

The ongoing consolidation trend across diverse financial sectors, the establishment of new types of financial institutions and globalization strategies have led to the creation of financial conglomerates in the European Union which offer their services across the globe. If such a group should find itself in a situation of financial distress, the risk of cross-border contagion might even arise in a worst-case scenario. Hence, to safeguard stability, it is crucial for financial conglomerates to be properly supervised.

With its diverse aims and its sectoral approach, the EU legislation applicable to financial institutions heretofore was not suited to providing adequate supervision of financial conglomerates.

Directive 2002/87/EC now provides for an adequate supervisory regime for financial groups with cross-sectoral financial activities, establishing supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. In addition, the directive aims to reduce differences between the existing EU provisions governing sectoral supervision and to eliminate any loopholes.

Background

Increasing financial market integration in the last decade and the related blurring of the traditional distinction between banking and investment sectors on the one hand and the insurance sector on the other have set in motion an intensive discussion about how to ensure sound supervision and the stability of the European financial system. Given the differences in the aims of the various sectoral EU provisions and in sectoral developments, sectoral legislation alone is insufficient to ensure the adequate supervision of the increasingly integrated financial sectors.

Against this background, at the end of 1999 the European Commission initiated the drafting of a directive on the supplementary supervision of financial conglomerates jointly with the Mixed Technical Group (MTG)¹. The intensive preparatory work of the Joint Forum² was key in the suc-

cessful submission of a directive proposal by April 2001 in line with the tight schedule established by the Financial Services Action Plan (FSAP)³. At the end of 2002, the European Parliament and the Council of the European Union adopted Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate by way of codecision.

This directive represents the first comprehensive implementation of international recommendations on the supervision of financial conglomerates that were agreed by the G-10.⁴

Bankassurance and Assurebanking

Cooperative ventures between banks and insurance companies date back to the 1980s and have produced various types of groups, especially in the past decade. This process has been

¹ *The Mixed Technical Group (MTG) was set up by the Banking Advisory Committee, the Insurance Committee and the High Level Securities Supervisors Committee. These bodies are the predecessors of the committees established for the financial services sector within the Lamfalussy committee structure.*

² *The Joint Forum on Financial Conglomerates (Joint Forum) is an international intersectoral group made up of representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the International Organization of Securities Commissions. For more information, please refer to: Joint Forum (1999a to c; 2001a and b).*

³ *On May 25, 1999, the Council of the European Union approved the Financial Services Action Plan with the objective of integrating the Single Market for financial services by 2005.*

⁴ *ZBB-Dokumentation (2003), p. 238.*

supported above all by deregulation measures, greater competition and demographic developments, all of which have helped create a new type of financial service provider on the global market. Epithets such as “bank-assurance” (denoting a financial group in which banks predominate) and “assurebanking” (insurance-dominated financial group) apply to the new “Allfinanz” financial service providers who may be classified as belonging to one of three business models depending on their complexity or structure: cooperative sales ventures, cross shareholdings or completely integrated groups in which banks and insurance companies have merged.⁵

The bulk of the cross-sectoral merger and acquisition (M&A) activities in Europe took place from 1999 to 2001, albeit mainly at the national level. The entire volume of national and international M&As of banks and insurance companies came to some EUR 72.3 billion in this period (national M&As accounted for EUR 56 billion of this total) and covered 15 large mergers.⁶ These mergers include e.g. the Allianz and Dresdner Bank merger in 2001, involving a transaction volume of EUR 22.3 billion, and the acquisition of Scottish Widows Fund & Life Assurance Society by Lloyds TSB Group in 2000, involving a transaction volume of EUR 12 billion. The individual other intersectoral M&A transaction volumes during this period ran to between EUR 1.2 billion and EUR 2.9 billion. The tension on international financial

markets, which began in 2001 and culminated in March 2003, put many financial intermediaries under – partly substantial – pressure to turn a profit. The decline in intersectoral M&A transaction volumes by EUR 3.5 billion in 2002 and 2003 clearly reflects these pressures.

The situation in the United States is entirely different. Until the end of the 1990s, legislation stipulated a strict separation of commercial and investment banking activities on the one hand and of banks and insurance companies on the other. This structure was long based on the Glass-Steagall Act enacted in 1933, and not until the passage of the Gramm-Leach-Bliley (GLB) Act in 1999 did a new era begin. GLB now allows for financial holding companies (FHCs)⁷ to provide any type of financial service. Contrary to expectations, however, the expected flurry of M&As between banks and insurance companies has not occurred in the U.S.A. As disparate insurance legislation from state to state remains a barrier to mergers of insurance companies and banks, the merger of Citicorp and Travellers Group to Citigroup remains the single largest U.S. intersectoral merger to date.

Motives and Challenges for Management

The exploitation of potential synergies of both costs and profits may be one motive for mergers across sectors.⁸ In addition, the income components of the different group enter-

⁵ Hülsen et al. (2003), p. 120.

⁶ Dierick (2004).

⁷ To be accorded the status of a financial holding company, an enterprise has to fulfill certain criteria, among others sufficient capitalization. The Federal Reserve Board is in charge of supervising financial holding companies.

⁸ However, there is little agreement on whether the potential synergy effects of conglomerates in fact boost profits, and in practice, economies of scale frequently cannot be achieved. Moreover, in the past a growing process of deconglomeration was observed in the nonfinancial sector (see Van Lelyveld and Schilder, 2002).

prises may combine to produce more stable and less volatile revenues. At the same time, mergers may strengthen the risk-bearing capacity of financial conglomerates, but may also involve contagion risk – the risk that problems in one type of financial establishment spread to another part of the financial sector – which could trigger novel and unprecedented risks that need to be adequately monitored by management.

The integration of bank and insurance company risk management – and hence the integration of all risk into the overall management process – faces group management with new challenges. Until now, heterogeneous financial groups have not had at their disposal fully comprehensive risk management procedures that are suited to capturing and monitoring all risk involved in the banking and insurance business.

Challenges for Supervisors and Consequences for Supervisory Practice

Under a single roof, heterogeneous financial groups unite a broad range of banking, investment and insurance operations, each subject to quite different types of risks. In this context, the accelerated establishment of heterogeneous financial groups in recent years has increasingly focused the supervisory authorities' attention on

improving and better coordinating the supervisory regime applicable to banks and insurance companies. Consequently, the need to establish suitable supervisory provisions for cross-sectoral financial groups arose, as the differences between the existing sectoral supervisory provisions in the EU left some gaps⁹ in the supervisory system, which may jeopardize the financial system. The implementation of the directives on the supervision of credit institutions on a consolidated basis and of insurance groups during the mid- to end-1990s already provided for the supervision of homogeneous financial groups.¹⁰

Directive 2002/87/EC goes one step further by providing for the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. The progressive harmonization of sectoral supervisory provisions in connection with this legislation helps further reduce the deficits in the supervisory regime. The supplementary supervision directive primarily pursues the following objectives:

- Prevention of multiple gearing of own funds instruments and of any inappropriate intragroup creation of own funds by means of debt issues by the parent company (capital leveraging).

⁹ The existing legislation does not cover certain types of financial groups (e.g. horizontal groups). Multiple gearing is covered only by sectoral standards or provisions. Identical supervisory issues are handled differently in different sectors. One and the same financial group may be subject to several directives, or to none at all.

¹⁰ These directives are Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis (now codified in Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions), Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions. For implementation in Austria, compare Article 30 Austrian Banking Act and Article 86a Insurance Companies Supervision Act in connection with Articles 86c to 86l.

- Greater cooperation and more exchange of information between the authorities responsible for supervision.
- Limits on intragroup transactions and risk concentration within a financial group, appropriate internal control mechanisms and adequate risk management processes.

Financial Conglomerates Act

In Austria, the Financial Conglomerates Act represents the transposition of the supplementary supervision directive into national law. This Act enters into force on January 1, 2005, and defines a financial group with cross-sectoral financial activities as a financial conglomerate pursuant to the Financial Conglomerates Act if the criteria specified in Article 2 item 14 (definition) and Article 3 (threshold for identifying a financial conglomerate) Financial Conglomerates Act apply.

In principle, financial conglomerates must meet all of the following conditions:

- Financial conglomerates are groups of companies including credit institutions or investment firms as well as insurance undertakings.
- At least one of the entities in the group must be within the insurance sector¹¹ and at least one must

be within the banking or investment services sector¹².

- The parent undertaking or at least one subsidiary undertaking in the relevant group is a regulated entity pursuant to Directive 2000/87/EC.¹³
- The activities of the entities within the group must occur in the financial sector¹⁴ (where there is no regulated entity pursuant to Directive 2000/87/EC at the head of the group) and the aggregated activities are significant.

In Austria, three heterogeneous financial groups are likely to fall within the scope of the Financial Conglomerates Act: Raiffeisen Zentralbank Österreich AG, Grazer Wechselseitige Versicherung AG and Wüstenrot AG.

Supplementary Supervision

The Financial Conglomerates Act contains a number of quantitative and qualitative provisions for the supplementary supervision of regulated entities within a financial conglomerate; these apply above all to capital adequacy, intragroup transactions, risk concentration and the fit and proper character of management.

As the competent supervisory authority, the Austrian Financial Market Authority (FMA) is obligated to determine whether a heterogene-

¹¹ Insurance undertakings, reinsurance undertakings or insurance holding companies pursuant to Directive 98/78/EC Article 1 subparagraph i.

¹² Credit institutions, financial institutions or ancillary banking services undertakings pursuant to Directive 2000/12/EC Article 1 items 5 and 23 and investment firms or financial institutions pursuant to Directive 2000/12/EC Article 1 item 5.

¹³ Credit institutions, insurance undertakings or investment firms.

¹⁴ In this context, the financial sector comprises the banking or investment services sector as well as the insurance sector. This distinction serves to differentiate between financial conglomerates and industrial or trade conglomerates. A group is considered to have its activities in the financial sector if the ratio of the balance sheet total of the regulated and nonregulated financial sector entities in the group to the balance sheet total of the group as a whole exceeds 40%.

ous financial group – one comprising entities within the banking and/or investment services sector and within the insurance sector – represents a financial conglomerate pursuant to the Financial Conglomerates Act.¹⁵ Supplementary supervision at the financial conglomerate level applies to all regulated entities in the group and is exercised via the FMA-licensed parent undertaking at the head of the group. However, if a nonregulated parent undertaking is at the head of the group (in the case of a mixed financial holding company), the supervisory authority addresses the FMA-regulated financial sector entity with the highest balance sheet total. Moreover, the Oesterreichische Nationalbank (OeNB) plays an important role in the supervision of financial conglomerates, as pursuant to Article 70 paragraph 1 item 3 of the Austrian Banking Act (on-site examination) it is responsible for assessing the proper limitation of market and credit risk of credit institutions or groups of credit institutions within financial conglomerates.

Capital Adequacy

Article 6 Financial Conglomerates Act provides for three methods to calculate capital adequacy requirements for a financial conglomerate;¹⁶ these methods are designed to prevent multiple gearing in a financial conglomer-

ate. The FMA may also permit financial conglomerates to apply a combination of these methods. Which method the financial conglomerate subject to supplementary supervision will have to apply is at the FMA's discretion to decide.

Financial conglomerates' capital adequacy is determined without prejudice to the existing sectoral rules for the calculation of supplementary capital adequacy requirements. In addition, the calculation of regulatory capital must extend to nonregulated financial sector entities and mixed financial holding companies, for which notional solvency (regulatory capital) requirements are to be calculated. Also, cross-sectoral participations and items referring to such participations must be deducted from capital. The own funds of the financial conglomerate must then correspond to at least the solvency requirements the financial entities in the conglomerate must fulfill.

Risk Concentration and Intragroup Transactions

The supervisory authority must take into account the specific group structure, degree of complexity, risk management structure and system of internal control mechanisms of the financial conglomerate when defining what type of risks¹⁷ and intragroup transactions¹⁸ regulated entities must

¹⁵ Pursuant to Article 4 Financial Conglomerates Act, however, financial companies themselves are responsible for identifying whether they represent a regulated entity within the meaning of Article 5 Financial Conglomerates Act. If they find this provision to apply, they must report this circumstance to the FMA immediately.

¹⁶ The accounting consolidation, deduction and aggregation, and book value and/or requirement reduction methods.

¹⁷ See Article 2 paragraph 19 Financial Conglomerates Act. In principle, risk concentration is defined as all exposures with a default risk borne by entities within a financial conglomerate that are large enough to threaten the solvency or financial position in general of the regulated entities within the financial conglomerate. For more information, please refer to Joint Forum (1999c).

¹⁸ See Article 2 paragraph 18 Financial Conglomerates Act. Intragroup transactions are all transactions by which regulated entities within a financial conglomerate rely either directly or indirectly upon other undertakings within the same group for the fulfillment of an obligation. See Joint Forum (1999b).

report and when determining appropriate thresholds.¹⁹

Supervisors may in particular monitor the possible risk of contagion within the financial conglomerates (the risk that a problem in one part of a financial conglomerate could spread to other parts), the risk of a conflict of interests, the risk of circumvention of sectoral rules (regulatory arbitrage), and the risk that a general overview of the overall level or volume of exposure might be lacking.

Moreover, a key aspect of the supplementary supervisory provisions is the requirement that risk management sufficiently capture intragroup transactions and risk concentration at the level of the conglomerate to identify the possible risk of contagion at an early stage and to prevent any such contagion. To this end, risk management must be adequate at the conglomerate level, and appropriate internal control mechanisms pursuant to Article 11 Financial Conglomerates Act must be in place. Guaranteeing that adequate internal management strategies indeed comprise efficient internal control mechanisms and risk management processes²⁰ requires that the conglomerate subject to supplementary supervision reviews these strategies and measures at regular intervals.

Third Country Supervision and Equivalence

In some instances, the geographical scope of Directive 2002/87/EC goes beyond EU borders. If the parent undertaking of financial conglomerates subject to supplementary supervision is located outside the European

Union and its supervision is equivalent to that provided by the Directive, the provisions of the Financial Conglomerates Act are not applicable. In any other case, the supplementary supervision provisions of the Directive shall apply *mutatis mutandis*.

Determining whether equivalent provisions on the supplementary supervision of financial conglomerates apply in the nonmember country is at the discretion of the responsible coordinator, who may consult with the other EU supervisory authorities in charge.

In addition, the coordinator must take into account the general guidance provided by the Financial Conglomerates Committee assisting the European Commission pursuant to Article 21 paragraph 5 Directive 2002/87/EC.

Finally, close cooperation and exchange of information between the supervisory authorities of the countries involved are indispensable for the recognition of regulatory equivalence.

Concluding Remarks

Capital Reduction

As the legislation now also obliges nonregulated financial entities to fulfill notional capital requirements and to deduct cross-sectoral participations and items referring to such participations from capital, the implementation of Directive 2002/87/EC will entail a reduction of own funds in financial conglomerates.

Financial Stability

From the macroprudential perspective, it is crucial for the OeNB and other national central banks to be familiar with the extent and thus the

¹⁹ Van Cauter (2003).

²⁰ ZBB-Dokumentation (2003), p. 241.

systemic relevance of the links between banks and insurance companies in order to maintain financial stability. Establishing regular and systematic monitoring²¹ and a regular exchange of information about such heteroge-

neous financial groups between the central banks and the supervisory authorities at the European level represents a key step toward further enhancing financial stability in Europe.

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²¹ *Dierick (2004).*