive of 6 April 1992.

maintains supervision on each of the group entities while on the other introducing partial supervision on the mentioned specific features of group interaction.

Also, it does not constitute integrated group law, as supervision is not extended to a parent holding company unless that would be itself a credit institution. In case the parent is not a credit institution, the entry point to the regulation is constituted not by the parent company, but by the consolidated credit institution. With respect to supervision on a group that includes insurance companies the directive merely states that the authorities should co-operate closely [15].

The BCCI directive[16] has added some further specifications to this regulatory framework.

**9**. In the meantime, and pursuing a separate development, the insurance directives have stirred a different way. On the one hand, there have been no rules on consolidated supervision in the insurance sector. This is the more striking as interlinkage between insurance companies are as frequent as between credit institutions. This does not mean that the insurance directives have remained insensitive to group aspects, but rather that they have dealt with it in a different way.

Specific rules have been enacted dealing with "supplementary supervision" over insurance undertakings, whether within or outside the EU, whether supervised according to national law, or not. [17]

Characteristic for this type of group related supervision is that it is restricted to specific aspects of group life that are not receiving attention in the banking directives. Further the directive does not imply supervision to be exercised over the non EU-insurance companies[18]. Indeed not all insurance undertakings are subject to supervision in all states.

Among the items on which this directive especially focuses are the intra-group transactions: loans, guarantees, elements eligible for the solvency margin, investments reinsurance operations and cost sharing agreements are viewed with special interest, indeed all elements that, in the absence of a consolidated approach, may call attention from supervisors in a group perspective. With respect to these transactions the directive does not impose specific criteria, ceilings nor benchmarks, but merely states that these should be the subject of special

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15 Art. 7.4 of the directive. In national regulation these cooperation mechanisms have been further detailed, or have been the subject of agreements between supervisors.

16 See Directive 1995/26/EC of 29 June 1995, *OJ*, L 168, of 18 July 1995, p. 7, incorporated in directive 2000/12.

17 Directive 98/78/EC.

18 Art. 3(1) of the 98/78/EC directive of 297 October 1998 on the supplementary supervision of insurance undertakings in an insurance group.

attention of the supervisor, which should take the appropriate measures in case it would appear that the solvency of the insurance undertaking would be jeopardised[19].

Another aspect of "supplementary supervision" relates to the "adjusted solvency requirement" which aim, i.a. to avoid the double gearing well known in banking supervision[20].

**10**. This piecemeal approach, whereby the group is not taken into consideration as a whole, will, in part, also be found in the recently proposed directive on "the supplementary supervision on credit institutions, insurance undertakings and investment firms in a financial conglomerate"[21]. This important proposal aims at introducing a further step towards an overarching form of group supervision with respect to conglomerate groups, composed of financial, and possibly also non-financial companies. These groups may be headed either by a bank, an insurance company - referred to as "regulated entities" or - as is increasingly the case - , by an undertaking that is neither a bank nor an insurance company, but a holding company and therefore would not be subject to any form of prudential supervision. The directive is addressed mainly to groups in which the provision of financial services is the dominant business activity, standing for more than half of the overall balance sheet total of the group[22].

The directive aims at combating certain shortcomings that have appeared in the existing supervisory scheme: on the one hand lacunae, on the other overlaps.

Lacunae relate to the absence of supervision on horizontal groups, the absence of adequate regulation at mixed group level of issues that have been taken into account at the level of the banking group (multiple gearing, being an example). There are further inconsistencies in the treatment of similar prudential questions. Besides, regulatory arbitrage between the banking and the insurance leg of these groups is increasingly calling attention: risks are being transferred from one leg to the other, altering the risk perception for each of the legs, but not for the group as a whole. Finally the need for a pre-established scheme for co-ordination of supervisory activities on a cross border basis, calls for action at the community level, rather than at the bi-lateral, national level.

**11.** Usually national rules on group law, and EU directives as well, are applicable to groups as defined in terms of parent and subsidiary companies. European regulation would normally follow the standard definitions used in the Seventh company law directive. However,

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19 Art 8(2) of the 98/78/EC directive.

20 For further details, see the annexes to the 98/78/EC directive "calculation of the adjusted solvency of insurance undertakings".

21 Referred to in note. 1.

22 See art. 3(1) of the directive. Further cases apply to some other hypothesis, such as groups headed by a bank or an insurance company

one finds starting with the BCCI and later insurance directives [23] an increasing reference to an extended "group" definition, using the rather confusing technique of "close links between undertakings". The notion refers to an expanded notion of "control": in addition to " control" in the sense of the Seventh company law directive, it includes shareholdings standing for 20% of more participations in the capital or voting rights of another company. This criterion was made optional in the Seventh directive[24]. To the extent that it is far from sure that a 20% shareholder can exercise sufficient influence on the subsidiary's decision making to bend the latter's behaviour, this extension contains the risk of weak enforceability if group management has to impose measures on partially controlled entities.

The proposed directive on financial conglomerates takes the ambit of the group anew a few steps further: the "group" is being defined as "two or more natural or legal persons between whom there are close links. "Close links" is defined as in the mentioned insurance directive, but then further broadened to horizontal groups, to participation's in the sense of the Fourth directive[25], or - what seems more controversial - "where in the opinion of the competent authorities one of more persons effectively exercise a dominant influence over another person". Here too, the same observation might be applicable.

**12.** The basic provision states that when and where the directive is applicable, "supplementary supervision" will have to be exercised on the group components.

"Supplementary supervision" will consist, according to the proposed directive, of the following three points:
- supervision on capital adequacy on a group basis, as analysed infra
- supervision on intra-group transactions
- supervision on risk concentration
- suitability of shareholders and directors.
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It is striking that this proposed directive introduces a certain number of prudential requirements but always addresses these to the "regulated entities" in the conglomerate, i.e. the bank, insurance companies or investment firms, but not to the top holding company. Several of the issues that the directive attempts to tackle would disappear if it included the "mixed financial holding company" into its ambit, save for introducing adequate rules dealing with the non financial firms in the group. Once more, the group is not approached as such but on the basis of its regulated components. So for instance, when the directive deals with the suitability of shareholders, it abstains from imposing separate regulation addressed to the

23 Art. 92/49 of 18 June 1992, (" Third non-life insurance directive"); also in art 1,m, of directive 92/96, ("third non life insurance directive")

24 See art. 1, (d) 3rd alinea, Seventh Company Law directive.

holding company, as it considers that the subject can be captured on the basis of the existing sectoral regulations that provide for shareholders to be declared "fit and proper".[26] This rather contorted view will raise eyebrows: at the legislative level, it would have been much simpler, and certainly more straightforward to enact the rules that are directly applicable to the holding company. An exception for non-EU parents could have avoided issues of extraterritorial reach, if this would have been necessary.

**13.** With respect to capital adequacy, the proposed directive introduces no new requirement, but states that the requirement - which is addressed only to entities subject to prudential regulation, - will be established on a group basis, at the level of the financial conglomerate, thus not directly addressed to the top holding company. The rule tends to avoid multiple gearing within the group, or to avoid third party funds to be recycled as the subsidiary's capital[27].

In addition, group management has to put in place adequate procedures - along with appropriate internal control mechanisms - to ensure that the available capital is correctly distributed among the regulated entities[28]. Here once more the rule is addressed to the regulated entities, although the top company, the "mixed financial holding" may act – as an "agent" - to transmit the data to the supervisors[29].

With respect to intra-group transactions and risk concentration in regulated entities, the rules of supplementary supervision do not call for specific ceilings or ratios. The directive calls only for adequate risk management processes and internal control mechanisms by the regulated entities allowing to identify, measure, monitor and control these transactions and the degree of risk concentration at the level of the financial conglomerate[30]. The directive limits itself to a few specific provisions relating to the items of intra-group transactions or risk concentration: so e.g. should the mixed parent holding company be included in the assessment, while the overall objective of the supervisors' monitoring is aimed at " possible risks of contagion, conflicts of interest, circumvention of sectors rules, and the level of volume of risks"[31]. A considerable programme on which the proposed directive unfortunately contains no further details.

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25 Art.17, first sentence of directive 78/660, standing for " rights in the capital... creating a durable link that is contributing to the companies activities".

26 Art 5, of the Second Banking directive, now art. 6 of the Directive 2000/14

27 Called "excessive leveraging" in the Explanatory memorandum to the proposed directive.

28 Art 5 (2), § 3 where the rule is formulated in general terms as "adequate capital adequacy policy at group level".

29 Art. 6 (3) of the proposed directive.

30 See art.6 (2) of the proposed directive.

31 See Annex II of the proposed directive.

Further detailed regulation, especially quantitative ceilings, have not been imposed at the directive level, but leave untouched the competence of the national authorities who should insure that adequate processes are followed by group management[32]

Yearly reporting will be necessary on transactions within the group and on group wise risk concentration: reporting is imposed on the top company, or on the regulated entity.

As to the fit and proper character of directors in regulated group entities, it is usual that these persons are involved in the management of the other group entities. Therefore there should be co-ordination between the different supervisors as to the reputation and experience of these directors. With respect to the directors active in other parts of the overall group, the proposed directive provides that: "reputation and experience of directors involved in the management of another entity of the same group" shall be the subject of consultation between authorities.

One could imagine that directors who have been declared "proper" for one activity would also be acceptable for the other group entities, while their experience has to be assessed separately[33]

Intra-group transactions will be the subject of particular attention if these are taking place between a regulated entity, e.g. a bank, and its mixed activity holding company: here "general supervision" is called for, leaving ample room for interpretation: to what extent is the bank allowed to finance the mixed holding company's non-financial activities? And what about financing the other non-financial companies in the group? One may expect these subjects to come to the fore in further supervisory endeavours.

The proposed directive introduces "measures to facilitate supplementary supervision" i.e. default rules for co-ordination of multisector and multistate supervision, especially by introducing rules and criteria [34] allowing one supervisor to be designated as "co-ordinator", and describing his tasks[35] These model frameworks are of great importance for the actual functioning of cross border supervision within the European context. They will allow doing away with the complex contractual arrangements that have been introduced by some supervisors[36]

**14.** What do these directives in the field of prudential supervision contribute to the ongoing debate about the law of company groups in the EU? Are these the forebode for a new orientation in the way the EU looks at company groups?

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32 Art.6(4); however "pending further coordination".

33 See art. 25 of the proposed directive, modifying art 12 of directive 2000/12 and containing the obligation for the supervisors to consult.

34 See art.7 (2) of the proposed directive.

35 Art 8 of the proposed directive.

36 See the four party agreement between the Dutch and Belgian banking an insurance supervisor relating to the Dutch Belgian Fortis banking and insurance group, described in the Annual Report of the Belgian Banking and Finance Commission, 2000-2001, p. 131.

When one confronts these developments in the field of the regulation of financial supervision with the common rules and concepts of group law, it seems that two, apparently contradictory movements are at work.

According to a first movement, which one could identify as a drive for "construction", the group is being viewed as an "entity". The rules to be applied take into account the amalgamated group, and are addressed to the group management. Per hypothesis, each single group company remains outside the ambit of the regulation; it is indirectly addressed through the management of the overall group. This technique can easily be applied to homogeneous groups, composed of banking and investment firms. It could have been followed in the case of financial conglomerates as well: obviously times are not yet ripe for such a comprehensive approach.

A second movement goes into the direction of "deconstructing" the group, by formulating rules that are indirectly addressed to the group management, while focusing on the internal mechanisms within the group. Here the distribution of group own funds over the different group entities comes into play, whereby it is assumed that group management will ensure that each of the group components will be endowed with sufficient own funds in relation to the risks it undertakes.

The same approach can be recognised as underlying the call of the proposed directive to deal with intra-group transactions. By nature, these transactions relate to the individual - mostly contractual - relations between the group entities. Supervisors should ensure that risks flowing from nitre-group transactions are adequately monitored in the light of the four objectives mentioned above. The directive remains vague as to the objective of the supervision or to the limits of the risks flowing from these transactions: is the purpose to avoid divergent risk assessment techniques or risks being concentrated in both the banking and the insurance leg, or does it extend to shifting of risks from one to the other leg, or what? The proposed directive merely states that competent authorities shall "monitor" these risks, while member states shall provide the necessary powers to their supervisors "to take any measure deemed necessary in order to avoid or to deal with the circumvention of sectional rules by regulated entities in an financial conglomerate"[37]. Anyhow, there can be little doubt that the rule is aimed at individual transactions between group entities, allowing both a solo and a group appreciation. In case of a transfer of risks from the banking to the insurance pillar, the group risk will be decisive. In case of a risk transfer from an "industrial" or non-financial branch to the financial branch within the conglomerate group, the assessment will be on the basis of sound and arm's length business judgement: a solo approach will be more indicated.

[37] Art 13 of the proposed directive.

**15.** The proposed directive therefore rightly recognises that, at least for the purposes of prudential supervision, one should view not only the individual group companies, nor the overall economic entity, but at the same time, the position and relationships of the individual group entities within the company group. More specifically the transactions that are taking place within the group, or the risks that may occur within the group context but may be obliterated as a consequence of consolidation, should receive separate attention. Without reducing the virtues of the consolidated picture, one should simultaneously also look at the deconsolidated one.

This double tier approach - integrated and disintegrated - is increasingly calling attention in legal writing. The fairness of individual intra-group transactions has been at the centre of legislation in several jurisdictions. To name but two: German Konzernrecht is based, as far as the de facto groups are concerned, on the idea that intra-group transactions, and relations should be corrected if the subsidiary did not abstain an adequate price for the offers it had made in the group interest. Belgian company law contains elaborate rules avoiding parents of listed companies to take advantage of their dominant position to impose transactions to their listed subsidiaries that would be detrimental to the latter's interests, including to their minority shareholders, or even creditors[38].

In terms of disclosure also, there have been calls for obliging groups to disclose more information on their intra-group dealings: [39] in the statement published by Forum Europaeum on the future of European Group Law, it was stated: "the legal position of the corporate group is, in all member states, marked by the tension between unity and diversity.... The creditors and outsiders in a subsidiary should be verbally - rather than by means of figures - informed of group risks - and opportunities were relevant which may affect the subsidiary. "

It is likely that this two or three tier approach will gain momentum[40].

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[38] A special regulation was introduced in the Companies code, art. 524; for a comment see WYMEERSCH, Der neue Belgische Gesetzesentwurf über Corporate Governance, forthhcoming in ZGR, 2001

[39] See Forum Europeaeum Konzernrecht, Konzernrecht für Europa, ZGR, 1998, 672; on the subject of "Gruppenpublizität", at p. 700; in English: Corporate Group Law for Europe, Corporate Governance Forum, Stockholm, 2000; for other comprehensive observations and analyses in different directions, see MONTALENTI, P., Persona Giuridica, Gruppi di Società, Corporate Governance, Cedam, 2000; comp. The approach by G. TEUBNER, Unitas Multiplex, Das Konzernrecht in der neueren Dezentralität der Unternehmensgruppen, ZGR, 1991, 189.

[40] In accounting terms, the call for segment reporting (IAS 14), based on business line consideration and disregarding the existence of different legal entities, goes into the same direction.