

REGULATORY FRAMEWORK OF FINANCIAL CONGLOMERATES IN EUROPE

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Abstract

This paper deals with the analysis of the regulatory framework of financial conglomerates in Europe. The term financial group is very often confused with the term financial conglomerate. We can say that the financial conglomerate is a financial group, but the reverse cannot be said. Financial conglomerate is defined by the Directive 2002/87/EC, but in 2011 there was a “redefinition” of the term and that of the new Directive 2011/89/EU. The new directive should improve the supplementary supervision of financial entities in a financial conglomerate. The analysis of regulatory framework of financial conglomerates in Europe is the aim of this paper. The first part is focused on the structure of financial conglomerates and system of risks from the perspective of regulated entities and non-regulated entities. In the main part (second) is analyzed calculation of capital adequacy in financial conglomerate.

Introduction

In the Czech Republic, the activities of financial conglomerates are controlled by the Czech National Bank, through Law No. 377/2009 Coll., on the supplementary supervision of banks, credit unions, electronic money institutions, insurance undertakings and investment firms in a financial conglomerate and amending certain other Acts (the Act on Financial Conglomerates) [1]. The Directive 2002/87/EC [2] of the European Parliament and of the Council of December 16, 2002 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 and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council (the Supplementary Supervision Directive) was transposed in this Act. In the year 2011, the European Parliament and Council adopted a new Directive 2011/89/EU [3], whose main objective is improving the supplementary supervision of financial entities in a financial conglomerate.

Since the objective of improving the supplementary supervision of financial entities in a financial conglomerate cannot be sufficiently achieved by the Member States, the Directive 2011/89/EU was published, by which it is possible to achieve this goal at the Union level.

In the understanding of professionals in the Czech Republic, unfortunately, the difference between the concepts of financial group and financial conglomerate very often leads to confusion. In connection with the implementation of European legislation into national

legislation in the last years, most talked about have been financial groups and conglomerates and the transparency of their interconnection.

1 Understanding of Financial Conglomerates

To understand the financial conglomerates it is necessary to understand the basic difference between financial group and financial conglomerate. These terms, however, very often mistaken in the literature, lead to confusion. Financial conglomerate can be understood as a financial group, but this claim cannot be reversed.

Financial conglomerate has been defined in Directive 2002/87/EC, but in 2011 a new directive 2011/89/EU, which defines a financial conglomerate as a group or subgroup, where a regulated entity is at the head of the group or subgroup, or where at least one of the subsidiaries in that group or subgroup is a regulated entity, and which meets the following conditions [3]:

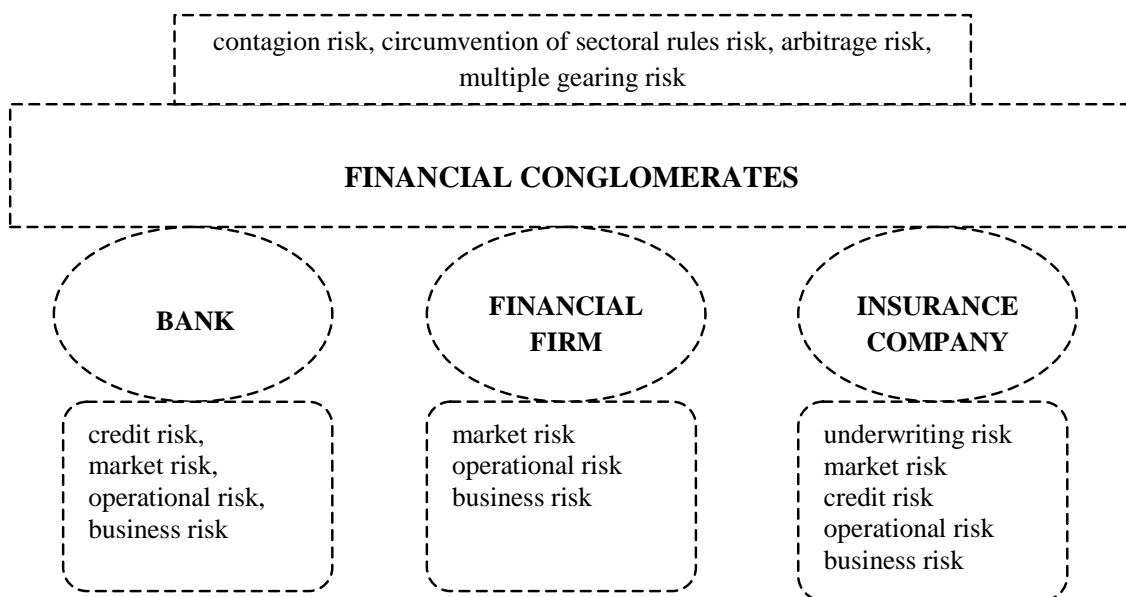
- where there is a regulated entity at the head of the group or subgroup:
 - that entity is a parent undertaking of an entity in the financial sector, an entity which holds a participation in an entity in the financial sector, or an entity linked with an entity in the financial sector by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC [4];
 - at least one of the entities in the group or subgroup is within the insurance sector and at least one is within the banking or investment services sector; and
 - the consolidated or aggregated activities of the entities in the group or subgroup within the insurance sector and of the entities within the banking and investment services sector are both significant within the meaning of Article 3(2) or (3) of this Directive; or
- where there is no regulated entity at the head of the group or subgroup:
 - the group's or subgroup's activities occur mainly in the financial sector within the meaning of Article 3(1) of this Directive;
 - at least one of the entities in the group or subgroup is within the insurance sector and at least one is within the banking or investment services sector; and
 - the consolidated or aggregated activities of the entities in the group or subgroup within the insurance sector and of the entities within the banking and investment services sector are both significant within the meaning of Article 3(2) or (3) of this Directive.

The term financial conglomerate is a group consisting of at least one bank, insurance and investment (financial) firm.

The activities of the sectoral supervisors and regulators may be obstructed through the circumvention of sectoral rules [5], [6]. Near the regulatory point of view of the supervision of financial conglomerates, there are different levels of supervision [5]:

- at the single entity level,
- at the group level,
- at the conglomerate level.

The systems of risks of a financial conglomerate depend on the risk of the entities within the group and on the risk pertaining to the group as a whole (see in Fig. 1).



Source: Own elaboration from [5]

Fig. 1: System of Risks of the Financial Conglomerate

The entities that are part of financial sectors are represented in the following Tab. 1.

Tab. 1: Financial Sector Entities

Entities \ Sector	Banking Sector	Investment Sector	Insurance Sector	Mixed financial holding company
Regulated Entities	Credit institution Asset management company	Investment firm Asset management company	Life insurance undertaking Non-life insurance undertaking Asset management company	
Non-Regulated Entities	Financial institution (other than an investment) Ancillary banking service undertaking	Financial institution (other than an investment firm)	Reinsurance undertaking Insurance holding company	Mixed financial holding company

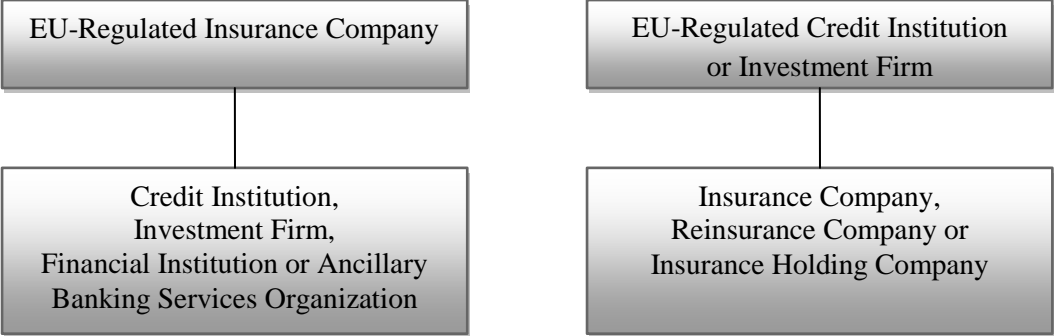
Source: Own elaboration from [7]

2 Calculation of Capital Adequacy in Financial Conglomerate

Capital adequacy in financial conglomerate is the most important aspect of the group financial position with respect to financial health of the conglomerate.

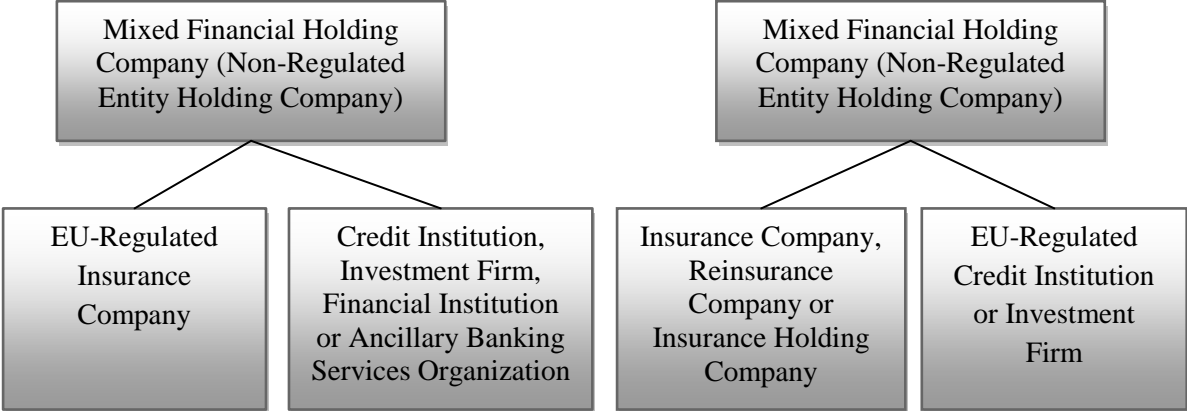
2.1 Financial Conglomerates Subject to Supplementary Supervision

The first three figures show hypothetic structures of financial conglomerate. Fig. 2 shows the notional solvency requirement of a non-regulated entity is equal to the capital requirement with which such an entity would have to comply under the relevant sectoral rules if it was a regulated entity of that particular financial sector [7].



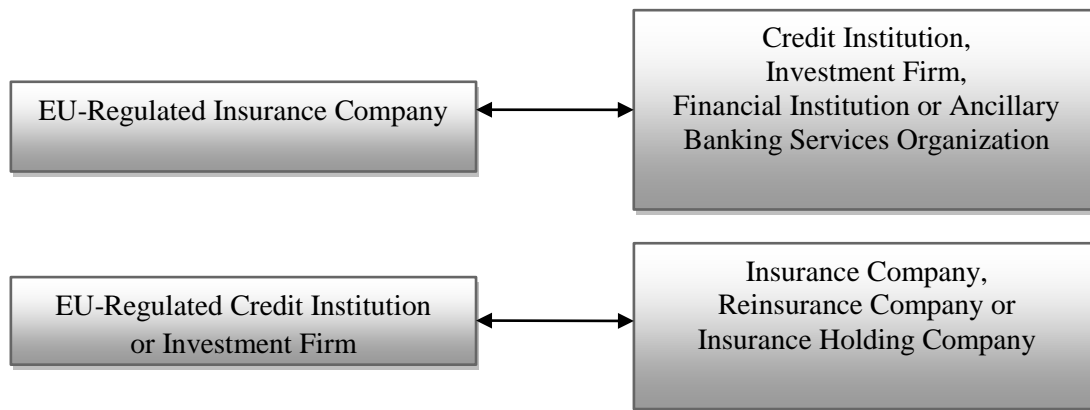
Source: Own elaboration from [6], [7]
Fig. 2: Group headed by an EU-Regulated Entity

The national solvency requirement of a mixed financial holding company is equal to the capital requirement of the most important financial sector within the financial conglomerate; this situation corresponds to Fig. 3.



Source: Own elaboration from [6], [7]
Fig. 3: Group headed by a Mixed Financial Holding Company with EU Head Office

There are no capital ties between entities in a financial conglomerate in the horizontal conglomerates (see Fig. 3). The coordinator normally identifies the proportional share of each entity to cover the solvency deficit of another entity.

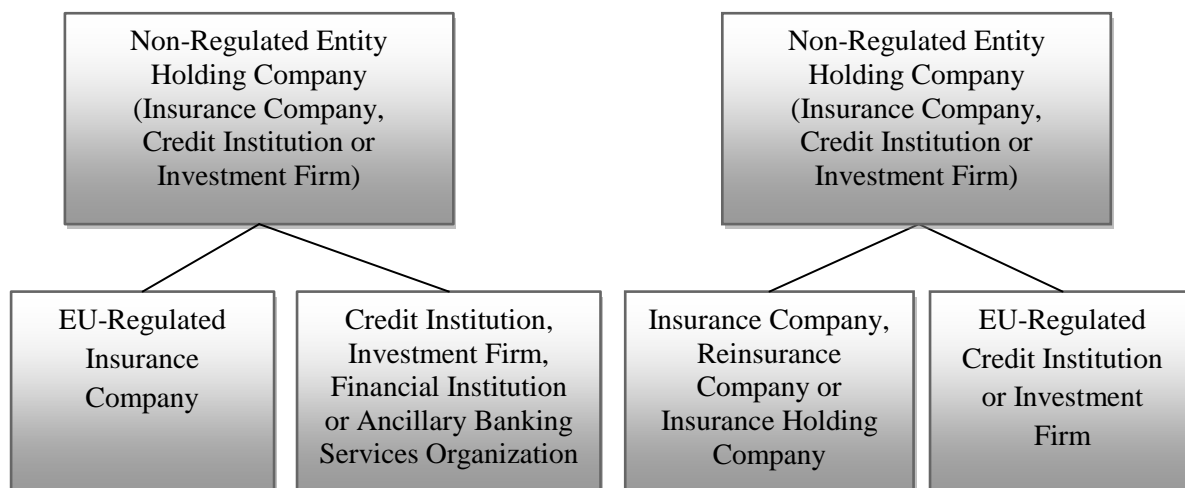


Source: Own elaboration from [6], [7]

Fig. 4: Horizontal Financial Conglomerate

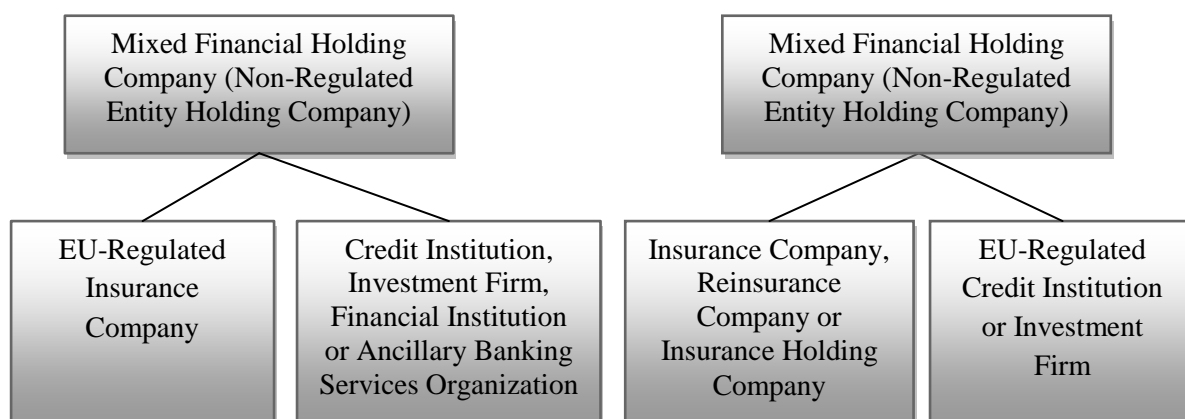
2.2 Financial Conglomerates Subject to Equivalent, Analogous or Appropriate Supplementary Supervision

Fig. 5 shows the hypothetical structure of financial conglomerates, if the group is headed by a non-regulated entity holding company.



Source: Own elaboration from [6], [7]

Fig. 5: Group headed by a Non-EU-Regulated Entity



Source: Own elaboration from [6], [7]

Fig. 6: Group headed by Mixed Financial Holding Company with Non-EU Head Office

Conglomerates that are headed by a mixed financial holding company are subject to supplementary supervision only if the group is mainly engaged in the financial sector, i.e., banking, insurance or investment services, and that in all financial conglomerates, the banking sector and the insurance sector must be significant [7].

2.3 The methodologies to calculate capital adequacy

There are three methods [6], [7] to identify the solvency requirement of the financial conglomerates. The aim of each method is to preserve the integrity of capital in the financial conglomerate and to ensure that it captures the risk of the group as a whole. The European Commission indentified these methods: accounting consolidation method (1); deduction and aggregation method (2); book value/requirement deduction method (3). All of the methods identify the supplementary capital adequacy requirements.

Method 1: Accounting consolidation, when the financial conglomerate is headed by a regulated entity and the other regulated entities belong to other sectors of financial conglomerate, can be expressed in the following formula:

$$SuppCAR = OF_{group} - \sum_i SR_{financial\ sector_i} \quad (1)$$

where $SuppCAR$ is Supplementary Capital Adequacy Requirement, OF_{group} is Own Funds,

$SR_{financial\ sector_i}$ is Solvency Requirement, i are entities of the financial sector within the group.

Method 2: Deduction and aggregation, when the financial conglomerate has a high degree of heterogeneity, is equal to:

$$SuppCAR = \sum_i OF_{reg\ and\ unreg} - \left(\sum_i SR_{reg\ and\ unreg} + \sum_j BV_{other} \right) \quad (2)$$

where $SuppCAR$ is Supplementary Capital Adequacy Requirement, $OF_{reg\ and\ unreg}$ is Own Funds, $SR_{reg\ and\ unreg}$ is Solvency Requirement, BV_{other} is Book Value of the participation, i are entities of the financial sector within the group, j are entities not belonging to the financial sector within the group.

Method 3: Book value/requirement deduction, when the parent entity has the most important role within the conglomerate, corresponds to:

$$SuppCAR = OF_{parent} - \left[SR_{parent} + \max(BV_k; SR_k) \right] \quad (3)$$

where $SuppCAR$ is Supplementary Capital Adequacy Requirement, OF_{parent} is Own Funds, SR_{parent} is Solvency Requirement, BV_k is Book Value of the participation, k is entities of the financial sector within the group.

Conclusion

This paper has analyzed the regulatory framework of financial conglomerates in Europe. The choice of methodology to calculate the capital requirement depends on the structure of the conglomerate. The financial conglomerates are regulated from Directives of the EU to maintain transparency of reporting capital adequacy requirements. Another important

influence is seen in the functioning of the new supervisory system. It will increase the effectiveness of the supervisory control within the financial entities of the financial conglomerate.

Acknowledgements

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Literature

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REGULATORNÍ RÁMEC FINANČNÍCH KONGLOMERÁTŮ V EVROPĚ

Tento článek se zabývá analýzou regulačního rámce finančních konglomerátů v Evropě. Pojem finanční skupina je velmi často zaměňován s pojmem finanční konglomerát. Lze konstatovat, že finanční konglomerát je finanční skupina, ale toto tvrzení nelze říci opačně. Finanční konglomerát definovala směrnice 2002/87/ES, ale v roce 2011 proběhla „redefinice“ tohoto pojmu a to vydáním nové směrnice 2011/89/EU. Nová směrnice by měla zlepšit doplňkový dozor nad finančními subjekty ve finančním konglomerátu.

DER ORDNUNGSPOLITISCHE RAHMEN FÜR FINANZKONGLOMERATE IN EUROPA

Dieser Artikel analysiert die Rahmenbedingungen für Finanzkonglomerate in Europa. Der Begriff der finanziellen Gruppe wird sehr häufig mit dem Konzept eines Finanzkonglomerats verwirrt. Daraus kann geschlossen werden, dass des Finanzkonglomerats eine Finanzgruppe ist, aber dieser Anspruch kann nicht in umgekehrter gesagt werden. Finanzkonglomerats, die Richtlinie 2002/87/EG, aber im Jahr 2011 war „Neudefinition“ des Begriffs durch die Ausgabe einer neuen Richtlinie 2011/89/EU. Die neue Richtlinie sollte die Verbesserung der zusätzlichen Beaufsichtigung der Finanzunternehmen eines Finanzkonglomerats.

RAMY REGULACYJNE DLA KONGLOMERATÓW FINANSOWYCH W EUROPIE

Ten artykuł analizuje ramy regulacyjne dla konglomeratów finansowych w Europie. Pojęcie grupy finansowej jest bardzo często mylone z pojęciem konglomeratu finansowego. Można stwierdzić, że konglomerat finansowy jest grupą finansową, ale stwierdzenie to nie można powiedzieć, w odwrotnej kolejności. Konglomeratu finansowego, dyrektywa 2002/87/CE, ale w 2011 była „redefinicja” terminu poprzez wydanie nowej 2011/89/EU dyrektywa. Nowa dyrektywa powinna poprawić do dodatkowego nadzoru nad podmiotami finansowymi konglomeratu finansowego.