Financial Groups and Conglomerates

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Until the mid-1980s, financial institutions in Denmark were sector-specific. The establishment of Hafnia Invest A/S in 1984, and subsequently Baltica Holding A/S and TopDanmark A/S, marked the beginning of a new era. Legislation in Denmark was liberalised in 1989-90, giving wider scope to conduct other types of financial activities via subsidiaries. Among other things, this meant that banks could own subsidiaries operating in other financial sectors.

Within the EU, the term financial group is used to describe financial undertakings that are affiliated by ownership and which comprise at least one other financial company besides the parent company. Traditional financial groups typically operate within one sector, e.g. a parent bank and a number of subsidiary banks in a banking group. A financial conglomerate is a group with activities in at least two financial sectors, including at least one insurance company.

Mergers between financial enterprises across financial sectors and national borders, leading to the establishment of financial groups and conglomerates with activities in several countries, is a natural element of the development of the single financial market in the EU. This development makes new demands of the boards and managements of financial enterprises, but also of regulation and supervision, since there is a risk of transferring potential problems between companies in the same group.

The regulation and supervision of financial enterprises take the individual company as their point of departure. In contrast to this approach, there is an increasing tendency to form international financial groups and conglomerates where decisions are taken across the legal corporate structures. This development presents a challenge in relation to supervision of the individual company, but also in relation to cooperation between national and international supervisory authorities in order to conduct supervision of the entire group.

This article investigates the extent to which the formation of national and cross-border financial conglomerates changes the risk scenarios for the individual companies that are subject to supervision, and whether the regulation and supervision of these cross-border conglomerates can

keep up with developments, the ultimate objective being to ensure financial stability.

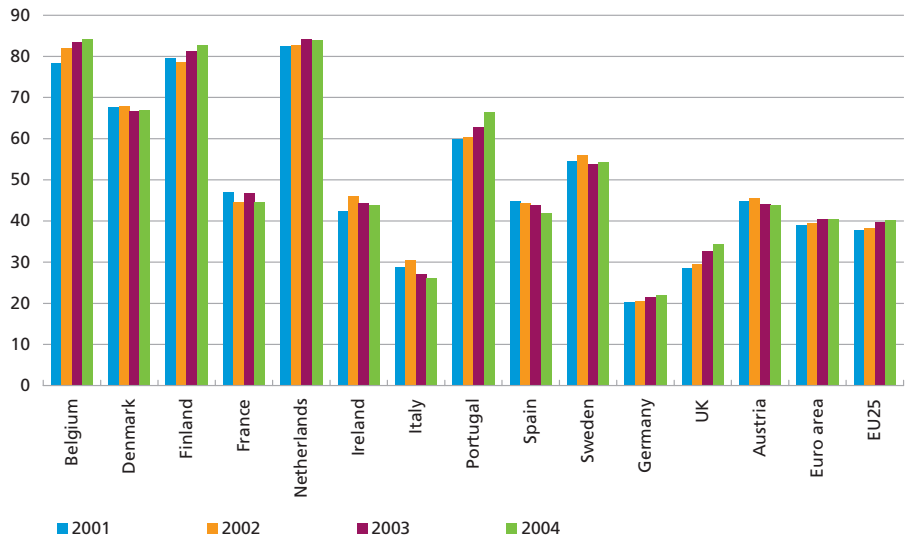
A CHANGING FINANCIAL LANDSCAPE WITHIN THE EU/EEA

Many of the mergers that have taken place in the financial sector in Denmark and within the EU/EEA in the last 15-20 years have led to the formation of financial groups and conglomerates. Previously, mergers mainly took place within one country, but in recent years cross-border mergers have also been seen.

To some extent the opportunities to achieve economies of scale via domestic mergers seem to have been exhausted. This applies particularly to the high concentration of the largest banks in the small EU member states, cf. Chart 1. On the other hand, national competition considerations can make it more difficult for small member states to establish large financial groups in an international context.

For some years, Nordic banks and insurance companies have focused on the entire Nordic region, rather than just their home country. The formation of Nordea and Danske Bank's acquisitions of Östgöta Enskilda Bank in Sweden and Fokus Bank in Norway are examples of this. Danske Bank's acquisitions of National Irish Bank and Northern Bank in 2004 show that

CR5 INDEX, SELECTED EU MEMBER STATES, PERCENTAGE OF TOTAL ASSETS — Chart 1



Note: CR5 is the market share of the largest 5 credit institutions on an institution basis. For Denmark, mortgage-credit institutes are included.
Source: ECB.

the financial groups are expanding into new regions. To varying degrees the development in the rest of the EU/EEA shows the same tendency, e.g. Spanish Santander's acquisition of Abbey National in the UK, Italian Unicredito's acquisition of HVB in Germany, and ABN Amro's acquisition of Banca Antonveneta in Italy.

This development is an element of the financial integration and the creation of the single market for financial services in the EU. The "second generation" of financial directives[1] has given the opportunity and the right to conduct cross-border business activities within the EU/EEA.

SPECIAL RISKS RELATING TO CONGLOMERATES

A financial enterprise that is part of a financial group or conglomerate may, in addition to the ordinary risks in financial enterprises, e.g. credit risk, market risk and insurance risk, also be exposed to risks resulting from the group affiliation. The common denominator of these risks is the risk of contamination, i.e. the risk that problems within one company are transferred to other companies within the same group, even though they are independent legal units. The contamination risk may relate to internal issues within the group. For instance, the individual company may trade with other companies within the same group (intra-group transactions) on non-market terms. There may also be a capital deficit in the group and in the individual company due to multiple gearing, i.e. simultaneous use of the same capital to meet statutory capital requirements in several companies within the group. In addition, complex group structures can make it difficult to assess the finances of the group. A company that is part of a group may also incur risks that it would not otherwise have taken on if the board and management had acted independently in the interests of that company alone.

External factors can also contribute to transferring problems from one company to another. These may be direct or more indirect factors, collectively known as reputational risk. More specifically, if one part of a group acquires a poor reputation, this may rub off on the rest of the group, so that the whole group experiences problems in one or several areas.

Group risks for a conglomerate can be amplified as a consequence of different legislation, supervisory practice and culture within the various financial sectors.

[1] Insurance directives 92/49/EEC and 92/96/EEC and the second banking directive, 89/646/EEC.

Risks relating to cross-border groups and conglomerates are fundamentally the same. However, the fact that activities expand across national borders may complicate matters. Risks may be augmented as a result of different jurisdictions, and particular supervisory risks may arise as a consequence of different rules and supervisory practices, as well as the need to coordinate supervisory activities.

REGULATION OF GROUPS AND CONGLOMERATES IN THE EU

In principle, the issues relate to all companies in a group, but often legislation is aimed at protecting subsidiaries and affiliates.

Within the EU, the regulation of financial enterprises seeks to take the various types of risk into account. Financial enterprises are regulated individually by directives covering the individual sectors, e.g. insurance[1] and banking[2]. This regulation takes the individual company as its point of departure. The supervisory authority of the home country issues the licence to operate and supervises the individual company. In addition, banking groups are regulated by the Directive on the supervision of credit institutions on a consolidated basis.[3] The directive concerns supervision of groups comprising several credit institutions, including cross-border groups. If the parent company is a credit institution, the supervisory authority of the parent company is responsible for exercising supervision on a consolidated basis, and for this purpose it must require full consolidation of the group in terms of solvency, market risks and control of large exposures. In addition, there must be adequate internal control mechanisms for the production of any data and information which would be relevant for the purposes of supervision on a consolidated basis.

For insurance groups, the insurance directive[4] enables the supervisory authority to conduct supplementary supervision if a company is part of a group, e.g. a cross-border group. Supplementary supervision primarily consists of calculating an "adjusted solvency situation", among other things to prevent multiple gearing, as well as receiving information from other companies in the group.

As regards mixed groups, conglomerates, the conglomerates directive was adopted in 2002[5]. It aims at ensuring uniform terms of competition for different types of financial group by imposing a number of obligations which transcend sector divides and national borders. It is not an

[1] Directives 92/49/EEC and 92/96/EEC.
[2] Directive 89/646/EEC (2000/12/EC).
[3] Directive 92/30/EEC.
[4] Directive 98/78/EC.
[5] Directive 2002/87/EC.

actual consolidation directive in the same way as the credit institution directive, since the institution responsible for the consolidated supervision is not defined. Instead, the directive operates with a coordinator who is to coordinate supervisory activities between the authorities involved. The coordination primarily involves compiling information from the entire conglomerate. The directive aims to take group risks into account, since simultaneous use of the same capital in several entities of the conglomerate (multiple gearing) is not possible. In addition, the solvency position must be calculated at the level of the conglomerate, and intra-group transactions and risk concentration are regulated. To counteract lack of transparency in the conglomerate there are requirements of risk management, assessment of the fit and proper character of the management, and a requirement of close collaboration between the supervisory authorities. However, the directive does not require harmonisation of the actual supervisory provisions, or convergence of supervisory activities. It seeks solely to take account of the "extra" risks that may arise as a result of the formation of the conglomerate. The starting point is thus still the individual company.

The Danish rules

The Danish regulation of financial enterprises is based on European regulation. However, Denmark addressed some of the consequences of the formation of groups earlier than the EU. For instance, since 1994 the Act on Danish Commercial Banks and Savings Banks has contained provisions on intra-group transactions, and previously intra-group lending was prohibited. Since 2001, the various Danish supervisory acts[1] have been consolidated into one act, the Financial Business Act. The objective is, *inter alia*, to strengthen supervision of financial conglomerates, and the basic principle is that uniform financial services should be regulated in the same way, irrespective of which financial institution they are offered by.

The individual company subject to supervision

The legal regulation by the EU, and thus by Denmark, of groups and conglomerates is in principle secondary to regulation of the individual company. The regulation of conglomerates is based on legal structures and the autonomy of the individual company, since the licence to conduct financial activities is given to a legal unit that must independently comply with all supervisory provisions. This also applies to com-

[1] The Act on Danish Commercial Banks and Savings Banks, the Act on Insurance Companies, parts of the Mortgage Credit Act and the Act on Investment Companies.

panies within a group or conglomerate. Consequently, the board and management of each individual subsidiary within a group are responsible for the subsidiary's activities. This responsibility cannot be transferred to the parent company or other companies within the group, e.g. via outsourcing or similar. The supplementary group regulation must take into account any contamination or misuse on the part of the other companies in the group, so it is important that the board and management of the individual company are able to make decisions independently of the group management, to the benefit of the individual company. These issues are particularly relevant in connection with cross-border conglomerates.

BUSINESS LINES

Financial groups and conglomerates are often managed on the basis of business lines that extend across legal structures within the group, in order to achieve economies of scale and rationalisation gains. There is a tendency[1] for conglomerates, including particularly internationally active conglomerates, to centralise key management functions, e.g. risk management, internal control, treasury operations (including liquidity management and funding), compliance and audit. This centralisation can entail the transfer of strategic decisions from the individual company to the group. In addition, there is a tendency to outsource[2] a number of functions that are key to the operation of the individual company, e.g. IT functions, within the group or to external providers. Outsourcing mainly takes place in order to achieve cost savings.

These development trends can lead to increasing divergence between the legal and operational structures of a conglomerate. Consequently, it can be difficult to attribute functions and activities to the individual legal units within the conglomerate as assumed in the regulation of the individual legal entity. Major differences between the legal and operational structures might complicate the supervision of the individual company.

LEGAL FIREWALLS

Several of the provisions of financial legislation that aim to prevent or minimise contamination between companies within a group or con-

[1] See the Joint Forum's report from 2003, Trends in risk integration and aggregation, and Dirk Schoenmaker and Sander Oosterloo, Cross-Border Issues in European Financial Supervision, October 2004.

[2] See the Joint Forum's report from 2005, Outsourcing in Financial Services.

glomerate are based on a legal firewall principle. This means that in the event of a crisis it must be possible to shield the individual company subject to supervision from other units within the group/conglomerate. It is a precondition that the company is able to continue its activities independently. In other words, the supervisory authorities must ensure that the core functions required for it to operate as an independent company are present within a short time horizon.

This issue has been analysed by a Dutch working party[1], which has investigated whether groups/conglomerates can establish effective legal firewalls that reduce the risk of contamination between the companies and support the individual company's business continuity, irrespective of any problems within the group.

The working party proposes that effective legal firewalls constitute part of the framework for monitoring and control of risks in the supervisory process under the future capital-adequacy rules (Basel II for banks and Solvency II for insurance companies). As part of the supervisory process, the conglomerates themselves will have to consider which measures should be taken to establish adequate legal firewalls between the companies. These measures would be subject to evaluation by the supervisory authorities, which must be empowered to impose extra capital requirements if the measures are found to be insufficient. Moreover, it is proposed that each individual enterprise that is subject to regulation within a conglomerate must publish "Legal firewall procedures", including whether support can be expected from other group companies in the event of problems. As a minimum, the working party proposes that the following issues be taken into account:

- Good corporate governance: each individual company has its own independent board and management, so that decisions are made in the interests of the company. This means that there are limits to the number of board members from other companies within the group. There should be a majority of non-group board members. This applies particularly if the group is managed according to a business principle. The board and management must have adequate tools to be able to assess the risks for the individual company.
- The company must be able to continue to operate alone, and consequently key functions cannot be outsourced.
- There must be rules for intra-group transactions based on market prices. There should be a clear policy for the terms on which intra-group outsourcing can take place.

[1] Council of Financial Supervisors in the Netherlands, The Netherlands Bankers' Association and The Dutch Association of Insurers, Study on Financial Conglomerates and Legal Firewalls, prepared by Freshfields Bruckhaus Deringer, October 2003.

- The use of shared company names in marketing activities must be regulated; it must be stated that companies on different sides of the legal firewall will not offer financial support to each other, e.g. via disclaimers.
- The actual structure of the company must enable separation of functions.

Denmark already has legislation governing intra-group transactions. On the other hand, there are no specific provisions concerning good corporate governance, outsourcing and shared company names. Danish credit institutions also tend to centralise functions via business lines extending across legal structures.

SUPERVISORY COLLABORATION WITHIN THE EU

International financial groups that are operationally integrated and looking for synergies and savings on the one hand, and supervisory authorities that are restricted by legislation and national borders on the other hand, constitute a challenge to financial stability, nationally and internationally. In addition, the fact that the financial groups are subject to different supervisory regimes in the various member states where they operate can in itself constitute a barrier to financial integration within the EU. Against this background there may be a need to increase collaboration between supervisory authorities within the EU, partly to improve the efficiency of supervision, and partly to ease the regulatory burden on financial groups.

Within the EU, three supervisory committees have been established. They are CESR[1] (securities), CEBS[2] (banking) and CEIOPS[3] (insurance), with representatives from the supervisory authorities of all EU member states. The purpose of setting up these committees is to work for uniform implementation of EU regulation, but also to promote uniform supervisory practices within these sectors. Issues of particular interest to the committees are cross-border operations, collaboration in relation to supervision of groups, and multilateral collaboration.

No conglomerates committee has been set up, but it has been discussed how the conglomerate issues can be addressed under the new structure.

The supervisory committees are not supranational supervisory authorities, and supervision of financial enterprises is still based on national

[1] Committee of European Securities Regulators.
[2] Committee of European Banking Supervisors.
[3] Committee of European Insurance and Occupational Pensions Supervisors.

supervision of the individual enterprise. In 2004, CESR published a report[1], in which it, among other things, proposed that the Committee should be a type of supervisor of the national supervisory authorities in the securities area, so that disputes between the supervisory authorities of different member states in relation to specific cases can be addressed on a non-legally binding basis. Similar ideas have been launched in relation to banking and insurance. The present structure of supervision of financial enterprises imposes very high requirements in terms of willingness and ability to work together and to coordinate supervisory activities in order to meet the needs that arise. There can thus be no doubt that the supervisory structure within the EU will continue to develop so as to fulfil the requirements of the market players for effective supervision, but also the need for adjustments in order to ensure financial stability.

[1] Which supervisory tools for the EU Securities markets? Preliminary progress report, 28 October 2004.