Box 7

FINANCIAL STABILITY AND BANCASSURANCE GROUPS – LESSONS FROM THE EURO AREA EXPERIENCE DURING THE FINANCIAL CRISIS

A popular financial services model in Europe is a melding of banking and insurance activities together under one roof – or so-called bancassurance groups. These arrangements can yield many benefits, including economies of size and scope, and sectoral diversification can reduce income and balance sheet volatility.[1] The financial crisis, however, also highlighted the fragilities of this model, with recourse to state aid by several financial groups with significant banking and insurance activities. First, the complexity and the inherent opacity of the structure pose challenges in terms of risk management, market discipline and supervisory control. Second, the multiple use of regulatory capital may overstate the capacity of a group to absorb losses – either across the various regulated entities within the group (double or multiple gearing) or through the use of debt issued at the holding company level to acquire equity stakes in subsidiaries (double leverage). Third, intra-group transactions may lead to risk transfers and contagion channels within the group. Finally, the various units of a group may individually build up risk positions, which may lead to an uncontrolled concentration of risk at the group level. In the European Union, bancassurance groups are subject to supplementary supervision concentrating on these risks, provided that they match the criteria stipulated in the Financial Conglomerates Directive (FiCoD).[2]

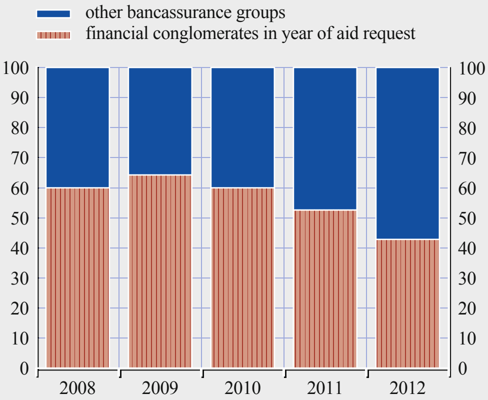
An analysis of bancassurance groups that suffered distress during the financial crisis can offer several insights into potential fragilities of this business model. To begin with, it is notable that many euro area bancassurance groups that received state aid in the context of the financial crisis did not qualify for the supplementary supervision under FiCoD (see Chart A).

An analysis of the causes of state-aid requests gives rise to three immediate observations (see Chart B). First, the number of cross-border and/or cross-sectoral cases underlines the importance of further enhancing group-level control and supervision – both at a euro area and at a global level (given a plethora of cross-border issues). Indeed, many of the state-aid requests at the start of the crisis were related to impairments in US entities. Concrete cases of cross-sectoral problems include in particular correlated exposures across the units and double leverage – such as the case of SNS Reaal, where a first request for state aid in 2008 was triggered by pressure on the capital of the insurance arm, with considerable group-level difficulties related to double leverage. The recent rescue further underlined the risks related to double leverage, as disentangling parts out of the group proved impossible owing to the need to repay the loans taken out by the holding company.

1 See F. Dierick, "The supervision of mixed financial services groups in Europe", *ECB Occasional Paper Series*, No 20, August 2004.
2 Broadly speaking, a financial conglomerate has to operate in the insurance sector and also have other (banking or investment) activities, and the extent of the activities should exceed the minimum thresholds.

Chart A Composition of euro area bancassurance groups having received financial crisis-related state aid

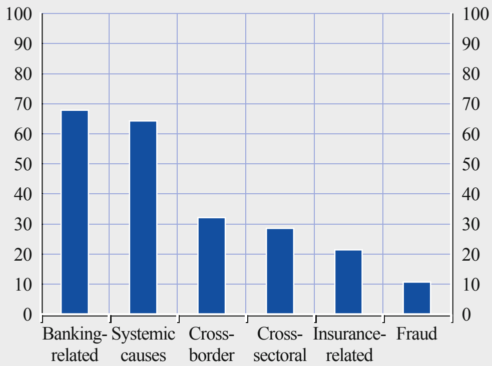
(2008 – 2012; percentage of the cumulative number of bancassurance groups having received state aid)



Sources: List of identified financial conglomerates, European Commission and national ministries of finance.
Note: The sample consists of 28 cases of state aid to financial groups with both banking and insurance activities for which sufficient information was available.

Chart B Main contributors to financial crisis-related state-aid requests for euro area bancassurance groups

(percentages)



Sources: European Commission, national ministries of finance and ECB calculations.
Notes: Multiple entries are possible. Cross-sectoral contributors include multiple gearing, double leverage, intra-group contagion, and concentrated exposures across sectors. Systemic causes include, inter alia, requirements to raise capital above regulatory minima owing to a general loss of confidence, and are included only when they are considered to have had a decisive impact on the aid request.

Second, the need for state aid seems to have originated predominantly from the banking units of the groups. The causes include in particular reliance on short-term funding and excessive mortgage or commercial property lending during the years preceding the crisis. Requests originating from the insurance arms have typically related to mark-to-market valuation declines in investments, sometimes combined with non-standard business features that have allowed policyholders to withdraw policies at low cost (e.g. Ethias). Despite these high-profile cases of difficulties with conglomerates, it should be acknowledged that many other cases have underlined the benefits of diversification (such as the case of Irish Life & Permanent Group).

Third, the majority of cases involve systemic causes, a result that underlines the importance of improved macro-prudential supervision and policies to maintain general confidence and contain accumulations of system-wide risks.

The number of cases of distress and their heterogeneity have culminated in a regulatory push to enhance the supervision of financial conglomerates. This includes measures to strengthen financial stability in four areas. First, the identification of conglomerates will be improved with the introduction of risk-based assessments in addition to quantitative thresholds as part of the first review of FiCoD by mid-2013, alongside enhanced transparency for legal and operational structures.[3] Second, the same legislation will see the introduction of living wills

3 A second review has also already been initiated, motivated inter alia by the need to further improve the identification of financial conglomerates and the potential systemic issues related to them. The conclusion of the review will take place once the new sectoral legislation has become applicable.

for conglomerates, which should facilitate the separation of units in resolution cases in the future.[4] Third, elements of improved group supervision (e.g. with regard to the double counting of holdings in insurance subsidiaries, corporate governance and remuneration policies) are included in the new sectoral legislation, in particular CRD IV and Solvency II. Finally, the single supervisory mechanism (SSM) will inevitably improve cross-border supervision in the participating countries. The macro-prudential aspects of supervision will be strengthened by the mandate of the SSM. The SSM is also expected to take over the supplementary supervision of bank-led conglomerates.

All in all, the analysis of euro area bancassurance groups that experienced distress during the financial crisis suggests that contagion has more often taken place from the banking units towards the insurance units than vice versa. This implies that the close ownership ties with banks do have an impact on the performance of the sector. Close monitoring of potential contagion channels within financial groups, including via liquidity swaps, is thus important for the stability of the sector – which several ongoing regulatory initiatives should help to address.[5]

4 The living wills requirement will be further reinforced by the European Bank Recovery and Resolution Framework.
5 A recent EIOPA survey highlighted the risks related to liquidity swaps. Although the extent of such activity was found to be low, careful consideration of intra-group swaps was recommended as they may not be motivated by the business needs of the insurer. See EIOPA, *Financial Stability Report 2012 – Second half-year report*, December 2012.