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

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 lever,
- 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).
The entities that are part of financial sectors are represented in the following Tab. 1.

**Tab. 1: Financial Sector Entities**

<table>
<thead>
<tr>
<th>Entities \ Sector</th>
<th>Banking Sector</th>
<th>Investment Sector</th>
<th>Insurance Sector</th>
<th>Mixed financial holding company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulated Entities</td>
<td>Credit institution Asset management company</td>
<td>Investment firm Asset management company</td>
<td>Life insurance undertaking Non-life insurance undertaking Asset management company</td>
<td></td>
</tr>
<tr>
<td>Non-Regulated Entities</td>
<td>Financial institution (other than an investment) Ancillary banking service undertaking</td>
<td>Financial institution (other than an investment firm)</td>
<td>Reinsurance undertaking Insurance holding company</td>
<td>Mixed financial holding company</td>
</tr>
</tbody>
</table>

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.
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

**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:

\[ \text{SuppCAR} = OF_{\text{group}} - \sum_{i} SR_{\text{financial sector}} \]  

where \( \text{SuppCAR} \) is Supplementary Capital Adequacy Requirement, \( OF_{\text{group}} \) is Own Funds, \( SR_{\text{financial sector}} \) 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:

\[ \text{SuppCAR} = \sum_{i} OF_{\text{reg and unreg}} - \left( \sum_{i} SR_{\text{reg and unreg}} + \sum_{j} BV_{\text{other}} \right) \]  

where \( \text{SuppCAR} \) is Supplementary Capital Adequacy Requirement, \( OF_{\text{reg and unreg}} \) is Own Funds, \( SR_{\text{reg and unreg}} \) is Solvency Requirement, \( BV_{\text{other}} \) 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:

\[ \text{SuppCAR} = OF_{\text{parent}} - \max \left( SR_{\text{parent}} + \max \left( BV_{k} ; SR_{k} \right) \right) \]  

where \( \text{SuppCAR} \) is Supplementary Capital Adequacy Requirement, \( OF_{\text{parent}} \) is Own Funds, \( SR_{\text{parent}} \) 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

[1] Zákon č. 377/2009 Sb., o doplňkovém dozoru nad bankami, spořitelními a úvěrními družstvy, institucemi elektronických peněz, pojišťovnami a obchodníky s cennými papíry ve finančních konglomerátech a o změně některých dalších zákonů (zákon o finančních konglomerátech).


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DER ORDNUNGSPOLITISCHE RAHMEN FÜR FINANZKONGLOMERATE IN EUROPÄ


RAMY REGULACYJNE DLA KONGLOMERATÓW FINANSOWYCH W EUROPIE