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Regulating financial conglomerates

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Abstract

We analyze the risk-taking incentives of a financial conglomerate that combines a bank and a non-bank financial intermediary. The conglomerate's risk-taking incentives depend on the level of market discipline it faces, which in turn is determined by the conglomerate's liability structure. We examine optimal capital regulation for standalone institutions, for integrated conglomerates and holding company conglomerates. We show that, when capital requirements are set optimally, capital arbitrage within holding company conglomerates can raise welfare by increasing market discipline. Because they have a single balance sheet, integrated conglomerates extend the reach of the deposit insurance safety net to their non-bank divisions. We show that the extra risk-taking that this effect causes may wipe out the diversification benefits within integrated conglomerates. We discuss the policy implications of these results.

JEL classification: G21; G22; G28

Keywords: Financial conglomerate; Capital regulation; Regulatory arbitrage

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1. Introduction

The emergence of financial conglomerates is one of the major financial developments of recent years.[1] Financial conglomerates are institutions that provide under a single corporate umbrella banking, insurance and other financial products. Conglomeration has been motivated by cost advantages from economies of scale and scope in insurance sales and securities underwriting, and by the perceived advantages of risk diversification.[2]. The recognition of the importance of conglomeration for the financial sector has led the Group of Ten to study its potential implications for public policy. Their study is inconclusive regarding risk taking and risk assumption.[3] This paper is concerned with risk taking and risk shifting in financial conglomerates, and their implications for optimal capital regulation.

We analyze the extent to which risk-taking incentives in financial conglomerates and their optimal capital regulation are affected by organizational form. Dierick (2004) and Shull and White (1998) discuss the different legal structures available to conglomerates. Although the choice of legal structure may be restricted by regulation,[4] it is essentially a choice between structuring the conglomerate as an integrated entity subject to a unique liability constraint, or structuring it as a holding company and allowing its various divisions to fail independently. For example, universal banks are structured as integrated entities and are engaged in the same activities as bank holding companies. The conglomerate's capital regulation is constrained by its organizational form. Integrated entities face a single capital requirement, while the regulator can set separate capital requirements for each division of a decentralized conglomerate.

Decentralized conglomerates can take advantage of the separate capital requirements for their constituent divisions by transferring assets between divisions in order to avoid high capital charges. This process is popularly referred to as *regulatory*, or *capital*, *arbitrage*. Regulators usually regard capital arbitrage as a *risk* of conglomeration: see for example Dierick (2004). The Joint Forum (2001) provides an extensive discussion of regulatory arbitrage and is ambivalent as to its effects, concluding that it must be accompanied by evidence of adequate risk management

[1] The November 1999 Gramm–Leach–Bliley Act dismantled legal barriers to the integration of financial services firms which had been erected by the 1933 passage of the Glass–Stegall Act. Its passage made conglomeration legal in the United States. The Gramm–Leach–Bliley Act was a response to market forces which had already resulted in the Federal Reserve Board's approval in 1998 of the merger of Citicorp and Travelers. Conglomeration in Europe, which was subject to fewer regulatory hurdles, followed the same trend: between 1985 and 1999 the value of merger and acquisition deals involving a commercial bank and an insurance company was \$89.6 billion, or 11.6% of all acquisitions by European financial institutions. See Lown et al. (2000) for detailed discussion of and statistics concerning, the development of the European Bancassurance market. A detailed discussion of conglomeration experience in the Benelux countries is provided by the National Bank of Belgium (2002).

[2] For a detailed discussion for the rationale behind conglomeration, see Berger et al. (2000), Milbourn et al. (1999) and Dierick (2004). Santos (1998) discusses mergers between banks and insurance firms. A substantial literature considers conglomeration in non-financial firms. This literature examines rationales such as improved asset allocation and managerial perquisite consumption, but does not consider the effects which we discuss in this paper: see for example Inderst and Müller (2003) and Scharfstein and Stein (2000).

[3] "The potential effects of financial consolidation on the risk of individual institutions are mixed, the net result is impossible to generalize, and thus a case-by-case assessment is required. The one area where consolidation seems most likely to reduce firm risk is the potential for (especially geographic) diversification gains. Even here, risk reduction is not assured, as the realization of potential gains is always dependent upon the actual portfolio held" (Group of Ten, 2001, p. 3).

[4] Within Europe, it is illegal to combine insurance with banking, securities or any other commercial business in the same legal entity (Dierick, 2004, p. 17: see Article 6(1)(b) of the Life Assurance Directive and Article 81(b) of the Non-Life Assurance Directive).