Supervision of financial conglomerates in Germany

The implementation of the European Financial Conglomerates Directive[1] into German law took effect on 1 January 2005.[2] It provides the regulatory answer to an issue which, over the past two decades, has been dealt with on the financial markets under the heading "one-stop finance" or – depending on the perspective – more specifically "bancassurance" for bank-dominated financial groups or "assurbanking" for insurance-dominated financial groups. Changes in market conditions have induced banks and insurance corporations to engage in many different forms of cooperation.

However, this cooperation is of supervisory relevance only if cross-sector banking and investment services as well as insurance services are provided within a single group of enterprises. The significance of such corporate groups which are active in various sectors differs quite considerably from one European country to another. In Germany, financial conglomerates are of greater importance in the insurance sector, where they account for a total of 52% of the gross premiums written. By contrast, with a market share of only 15.5% of deposits, they play a less significant

1 Directive 2002/87/EC of the European Parliament and of the Council of 16 December 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 (OJ L 35 of 11 February 2003, pp 1-27).
2 Act Implementing the Financial Conglomerates Directive (*Finanzkonglomeraterichtlinie-Umsetzungsgesetz*) of 21 December 2004 (Federal Law Gazette I, p 3610).

role in the banking sector. The focus of the new supervisory regime is now on laying down specific capital requirements at a financial conglomerate level and subjecting the risk concentrations as well as the intra-group transactions of such conglomerates to separate supervision.

One-stop finance

Changes in financial market structures ...

The dynamic developments and lasting changes in financial market structures over the past 20 years have increasingly blurred the dividing line between banking and insurance business. Banks and insurers alike consider, above all, the area of long-term investment and provisioning products – which can be flexibly adapted to changing customer needs or greater customer demands with regard to terms and conditions or yield – to be a growth market. Moreover, suppliers, by diversifying the financial products they offer and increasing flexibility in meeting customers' wishes and needs, aim to broaden and stabilise the earnings base across the existing range of business. In addition, they attempt to tap new and attractive sources of income in a capital-preserving manner through using other distribution channels.

... diversification of financial products ...

... development of new distribution channels and ...

In contrast to the insurance industry, the banking industry has found it difficult to develop new distribution channels, as experience has shown that it is easier to sell insurance products at bank branches than banking products via insurance field service staff. The banking industry has therefore focused its attention on exploiting the opportunities on offer in the area of private old-age pension provisioning in both the savings phase and subsequent asset management, and reducing the dependence of the results on the net interest received by increasing commissions. At the same time, attempts have been made to offset income volatility to a certain extent through the fact that, according to experience, the earnings of banks and insurers react differently to cyclical fluctuations – at least in part. Banks have also endeavoured to use their own products to make inroads into areas which have so far been the exclusive domain of insurance corporations, for instance, by developing and deploying suitable credit derivatives to gain a foothold in a market segment hitherto dominated by credit insurance. The term "one-stop finance" therefore signifies a strategy of providing customers with comprehensive financial services beyond the original field of activity within a sector and strengthening customer ties through optimising customer orientation, thus generating a more sustained and steadier income.

... offsetting income volatility

Forms of cooperation

This business strategy has been implemented in many different forms with varying degrees of intensity depending on the level of integration of the new business areas, ranging from forms of loose, open cooperation to complete integration in a group. Open cooperation is typically characterised by the brokering of products provided by changing partners. The idea here is to be able to offer, where possible, tailor-made products depending on need and in a customer-oriented manner. However, such open cooperation is often characterised by the absence of a unified market presence, such as the formulation

Open cooperation

and pursuit of joint strategic goals. Instead, the goals pursued by each of the cooperation partners prove to be factors derived from the strategic orientation laid down for the original business line.

Formalised cooperation

The formalised forms of cooperation are the next higher level of cooperation in terms of intensity. They are usually based on contractual agreements containing an – at least limited – exclusivity clause. These forms are often backed by mutual cross-shareholdings on the part of the cooperation partners. Such formalised cooperation has the advantage of allowing a unified market presence and, moreover, requires only a modest level of financial strength and capital input on the part of the partners. However, formalised cooperation provides only rather limited opportunities to significantly influence another cooperation partner. In the strategic orientation, it is therefore probably typical, in the event of a conflict of aims, for greater importance to be attached to the partners' self-interests in their usual areas of activity than to the jointly formulated goals of cooperation.

Open or guided architecture

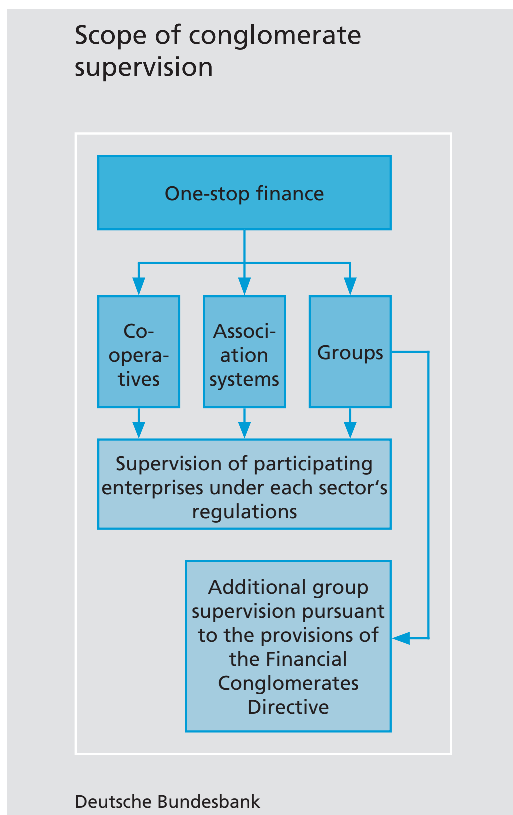
Open or guided architecture approaches have hardly played a role as alternative cooperation models in the area of one-stop finance so far. Such strategies – which have already been used in the sale of fund products for some time – give customers the opportunity to choose between the products offered by all or certain suppliers, for instance, a variety of investment companies. Although these approaches provide the incentive for all cooperation partners, including intra-group or network enterprises, to face broad-based competition, the predominant trend in one-stop finance strategies is still to concentrate on a single partner or very few permanent partners.

Associations

In principle, at least, associations in the savings bank and cooperative bank sectors should also be regarded as formalised cooperation models. However, they each exhibit network-specific features and, in some cases, a higher degree of mutual connection than other conventional forms of formalised cooperation. For instance, in the savings bank sector, insurance corporations are, as a rule, owned by the various savings bank associations. In the cooperative bank sector, the insurance corporation is a subsidiary of the leading institution.

Groups

The formation of cross-sector groups can be broken down according to the foundation strategies applied, ie joint or individual establishment and takeover strategies. A group strategy ensures a unified presence in the market and promotes coordinated financial products from the various sectors in the best possible way. In comparison with cooperation arrangements, however, a group strategy exacts a far higher demand for capital. In certain market environments, the lower flexibility may also appear to be a disadvantage. Indeed, dependence on the quality of a group enterprise is much greater than in the case of the cooperation models. The problem of strong interdependence also arises in the associations, however. In some cases, such interdependence may have considerable repercussions for the way in which an enter-



prise's own customers judge its trustworthiness.

No superior one-stop finance strategy

Owing to the various advantages and disadvantages of the different one-stop finance strategies, no one strategy has hitherto emerged as being the clearly superior one in practice. According to a study[3] by an investment bank, one-stop finance strategies are most successful if the insurance products are broadly tailored to banks' needs and the insurance corporation's presence in the market also corresponds to that of the bank. Although this strategy is best put into practice in a group, the trend in recent years has again been to move away from one-stop financial services groups. A change in strategy is currently discernible in the banking industry. In some cases, banks are selling off their participating interests in insurance undertakings and instead seeking and agreeing on formalised cooperation. This is a sign of a reversal of the trend towards cross-sector mergers and acquisitions which has prevailed over the past few decades and which has caused vast changes such as the repeal of the specialised banking system in the United States owing to the passage of the Gramm-Leach-Bliley Act.

Changes in customer preferences

Customers, too, have recently been showing less need for a "one-stop financial" strategy. New technologies and the high density of information on financial services have diminished the weight of the argument of comfort associated with one-stop finance strategies. Customers are now more willing to switch brands and will look for the best deal being offered by the best service provider. At the same time, the wide range of products offered by one provider, from residential mortgage loans to option transactions to baggage insurance, is often regarded as being too large and not exactly a seal of quality. In addition, whereas customers generally solicit extensive advice for investment and provisioning products, property insurance is often no longer regarded as a financial service but only as a protection against risk. From the customer's point of view, an overextended range of services ultimately calls the seller's competence into question. It threatens to water down the core competence of a brand name. This means that customers regard one-stop finance strategies as making sense particularly in those cases in which a product-neutral, customer-oriented advice can be im-

3 Monitor Group and JP Morgan, Combining Strengths: Bancassurance, 2002.

parted as a claim to competence which supports customers and relieves them of some of the effort involved in processing the flood of information. This is increasingly shining a spotlight on "open architecture" and "guided architecture" approaches, which are most conducive to the implementation of such a one-stop finance strategy.

Significance of financial conglomerates

No special supervision to date

In the past few decades, financial groups providing services and selling products in different financial sectors have been appearing on the financial markets. Credit institutions, investment firms and insurance undertakings belonging to such conglomerates, however, have to date not been subject to consolidated group supervision, even though some of these conglomerates are among the largest players on the financial markets and provide services across the globe. Were such conglomerates to encounter serious financial difficulties, this could jeopardise the stability of the financial system and cause considerable damage to individual savers, insurance undertakings or investors.

Eight German financial conglomerates …

The application of the Financial Conglomerates Directive in Germany will probably be focused on eight financial conglomerates. Given that a total of roughly 2,400 credit institutions, 450 insurance undertakings (excluding pension schemes and burial funds) and 830 financial services enterprises are licensed to do business in Germany, this number seems rather small – especially since the frequent use of "bancassurance" in the media would suggest that financial conglomerates are more widespread. In actual fact, the types of one-stop finance in Germany described above represent a much wider spectrum of cross-sector links than suggested by the narrow definition in the Financial Conglomerates Directive, which is confined to the integration of banks, insurance undertakings and investment firms in a single group. The new provisions cover neither contract-based sales and distribution cooperation between banks and insurance undertakings, which is relatively frequent in Germany, nor unqualified minority shareholdings between these two sectors.

… with different degrees of market power …

Despite their small number, the eight (probable) financial conglomerates in Germany, cover a considerable market share; their importance is very much greater in the insurance sector than in the banking sector. In 2003, these eight groups accounted for 43% of the gross premia written in German life insurance, damage/accident insurance, reinsurance and health insurance business. In deposit business with domestic non-banks, their market share was 12% in December 2004. If the analysis is extended to include banks and insurance undertakings active in Germany which belong to non-resident financial conglomerates based in western Europe, it increases the market share in insurance business held by financial conglomerates by a further 9 percentage points to 52% and the share in deposit business by 3.5 percentage points to 15.5%. Within the group of conglomerates, however, market share is distributed rather unevenly. The two largest German conglomerate groups already account for 33 percentage points of the 52% market

share in all insurance premia and just under 8 percentage points of the 15.5% share in deposits. It is not only the different significance of the individual groups that is striking but also the fact that the market shares in insurance business far exceed those in banking business. However, this is less a reflection of typical features of one-stop finance and more a reflection of structural concentration features in the two sectors. Because of the market position of savings banks and credit cooperatives, in particular, the five largest German banks account for a market share of only 18% in deposit business with domestic non-banks (as at December 2004). By contrast, the market shares of the five largest insurance undertakings range from 28% to 74% depending on the business line.[4]

... and heterogeneous development ...

There is a certain heterogeneity in the type of business conducted by German financial conglomerates. Whereas insurance services are offered by all conglomerates on a broad base, the banking services offered by some groups are restricted to the business of building and loan companies. In this confined market, in turn, the financial conglomerates have an important position, accounting for 45%.[5] Not all financial conglomerates offer investment services. For the groups active in this business line, it is often not even necessary to establish a subsidiary of their own because member credit institutions with a full banking licence can render the investment services themselves.

... have simply evolved

For the most part, the heterogeneity of German financial conglomerates has simply evolved and is reflected in each company's history. Three types of conglomerates can be identified: those established prior to the Second World War, those from the 1960s and 1970s, and those formed in the past ten years. In older groups, the "foreign" element tends to have evolved organically from scratch. Younger conglomerates, by contrast, are also the result of mergers and acquisitions, and this, even after allowing for the necessary costs of integration, makes it possible for them to overcome barriers to market entry more quickly. Finally, it is striking that none of the eight financial conglomerates has given up focusing on its core activities in favour of its more recent business lines.

Significance of conglomerates in EU-15

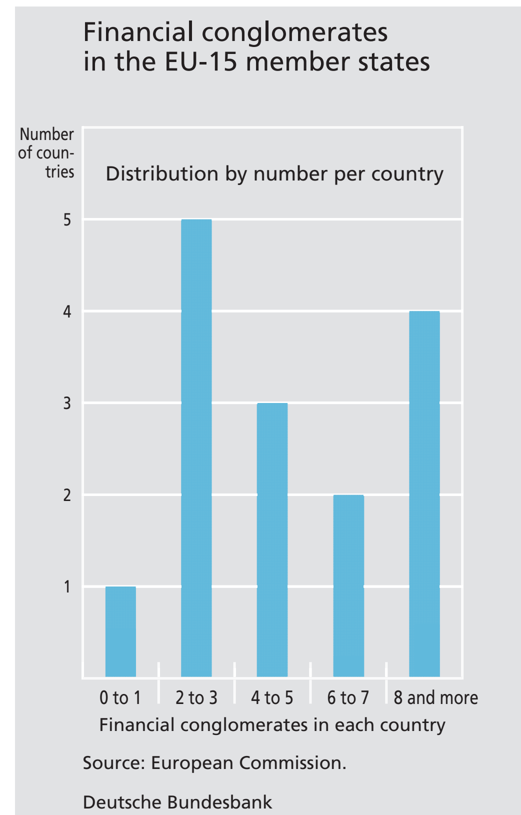
The small number of financial conglomerates in Germany in absolute terms is not specific to this country. Even in those EU-15 countries whose financial systems are characterised to a much greater extent by the definition of one-stop finance, such as Italy, Spain and France, the number of conglomerate groups is no higher, either. More extensive comparison within the EU-15 is possible only to a limited extent for two reasons. One is that conglomerates have not been fully identified in all countries, and the other is that smaller groups, in particular, do not publish consolidated figures. If one therefore confines one's attention to large financial conglomerates,[6] it

4 In terms of gross premia written, in 2003 the five largest German companies accounted for percentage shares of 33% in life insurance, 51% in health insurance, 28% in damage and accident insurance and 74% in reinsurance (source: BaFin).
5 The building and loan associations belonging to financial conglomerates held 45% of non-banks' building and loan deposits as at December 2004, with the two largest conglomerates accounting for no more than just under 5 percentage points.
6 In this context, a financial conglomerate is deemed to be "large" if either the banking or insurance group is one of the five largest national players in its industry.

is striking that particularly the relative deposit volumes in banking business and, in some cases, also the relative volumes of insurance premia of the foreign EU-15 groups[7] are far higher than those of German conglomerates (see chart on page 46). This is due not only to differences in the distribution of domestic market shares but, above all, to the fact that many foreign groups – particularly from smaller countries – are far more active across borders. Banking business, and naturally wholesale banking above all, is regularly affected more strongly by this trend than the insurance arm of a financial conglomerate. By contrast, bancassurance has been focused mostly on the life insurance sector, and, as a typical example of retail business, the sale of life insurance has remained closely confined to national markets owing to cultural, linguistic and legal differences among countries.

Comparison with German conglomerates

The vast majority of large financial conglomerates in the EU-15 originated in the banking industry – in contrast to those in Germany. More attractive potential for cross-selling, especially in countries with a small percentage of tied insurance agents, and higher market shares of many banks in retail business may be the reasons. Whereas only one-quarter of new life insurance contracts were sold through banks in Germany in 2003, in some EU-15 member states banks acted as a distribution channel for 50% to 75% of this business.[8] Another difference between foreign conglomerates and their German competitors is that many foreign conglomerates only came into being in the past 15 years following the lifting of legal barriers separating the individual financial sectors. As in the German



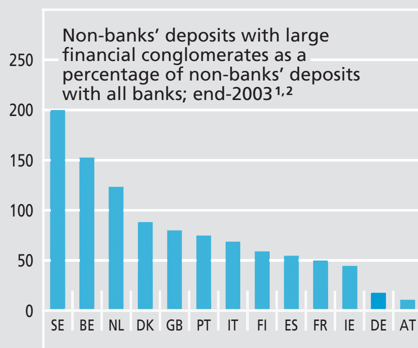
case, most of the foreign financial conglomerates that came into being during this period were formed through mergers and acquisitions. Even if it is primarily the insurance arms of some EU-15 conglomerates that have encountered particular strains in the past few years owing to developments in the capital markets, the financial conglomerate organisational form has become entrenched in many countries.

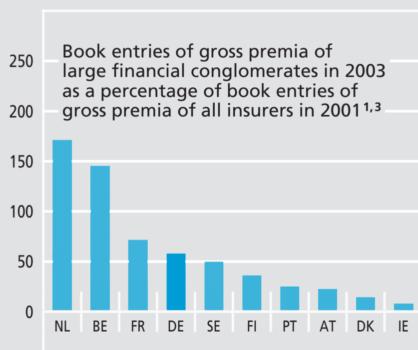
Diversification effects ...

Financial conglomerates exert a particular influence on financial system stability precisely when they hold a significant market share in

7 In the absence of more precise figures, relative deposit and premium volumes are presented as a ratio of total deposits or premium volumes of the group to the total deposits or volumes in the group's home country.
8 See the 2003/2004 Tillinghast survey on distribution practices and plans, as well as UBS.

Market shares of major financial conglomerates in selected EU countries*





* Large financial conglomerate: a group of companies that provides mainly banking and securities services as well as insurance services and whose banking and/or insurance group is one of the five largest national enterprises in the sector. — **1** Values in excess of 100% are the result of different sources of data: deposits/premia of individual conglomerates are both domestic and foreign whereas those of all banks/insurance companies are only domestic. — **2** Sources: BankScope and ECB. — **3** Data not available for Italy, Spain and the United Kingdom. Sources: ISIS, annual reports of the enterprises in the conglomerate, Moody's and the OECD.

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several financial sectors and acquire increasing importance in the market owing to their size. Diversification effects that enhance the immunity of the group – and ultimately also of the overall system – to external shocks can also create positive benefits. For one thing, the different maturity structures in the balance sheet (long-term bank assets contrasting with long-term insurance technical reserves) can reduce structural mismatches, and this is likely to make the asset and liability management of the conglomerates easier. For another, various studies based on share prices and annual accounts figures[9] indicate that the diversification of business areas and customer groups can result in financial conglomerates having a more stable profitability profile than banking-only or insurance-only groups. However, the diversification effects are tempered by the fact that banking and insurance revenue are both dependent on exogenous factors such as bond yields, share prices and indicators of business activity.

... efficiency gains ...

Potential efficiency gains obtained through the utilisation of economies of scale and scope also enhance financial conglomerates' ability to bear risk. This means that, for instance, more extensive opportunities for cross-selling might have helped the earnings of building and loan associations belonging to conglomerates to outpace those of the rest of the market over the past seven years (see chart on page 47). However, various examples over the past few years have shown that the specific environment in which the company is active is the crucial factor in determining whether the desired efficiency gains are actually achieved.

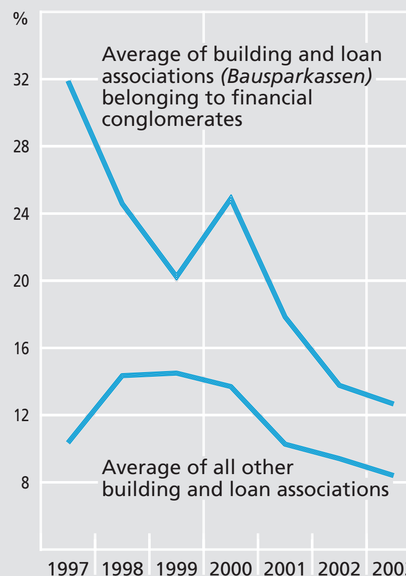
... and additional risks

The same applies for those factors that are detrimental to the ability to bear risk. Such

9 See, for instance, OECD (2004), The Performance of Financial Groups in the Recent Difficult Environment, in *Financial Market Trends*, March 2004, and G De Nicolo *et al* (2003), Bank Consolidation, Internationalization and Conglomeration: Trends and Implications for Financial Risk, IMF Working Paper 03/158. The opposite conclusion, ie that there is a discount on financial conglomerates' share prices, is reached by, for instance, L Laeven and R Levine (2004): Is There a Diversification Discount in Financial Conglomerates?

factors include the greater complexity of conglomerates, their reduced transparency and size-induced reduction in flexibility, and the opportunity of supervisory arbitrage. Other factors to be listed here include conflicting corporate cultures and the similar vulnerability of banks and insurance undertakings within a group in the event of unfavourable capital market developments. The formation of a conglomerate, moreover, also involves the risk of problems in one financial sector spilling over more quickly to other sectors – both within the conglomerate itself and throughout the financial system in general. Potential diversification and efficiency gains therefore offset greater networking and homogeneity of the overall system, which could result in vulnerabilities.

German building and loan associations' return on equity*



* Annual result before transfer of profits/dividends and taxes relative to balance sheet capital.

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The supervisory approach

Initial ideas on conglomerate supervision

Since as far back as the early 1990s, the question of supervising financial conglomerates has been the subject of discussion in scholarly literature. The objective should be to comprehensively capture the risks generated by the various types of business and their interactions, which contribute to creating a particular structure of risk associated with financial groups that are active across sectors. In April 1994[10] the Bundesbank also proposed comprehensive consolidation of bancassurance enterprises in order to prevent double gearing and to ensure adequate capitalisation. The institutional reaction to the blurring of the boundaries between sectors in many other countries, as well as in Germany, was to create an integrated supervisory authority.

Joint Forum on Financial Conglomerates

At the international level, the Joint Forum on Financial Conglomerates, established in 1996, addressed the issue. The Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO) work together in this Joint Forum. Following an extensive consultation process, in 1999 the Joint Forum published several documents on the supervision of financial conglomerates that had been compiled to form a compendium in 2001.[11] In line with the mandate of the Joint Forum, these documents begin by

10 See Deutsche Bundesbank, Financial conglomerates and their supervision, *Monthly Report*, August 1994, pp 49-60.
11 Published at the following web addresses: www.bis.org/publ/joint02.pdf and www.iaisweb.org/1343compendium.pdf.

addressing the coordination of the supervision of financial conglomerates and the exchange of information among supervisors. This is followed by sections on the fitness and propriety of managers, including those at financial holding company level, as well as on capital adequacy, intra-group transactions and the risk concentrations resulting from the various fields of business activity in the financial conglomerate.

Mixed Technical Group

This work done by Basel, and the work of the Mixed Technical Group – a European Commission working group composed of experts from all three fields of supervision – formed the basis for a Commission proposal of April 2001 for a Financial Conglomerates Directive, which was adopted on 16 December 2002 as Directive 2002/87/EC.[12] It is part of the European Commission's Financial Services Action Plan (FSAP) for completing the single market for financial services. This directive was then implemented into German law with effect from 1 January 2005 by a relevant implementing act.[13]

Objectives of the directive

The additional supervisory provisions for financial conglomerates are intended to close the gaps in the current sector-related legal regulations and to ensure the sound supervision of additional risks associated with financial groups engaged in cross-sector financial activities. The legal framework for each individual sector is often insufficient to supervise groups active across sectors adequately because of their different approaches. Only one-stop finance approaches based on the formation of groups are covered by supplementary supervision. The focus here is on assessing the financial situation at conglomerate level, especially solvency to the exclusion of multiple gearing (ie the multiple use of capital). At the same time, risk concentrations and intra-group transactions are to be monitored. The Directive also made minimal adjustments to existing industry regulations for the supervision of credit institutions, insurance undertakings and investment firms in order to prevent supervisory arbitrage between sectoral supervisory requirements and the provisions for financial conglomerates. However, since this has by no means harmonised the industry-specific supervisory provisions yet, the introduction of the supplementary supervision of financial conglomerates pursuant to this directive is only a first step.

Definition of a financial conglomerate

Definition

Financial conglomerates are defined as groups of enterprises consisting of a parent company, its subsidiaries, and those enterprises in which either the parent or one of the subsidiaries has a stake. Groups of enterprises that are united to form a horizontal group are also covered by this definition. The group must contain at least one insurance undertaking and one company from the banking/investment sector. One of these enterprises must be subject to supervision. If there is no supervised enterprise at the top, the group may be regarded as a financial conglomerate

12 Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate; see footnote 1.
13 Act Implementing the Financial Conglomerates Directive (*Finanzkonglomeraterichtlinie-Umsetzungsgesetz*) of 21 December 2004; see footnote 2.

only if it is active mainly in the financial sector. In that case, the companies active in the financial industry must account for at least 40% of the entire group's balance sheet total.

Considerable cross-sector activity

Moreover, for a group to be classified as a financial conglomerate, the enterprises must have considerable aggregated and consolidated operations in both the insurance and the banking or investment services sectors. The balance sheet total of the smallest sector in the conglomerate must make up, on average, more than 10% of the balance sheet total and of the solvency requirements of all affiliated financial services enterprises taken together. Moreover, considerable cross-sector activity must be assumed to exist even if the enterprises' balance sheet total in each sector amounts to at least €6 billion.

Supervisory definition of conglomerates

It is the responsibility of the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* BaFin) to determine whether a group which is active in multiple sectors is a financial conglomerate within the meaning of the Banking Act or the Insurance Supervision Act. BaFin currently assesses these cases and takes its decisions on the basis of the annual accounts for the financial year that ended in 2003. In parallel to the national procedures for determining which units are financial conglomerates, national supervisors are currently in the process of coordinating, at the European level, ways of identifying financial conglomerate operating across sectors. Although the identified financial conglomerates have to be reported to the European Commission, the Banking Act, pursuant to the provisions for banking groups in section 10a, does not provide for an announcement of these financial conglomerates.

Capital requirements for financial conglomerates

Financial conglomerates must have an adequate capital base at the conglomerate level. The superordinated company of the financial conglomerate, with its domestic domicile, and its subsidiary enterprises in the conglomerate need to be included in the calculation of the capital. Own funds pursuant to section 10 of the Banking Act and section 53c of the Insurance Supervision Act may be included as conglomerate-level capital components. Pursuant to the planned Financial Conglomerates Solvency Regulation,[14] it will be possible to apply two of the three envisaged methods in the EU Directive or a combination thereof for calculating capital requirements in Germany.

Calculation on basis of consolidated accounts

In the "calculation on the basis of the consolidated accounts" method, the additional capital requirements of the financial conglomerate's supervised subordinated enterprises are calculated on the basis of the consolidated accounts. Since, under German law (section 10a of the Banking Act), consolidated bank-

14 The Financial Conglomerates Solvency Regulation, which is awaiting final ratification, has passed the consultation procedure with the credit and insurance industry associations and now needs to be sent by the Finance Ministry to the *Bundesrat* (upper house) for approval and to the Deutsche Bundesbank for consultation. Passage of the regulation is therefore not expected until the middle of the year.

ing and securities supervision is based on the individual financial accounts of the subsidiary enterprises compiled in accordance with the Commercial Code and not on the group account, a separate solution, taking these facts into account, needed to be found for implementation. The approach is as follows. First, the own funds (as defined in sections 10 and 10a (6) sentences 3 to 9 of the Banking Act) of the enterprises from the banking and investment services sectors are added up. For the enterprises from the insurance sector that are to be included, the own funds are calculated as defined by section 53c of the Insurance Supervision Act and by the relevant rules (for calculating adjusted solvency on the basis of the consolidated accounts) laid down in the Solvency Adjustment Regulation (*Solvabilitätsbereinigungs-Verordnung*). The own funds of the financial conglomerate calculated in this manner have to exceed the sum of the solvency requirements for each sector according to its respective industry regulations.

Deduction and aggregation method

The "deduction and aggregation method" focuses on the own funds of each supervised and unsupervised enterprise of the financial conglomerate that is active in the financial industry. Here, the total recognised own funds of these enterprises must exceed the sum of solvency requirements which these enterprises have to meet and the book value of participating interests held in other group enterprises.

The methods are regarded as equivalent, even if the consolidation method may be more advantageous in that third-party shares in the capital of subsidiary enterprises and holding companies can only be included using this method. In agreement with the associations of the credit and insurance industries, the third method contained in the regulation, "book value/requirement deduction", was not implemented, since it is based on the "equity method" of evaluating participating interests, which is not in common use in Germany. Irrespective of the calculation method, there is no question given the rules and regulations relevant for each sector, of the own funds of enterprises in a financial conglomerate included in the calculation being recognised more than once. Intra-conglomerate capital creation, such as through counter-financing between the enterprises in a conglomerate, has to be ruled out as well. Furthermore, the inclusion of unsupervised mixed financial holding companies in the calculation of additional capital requirements prevents excessive leveraging, ie the issuance of debt by the parent enterprise to create capital for the subsidiary.

Choice of method

As regards the method chosen, BaFin, after consulting the parent financial conglomerate enterprise, determines the calculation method if

– a supervised financial conglomerate enterprise or reinsurance enterprise licensed to do business in Germany is at the top of the financial conglomerate

– or all supervised companies in the financial conglomerate are domiciled in Germany.

Otherwise, the mixed financial holding company is free to choose the method of calculation.

The additional capital requirements are to be initially calculated on the basis of the annual accounts for the business year beginning either on 1 January 2005 or during that calendar year. So far there is no telling whether the additional capital requirements will increase the need for capital for the probable financial conglomerates in Germany, too. Since, at sector level, the capital requirements have been met, an additional need for capital can occur only if the intra-group capital creation cannot be offset by third-party-provided own funds that are not needed at the sector level. If, after the additional capital requirements are calculated, it turns out that the existing own funds are insufficient, the shortfall can be offset only by capital components recognised as permissible capital components in accordance with all sectoral regulations (cross-sector capital).

Capital deduction for participating interests in insurance undertakings

If a group is not deemed to be considerably active across sectors and is therefore not classified as a financial conglomerate, a new deduction arrangement applies to the group's banking and financial services institutions. At the individual institution level, they will have to deduct, in future, the following elements from the sum of their core capital and additional capital.

- Participating interests within the meaning of section 271 (1) sentence 1 of the Commercial Code in primary insurance companies, reinsurance companies and insurance holding companies.
- Direct or indirect participating interests amounting to 20% of the capital or voting rights of primary insurance companies, reinsurance companies and insurance holding companies.
- Claims arising from participation rights and subordinated liabilities vis-à-vis these holding companies.

On request, however, BaFin can waive the right to deduct these items if one of the methods described above is used to calculate capital adequacy.

Risk concentration in the conglomerate

Definition

Risk concentrations within the meaning of the Banking Act are all exposures of the enterprises within a financial conglomerate that are subject to default risk and are large enough to jeopardise the solvency or the general financial position of the supervised financial conglomerate enterprises. It makes no difference here whether the threat of default is based on, or can be based on, counterparty risk, credit risk, investment risk, insurance risk, market risk, any other type of risk, a combination of the above risks or an interplay between these types of risk.

Power to issue a regulation and transitional arrangement

The Financial Conglomerates Directive provides for the member states to develop their own standards for quantitative limits on risk concentrations or to allow their national

supervisors to do so until there is further co-ordination. The Banking Act takes this into account by giving the power to issue a legal regulation that can define the type of risk concentrations that are to be reported, the threshold values for qualifying them as significant and the upper limits for such significant concentrations of risk that have to be observed. Violations of these upper limits would have to be reported immediately to BaFin and the Bundesbank and, at BaFin's request, to be backed by capital. Until this legal regulation has been adopted, the significant risk concentrations to be reported are the counterparty, credit or investment risk exposure vis-à-vis a borrower unit which, individually or in total, amount to or exceed 10% of the conglomerate-level capital requirement. In addition, insurance risk concentrations that arise from the following factors and that have been identified by the internal risk management system as significant have to be reported.

– Major risks (see Article 10 (1) of the Introductory Act to the Insurance Contract Act (*Einführungsgesetz zum Gesetz über den Versicherungsvertrag*)).

– Cumulative risks (risks arising from the accumulation of damages from various insurance sectors).

– Risks that take a long time to develop and whose causes are difficult to pinpoint.

– Risks from a combination of or interplay among the individual types of risk.

For the transitional period, it was decided initially to forgo the setting of upper limits for significant concentrations of risk since the banking sector's large exposure rules and the insurance industry's investment rules are not compatible. Following the Banking Act's large exposure rules for counterparty, credit or investment risks would virtually nullify the existing investment regulations in the insurance industry, whose regulations governing the spreading of risk are not geared to capital.

Intra-group transactions

Definition

In the future, superordinated enterprises in a financial conglomerate will have to report significant intra-group transactions in the conglomerate to BaFin and the Bundesbank. The Banking Act defines intra-group transactions as transactions in which supervised financial conglomerate enterprises directly or indirectly draw on the support of other enterprises within the same financial conglomerate to fulfil an obligation. It is immaterial whether this happens on a contractual basis or otherwise and whether this is against payment or free of charge. These transactions include, for instance, all intra-group loans, guarantees, warranties and other off-balance-sheet transactions, transactions involving own funds components within the meaning of the Banking Act or Insurance Supervision Act, or cost-sharing agreements.

Power to issue a regulation and transitional arrangement

Regarding intra-group transactions, too, the Financial Conglomerates Directive provides for the member states to develop their own standards for quantitative limits on risk con-

centrations or to allow their national supervisors to do so until there is further coordination. This, in turn, is taken into account by way of an authorisation to issue a regulation. The type of transactions that need to be reported, the thresholds for categorising them as significant, the upper limits that have to be observed and limitations on the type of such transactions are to be defined in the legal regulation. Significant intra-group transactions may be conducted by the stated enterprises only on the basis of a unanimous decision by all managers. If the upper limits are breached, BaFin may order the violating party to back the excess amount with own funds. Until the legal regulation has been adopted, it will be necessary to report individual transactions if they reach or exceed 5% of the capital requirement at conglomerate level. Several transactions of one or more group enterprises during a business year have to be combined for each counterparty, even if individual transactions do not reach the aforementioned threshold.

Intra-group transactions within mixed corporate groups

The same applies to significant intra-group transactions for deposit-taking credit institutions, e-money institutions or investment firms within a mixed corporate group. These groups consist of a mixed enterprise and its subsidiaries. In this context, a mixed enterprise is an enterprise that is neither a financial holding company, a mixed financial holding group or an institution within the meaning of the Banking Act and whose subsidiaries include at least one deposit-taking credit institution, one e-money institution or one investment firm.

Internal risk management

Integral risk management

One of the major challenges facing the management of financial conglomerates will be integrating the management of risk across the various sectors. Risk management is currently focused on sector-specific risks. In future, it will also be necessary to introduce integral risk management in order to manage the group. As regards managing the risks of intra-group transactions and risk concentrations, the requirements that financial conglomerates have to meet have been described as proper organisation and adequate internal control methods. Whereas intra-group transactions within a mixed corporate group are governed in detail by the Banking Act, the detailed requirements for financial conglomerates will still need to be specified in a legal regulation.

Individual elements

To this extent, the EU Directive requires that, at the conglomerate level, appropriate risk management and adequate internal control methods be in place, including a proper business organisation and proper accounting procedures. Appropriate risk management includes the following elements.

– Sound governance and management.

– Approval and regular review of strategies and policies concerning all incurred risks by the appropriate governing body at conglomerate level.

– Adequate capital adequacy policies that anticipate the effects of their business

strategy on the risk profile and capital requirements.

– Adequate procedures which ensure that the risk monitoring systems are properly integrated into the organisation.

– Measures which ensure that the systems implemented in those enterprises subject to supplementary supervision are consistent so that all risks can be measured, monitored and controlled at the level of the financial conglomerate.

Proper internal control mechanisms include the following elements.

– Adequate mechanisms as regards capital adequacy (to identify and quantify all material risks) and to appropriately relate own funds to risks.

– Sound reporting and accounting procedures (to identify, measure, monitor and control the intra-group transactions and the risk concentration).

Coordination of the supplementary supervision of financial conglomerates

In order to ensure the efficiency of supplementary supervision, the Financial Conglomerates Directive envisages the appointment of a coordinator from among the competent authorities in several member states concerned. The coordinator would coordinate and exercise supplementary supervision over this financial conglomerate. The coordinator is to be chosen by the responsible national/sectoral supervisory authorities, with the choice being based on certain criteria such as the domicile and size of the enterprises and the relative importance of each sector in the conglomerate. However, the Financial Conglomerates Directive does not give the coordinator any decision-making or even implementation powers which would affect the tasks and responsibilities of the other competent supervisors. At the European Commission level, a working group composed of representatives of the national supervisory authorities are identifying such cross-border financial conglomerates with the aim of appointing the coordinator.

BaFin's tasks as a coordinator

If BaFin is appointed coordinator, the German Banking Act envisages the following tasks.

– The coordination of the collection and dissemination of pertinent information during ongoing monitoring and in crisis situations.

– The general assessment and supervision of a financial conglomerate's financial position.

– Assessment of compliance with provisions governing capital adequacy, risk concentration and intra-group transactions.

– Evaluation of the structure, organisation and internal control systems of the financial conglomerate.

– Planning and coordination of supervisory activities in cooperation with foreign au-

thorities and, within Germany, with the Bundesbank where credit and financial services institutions are concerned – both during ongoing supervision and in crisis situations.

Assessment and outlook

Financial conglomerates occupy a position of special importance in Germany, especially on insurance markets; this is evidenced by the significant market shares held by the two largest German groups as well as by the notable activities of major foreign financial conglomerates in Germany. The implementation of the EU Financial Conglomerates Directive in Germany takes account of the growing economic importance of financial conglomerates. For the first time, supervisors have been given a tool to overcome the risks to the financial system associated with financial conglomerates. It is particularly the supplementary capital requirements for financial conglomerates and the enshrined prohibitions on multiple use of capital ("double gearing"), internal capital creation and capital creation through an unsupervised parent enterprise issuing debt ("excessive leverage") which are intended to increase group solvency and contribute to financial market stability. The Bundesbank's comprehensive involvement in financial conglomerates' reporting improves its ability, within the framework of its statutory task of ongoing monitoring of credit institutions and financial services institutions, to assess the risks to enterprises within a conglomerate and the risks to financial market stability posed by financial conglomerates.

No integrated supervisory approach yet

All the same, in group-wide supervision of financial conglomerates, supervisors are challenged by the fact that sectoral supervisory requirements address the relevant risks differently and that there is still no integrated approach to cross-sector supervision of equivalent risks. Supervisors are therefore still largely confining themselves to a form of monitoring that informs them about risk concentrations and intra-group transactions but does not yet set integrated supervisory upper limits across all sectors. This appears sensible and reasonable. It is therefore important, prior to creating more extensive supervisory standards, to compile information and gather experience based on incoming reports. Arrangements to resolve or at least disclose conflicts of interest resulting from business activity in different financial sectors have not been reached, either. The focus of the supervision of companies belonging to a financial conglomerate will remain on individual supervision that is supplemented, but not superseded, by rules governing group-wide supervision (solo-plus approach). It remains to be seen whether the European deliberations on an overhaul of the insurance supervision system, titled "Solvency II", will result in a supervisory approach that will make integrated supervision across sectors possible through the envisaged incorporation of elements from banking supervisory strategy.

Unique supervisory strategy necessary for other one-stop finance strategies

Unique approaches need to be found for the other one-stop financial strategies which were mentioned at the beginning and which are not covered by the aforementioned supplementary supervision because a "group" does not exist. It is precisely for the various types of

more flexible and loose cooperation models that conglomerate supervision, which is geared to groups, would entail an unreasonable supervisory burden. Therefore, the focus here should be on close cooperation and an extensive exchange of information among the supervisory institutions in the various sectors. This exchange of information should pursue two objectives. One is to help improve the evaluation of cooperation with enterprises from the other financial sector in the case of sectoral individual supervision of an enterprise. The other is that it should also facilitate coordination between competent national supervisors in the deployment and evolution of the surveillance toolkit in connection with such one-stop finance strategies.

The provisions of section 7 of the Banking Act and section 84 (4) No 2a of the Insurance Supervision Act on the exchange of information mean that Germany already has the statutory basis for such close cross-sector cooperation between BaFin's insurance and banking supervisory wings, on the one hand, and the Bundesbank, on the other, which means that these one-stop finance strategies are also monitored. Furthermore, it must also be noted that the number of contact points between the banking and insurance industries is growing constantly, whether via direct credit relationships, credit risk transfer, the convergence of product markets or mutual dependence on the capital market. From this point of view, too, it is appropriate and necessary not only to focus on the joint supplementary supervision of financial conglomerates but also to keep a watchful eye on all key interrelationships between these two sectors in order to make an accurate assessment of their scope and relevance to the stability of the financial system.