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MOTIVES FOR FINANCIAL CONGLOMERATION AND THE RISKS INVOLVED

У статті досліджуються вимоги, яким має відповідати фінансова група, щоб кваліфікуватися як фінансовий конгломерат відповідно до Директиви ЄС про фінансові конгломерати. Наводиться динаміка фінансових показників найбільших світових фінансових груп за останні роки. Визначаються ключові характеристики основних сфер діяльності конгломерату та висвітлюються мотиви конгломерації та ризики, які з цим пов'язані.

Ключові слова: фінансовий конгломерат, регульована організація, міжсекторна інтеграція, Директива про фінансові конгломерати.

The paper examines the conditions required for a financial conglomerate to exist under the EU Financial Conglomerates Directive. The data on the financial results of the largest financial conglomerates are being reviewed. Finally, the research identifies the key characteristics of the conglomerate`s main business areas and sheds some light on the motives for conglomeration and the risks involved.

Key words: financial conglomerate, regulated entity, cross-sectoral integration, Financial Conglomerates Directive.

Financial services are often offered through group structures. Such groups, in particular those that combine banking and insurance, have become increasingly important in Europe and The USA over time. They often result from cross-sectoral mergers and acquisitions, which are typically domestic in nature. The majority of large banks and insurance companies in the European Union (EU) are now part of a wider banking and insurance (bancassurance) group.

Financial companies are increasingly moving into each other's traditional core business areas and one way of doing so is through financial services groups. Some of these groups, called "financial conglomerates",are active in several business areas such as banking and insurance. These groups pose certain risks which are not adequately addressed by the sectoral supervisory framework. In order to tackle this, the Financial Conglomerates Directive was adopted at the European Union (EU) level. This paper investigates in more detail the various issues related to the emergence of such conglomerates.

Because of demographic developments, deregulation, increasing competition and innovation, financial companies are increasingly moving into each other's areas. Banks are now acting as insurance agents or brokers by selling insurance policies through their branch networks, insurance companies are selling insurance policies that have all the characteristics of investment products, and many commercial banks have moved into the securities business. In Europe the combination of banking and insurance has become increasingly popular. Apart from banks developing insurance activities ("bancassurance" or "bankinsurance" in the narrow sense), insurance companies also develop banking activities ("assurfinance") or holdings combine both

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("allfinanz"). These cross-sectoral strategies can take different forms: distribution agreements, joint ventures, the establishment of own subsidiaries or mergers and acquisitions (M&A) involving already existing companies. This paper concentrates in particular on bancassurance groups as they are a common form of financial conglomerates in the EU [11].

In the most general sense, a financial conglomerate is a group of entities whose primary business is financial and whose regulated entities engage to a significant extent in at least two of the activities of banking, insurance and securities.6 According to this definition, bancassurance groups would qualify as financial conglomerate, but so would groups combining insurance and securities or banking and securities. The definition used in the different countries for their supervision of financial conglomerates is sometimes more restrictive than the aforementioned general definition. For example, the regulations on financial holding companies in the United States require the presence of a bank, which is not a prerequisite under the Financial Conglomerates Directive. Also, bank-investment firm groups do not fall under the Directive since they are treated as "homogeneous" groups while in the United States, the financial holding regulations apply.

Definition under the Financial conglomerate directive.

Although the Directive does not refer to the concept of systemic groups, it is this type of group that the EU legislator had in mind when establishing the supervisory framework. The following formal requirements have to be met for a group to qualify as a financial conglomerate under the Directive:

(i) the presence in the group of at least one regulated entity in the EU;

(ii) if the group is headed by a regulated entity, it must be the parent of, hold a participation in or be linked through a horizontal group with an entity in the financial sector;

(iii) if the group is not headed by a regulated entity, its activities should occur mainly in the financial sector;

(iv) the group should have at least one insurance or reinsurance undertaking and at least one entity from a different financial sector; and

(v) the group must have significant crosssectoral activities.

A "group" is a set of undertakings, consisting foremost of a parent undertaking and its subsidiaries as defined under the Consolidated Accounts Directive. However, according to the prudential objective of the Financial Conglomerates Directive, the group concept is at the same time wider than the one used for pure accounting consolidation. First, the supervisory authorities can include in the group entities between which in their opinion a dominant influence exists, even if they do not formally meet the accountancy definition of parent-subsidiary. Second, the group also includes the participating interests8 held by the parent and subsidiaries. And third, horizontal groups are equally covered.9 Because of the wider definition, a group that qualifies as a financial conglomerate does not necessarily coincide with a group that is required to publish consolidated accounts under the Consolidated Accounts Directive. In addition, the entities that have been used to check whether the group meets the definition of a financial conglomerate, are not necessarily the same that will be subject to the supplementary supervision provided for in the Financial Conglomerates Directive.

The group should include at least one regulated entity in an EU Member State. A "regulated entity" is a credit institution, insurance undertaking or investment firm as defined under the respective EU directives for those sectors. The reason for this requirement is that the aim of the Financial Conglomerates Directive is to create a supplementary supervision of EUregulated entities. If there are no such entities, there is no need for an additional layer of supervision. It is not required that the regulated entity is a credit institution. If the group is not headed by a regulated entity, which is the case when it is headed by a nonregulated entity or does not have a parent company (a "horizontal group"), the group's activities should mainly occur in the financial sector. When a non-regulated entity heads a financial conglomerate, its parent is called a mixed financial holding company. A quantitative threshold, based in principle on balance sheet data,[10] is used to define what "mainly occur in the financial sector" means. The ratio of the balance sheet total of the financial sector entities in the group to the balance sheet total of the whole group has to be greater than 40%.

The financial sector entities envisaged are:

(i) credit institutions, financial institutions and ancillary banking undertakings (= banking sector);

(ii) insurance undertakings, reinsurance undertakings and insurance holding companies (= insurance sector);

(iii) investment firms and financial institutions (= investment services sector);

(iv) mixed financial holding companies; and

(v) asset management companies.[11]

These various types of entity are defined under the respective sectoral Directives. Some of them are regulated entities according to these Directives, while others, such as financial institutions, reinsurance undertakings and the various holding companies, are not.

The group should have at least one entity in the insurance sector and at least one entity in another financial sector, i.e. the banking or the investment services sector. It is not required that there is a regulated entity in each financial sector covered by the group. For example, a group consisting of a regulated investment firm and an unregulated reinsurance undertaking could, in principle, qualify as a financial conglomerate.

The last condition is that the group should have significant cross-sectoral activities. For this assessment, two sectors are considered: (i) the insurance sector and (ii) the banking/investment services sector taken together, and both have to be significant. Again, quantitative criteria are used to define what "significant" means. There is a relative criterion and an absolute criterion.

The relative criterion refers to the importance of the sector in the group's total assets and solvency requirements, which has to be on average more than 10%.[12] The absolute criterion is that when the smallest sector, measured according to the above-mentioned relative criterion, has a balance sheet total of more than €6 billion, the cross-sectoral activities are also presumed to be significant. But if the group does not meet at the same time the minimum threshold of the relative criterion, the competent authorities may decide not to treat

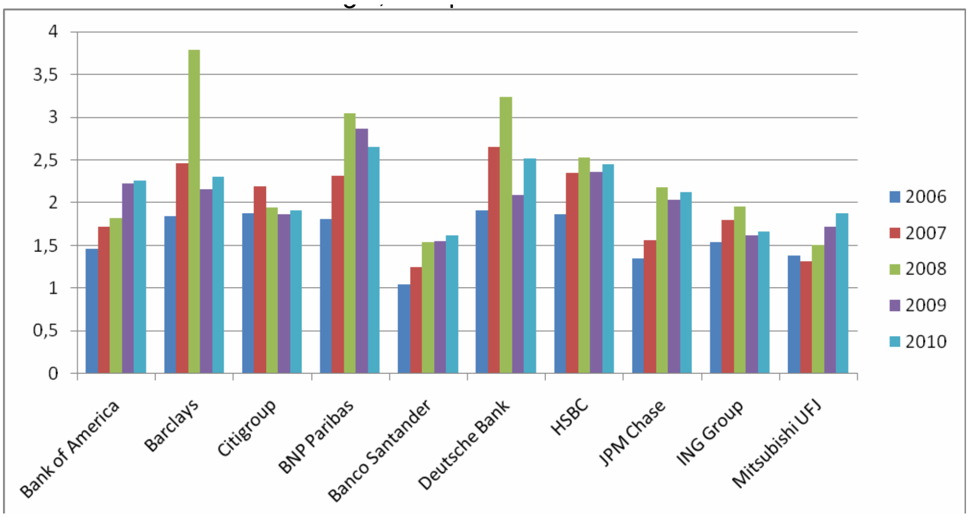

Chart 1. Total assets of ten financial conglomerates in 2006-2010 (trillions of dollars).
SThece: Based on information from annual reports of the financial conglomerates.

the group as a financial conglomerate

Today, a large number of financial groups operates in the world, each of which is quite a powerful player on the international financial markets. Charts 1and 2 show the financial performance of 10 financial groups, which are from different countries and continents of origin, but operate worldwide.

As it is seen from the chart, the volumes and dynamics of financial groups assets have some common trends: from 2006 to 2008 almost all of these groups had growth of total assets in each year of the analyzed period. An exception is Citigroup, where assets were of less volume in 2008 than in 2007, and Mitsubishi UFJ, whose assets in 2007 decreased compared to 2006, but during the next years we can see a steady growth of this indicator. At the same time there is a noticeable reduction in the amount of total assets of the most of these groups in 2009 in comparison with the figures of 2008. This can be explained by the sale of inefficient groups of assets as one of the steps to cope with the crisis. Then in 2010, as for all financial groups except BNP Pariba there was an increase in total assets if to compare to 2009.

The chart 2 shows that in 2008 almost all of the financial groups had decline in net income,

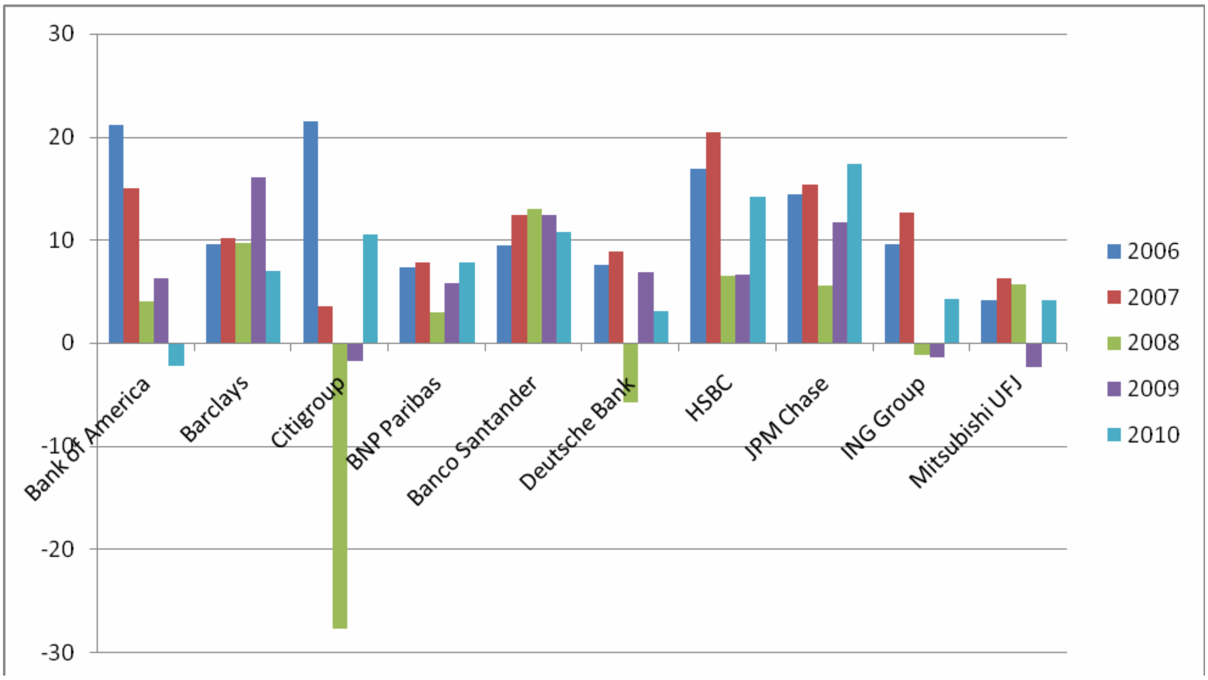

Chart 2. Net income of ten financial conglomerates in 2006-2010 (billions of dollars).
SThece: Based on information from annual reports of the financial conglomerates..

except only Banco Santander, which in 2008 had even some increase in income compared to the previous two years. However, in 2009 and 2010 it reduced, although it still remains at the highest level among these financial groups. Companies, which suffered from the crisis the most, are Citigroup, which had losses of 27.68, and $ 1.7 billion in 2008 and 2009 respectively, Deutsche Bank (5,74 billion dollars in 2008), Mitsubishi UFJ (2,29 billion dollars in 2009) and ING Group (1,07 and $ 1.3 billion U.S. dollars in 2008 and 2009).

And now let`s analyse the volumes of total revenues and net income of several financial groups in aspect of different areas of business in order to see how each of business segments was influenced with the financial crisis.

Chart 3 demonstrates the total net revenue of Bank of America.

Deposits include a comprehensive range of products provided to consumers and small bu-

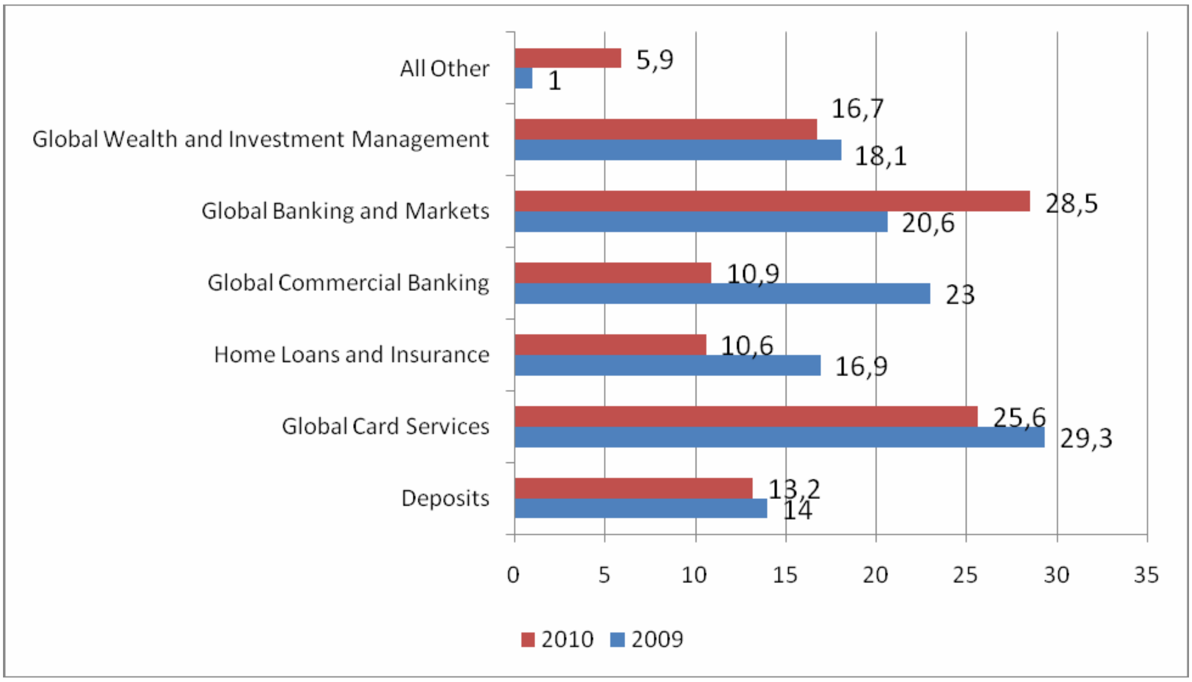

Chart 3. Total Net Revenue Per Line of Business of Bank of America (dollars in billions)
SThese: Based on data from Bank`s of America annual report

sinesses, including traditional savings accounts, money market savings accounts, CDs and IRAs, and noninterest- and interestbearing checking accounts. Deposit products provide a relatively stable sThece of funding and liquidity. In the U.S., we serve approximately 57 million consumer and small business relationships through a franchise that stretches coast to coast through 32 states and the District of Columbia utilizing The network of more than 5,800 banking centers, 18,000 ATMs, nationwide call centers and leading online and mobile banking platforms [1].

Global Card Services is one of the leading issuers of credit cards in the United States and Europe. We provide a broad offering of products including U.S. consumer and business cards, consumer lending, international cards and debit cards to consumers and small businesses. We provide credit card products to customers in the U.S., Canada, Ireland, Spain and the U.K. We offer a variety of co-branded and affinity credit and debit card products and are one of the leading issuers of credit cards through endorsed marketing in the U.S. and Europe.

Home Loans & Insurance provides an extensive line of consumer real estate products and services including fixed and adjustable rate first-lien mortgage loans for home purchase and refinancing needs, home equity lines of credit and home equity loans to customers nationwide.

Home Loans & Insurance products are available to The customers through The banking centers, mortgage loan officers in 750 locations and a sales force offering The customers direct telephone and online access to The products. These products are also offered through The correspondent loan acquisition channel.

Global Commercial Banking provides a wide range of lending-related products and services, integrated working capital management and treasury solutions to clients through The network of offices and client relationship teams along with various product partners. The clients include business banking and middle-market companies, commercial real estate firms and governments.

The lending products and services include commercial loans and commitment facilities,

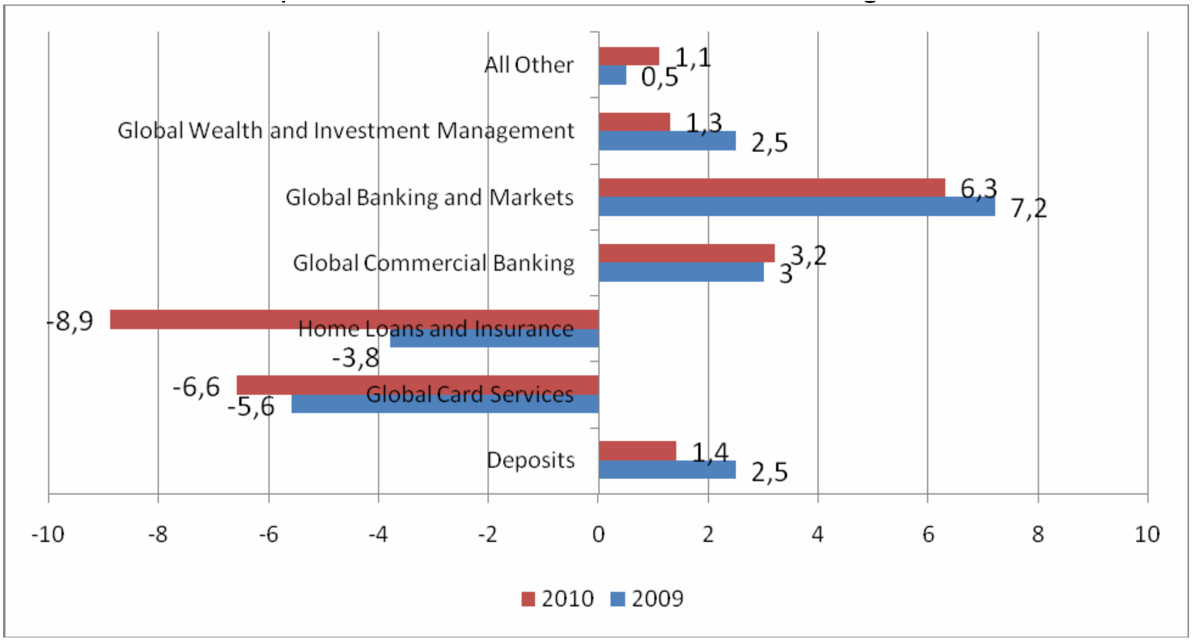

Chart 4. Net Income (Loss) Per Line of Business of Bank of America (dollars in billions)
Sourse: Based on data from Bank`s of America annual report

real estate lending, asset-based lending and indirect consumer loans. The capital management and treasury solutions include treasury management, foreign exchange and short-term investing options.

Global Banking & Markets (GBAM) provides financial products, advisory services, financing, securities clearing, settlement and custody services globally to The institutional investor clients in support of their investing and trading activities. We also work with commercial and corporate clients to provide debt and equity underwriting and distribution capabilities, merger-related and other advisory services, and risk management products using interest rate, equity, credit, currency and commodity derivatives, foreign exchange, fixed-income and mortgage-related products. GBAM is a leader in the global distribution of fixed income, currency and energy commodity products and derivatives, has one of the largest equity trading operations in the world and is a leader in the origination and distribution of equity and equity-related products. The corporate banking services provide a wide range of lending-related products and services, integrated working capital management and treasury solutions to clients [1].

Global Wealth & Investment Management (GWIM) provides comprehensive wealth management capabilities to a broad base of clients from the emerging affluent to the ultra high net worth. These services include investment and brokerage services, estate and financial planning, fiduciary portfolio management, cash and liability management and specialty asset management. GWIM also provides retirement and benefit plan services, philanthropic management, asset management and lending and banking to individuals and institutions. The primary wealth and investment management businesses are Merrill Lynch Global Wealth Management, U.S. Trust, Bank of America Private Wealth Management and Retirement Services.

Deposits include a full range of products for consumers and small businesses including traditional savings accounts, money market savings accounts, CDs, IRAs, and noninterest- and interest-bearing checking accounts. Deposits results also include student lending and the impact of The Asset and Liability Management activities. Global Card Services is one of the leading issuers of credit cards in the United States and Europe and provides a broad offering of products to consumers and small businesses, including U.S. consumer and business card, consumer lending, international card and debit card and a variety of cobranded and affi nity card products.

Home Loans & Insurance provides an extensive line of consumer real estate products and services including fi xed and adjustable rate fi rst-lien mortgage loans for home purchase and refi nancing, reverse mortgages, home equity lines of credit and home equity loans. HL&I also offers property, casualty, life, disability and credit insurance.

Global Banking provides a wide range of lending-related products and services, integrated working capital management, treasury solutions and investment banking services. The clients include multinationals, middle- market and business banking companies, correspondent banks, commercial real estate fi rms and governments. Global Markets provides fi nancial products, advisory services, fi nancing, securities clearing, and settlement and custody services globally to institutional clients. We also work with commercial and corporate clients to provide debt and equity underwriting and distribution and risk management products.

Global Wealth & Investment Management provides a wide offering of customized banking, investment and brokerage services to meet the wealth management needs of the individual and institutional customer base.

The primary wealth and investment management businesses are: Merrill Lynch Global Wealth Management; U.S. Trust, Bank of America Private Wealth Management; and Columbia Management.

On January 1, 2009, the Corporation acquired Merrill Lynch through its merger with a subsidiary of the Corporation in exchange for common and preferred stock with a value of $29.1 billion, creating a premier financial services franchise with significantly enhanced wealth management, investment banking and international capabilities. Under the terms of the merger agreement, Merrill Lynch common shareholders received 0.8595 of a share of Bank of America Corporation common stock in exchange for each share of Merrill Lynch common stock. In addition, Merrill Lynch non-convertible preferred shareholders received Bank of America Corporation preferred stock having substantially identical terms. Merrill Lynch convertible preferred stock remains outstanding and is convertible into Bank of America common stock at an equivalent exchange ratio. With the acquisition, the Corporation has one of the largest wealth management businesses in the world with more than 18,000 financial advisors and more than $1.8 trillion in client assets. Global investment management capabilities will include an economic ownership of approximately 50 percent (primarily preferred stock) in BlackRock, Inc., a publicly traded investment management company. In addition, the acquisition adds strengths in debt and equity underwriting, sales and trading, and merger and acquisition advice, creating significant opportunities to deepen relationships with corporate and institutional clients around the globe. Merrill Lynch's results of operations will be included in the Corporation's results beginning January 1, 2009 [1].

The Merrill Lynch merger is being accounted for under the acquisition method of accounting in accordance with SFAS 141R. Accordingly, the purchase price was preliminarily allocated to the acquired assets and liabilities based on their estimated fair values at the Merrill Lynch acquisition date as summarized in the following table. Preliminary goodwill of $5.4 billion is calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created from combining the Merrill Lynch wealth management and corporate and investment banking businesses with the Corporation's capabilities in consumer and commercial banking as well as the economies of scale expected from combining the operations of the two companies. The allocation of the purchase price will be finalized upon completion of the analysis of the fair values of Merrill Lynch's assets and liabilities.

On July 1, 2008, the Corporation acquired Countrywide through its merger with a subsidiary of the Corporation. Under the terms of the agreement, Countrywide shareholders received 0.1822 of a share of Bank of America Corporation common stock in exchange for each share of Countrywide common stock. The acquisition of Countrywide significantly improved the Corporation's mortgage originating and servicing capabilities, while making us a leading mortgage originator and servicer.

As provided by the merger agreement, 583 million shares of Countrywide common stock were exchanged for 107 million shares of the Corporation's common stock. The $2.0 billion of Countrywide's Series B convertible preferred shares that were previously held by the Corporation were cancelled.

The merger is being accounted for as a purchase in accordance with SFAS 141. Accordingly, the purchase price was preliminarily allocated to the assets acquired and liabilities assumed based on their estimated fair values at the merger date as summarized below. The final allocation of the purchase price will be finalized upon completing the analysis of the fair values of Countrywide's assets and liabilities. Purchase price $ 4.2.

On October 1, 2007, the Corporation acquired all the outstanding shares of LaSalle, for $21.0 billion in cash. As part of the acquisition, ABN AMRO Bank N.V. (the seller) capitalized approximately $6.3 billion as equity of intercompany debt prior to the date of acquisition. With this acquisition, the Corporation significantly expanded its presence in metropolitan Chicago, Illinois and Michigan by adding LaSalle's commercial banking clients, retail customers and banking centers. LaSalle's results of operations were included in the Corporation's results beginning October 1, 2007.

On July 1, 2007, the Corporation acquired all the outstanding shares of U.S. Trust Corporation for $3.3 billion in cash. The Corporation allocated $1.7 billion to goodwill and $1.2 billion to intangible assets as part of the purchase price allocation. U.S. Trust Corporation's results of operations were included in the Corporation's results beginning July 1, 2007. The acquisition significantly increased the size and capabilities of the Corporation's wealth management business and positions it as one of the largest financial services companies managing private wealth in the U.S. MBNA

On January 1, 2006, the Corporation acquired all of the outstanding shares of MBNA Corporation (MBNA) and as a result, 1,260 million shares of MBNA common stock were exchanged for 631 million shares of the Corporation's common stock. MBNA shareholders also received cash of $5.2 billion. MBNA's results of operations were included in the Corporation's results beginning January 1, 2006.

2004 Bank of America purchases FleetBoston Financial Corporation, extending the franchise throughout the Northeast, forming the first truly nationwide bank.

2006 Acquier MBNA, making BoA the largest credit card issuer in the industry.

2007 Acquissition of US Trust, a prestigious 153-yearold firm, adds scale to BoA`s private banking business an significantly advances capabilities to serve ultra high net worth clients.

2009 Acquires Merill Lynch [1].

Secondly, we are going to examine the role of different business segments of Citigroup (Chart 5).

Citigroup currently operates, for management reporting purposes, via two primary business

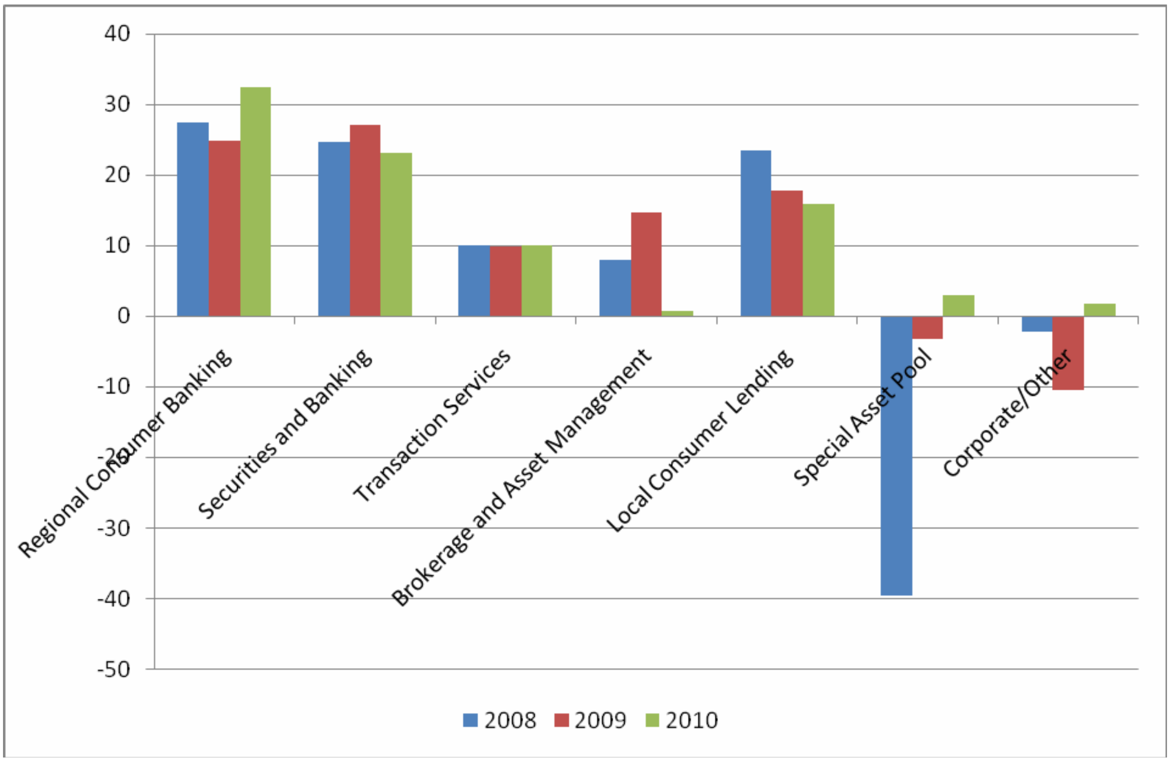

Chart 5. Total Net Revenue Per Line of Business of Citigroup (dollars in billions)
Sourse: Based on data from Citigroup annual report

segments: Citicorp, consisting of Citi's Regional Consumer Banking businesses and Institutional Clients Group; and Citi Holdings, consisting of Citi's Brokerage and Asset Management and Local Consumer Lending businesses, and a Special Asset Pool. There is also a third segment, Corporate/Other [3].

In 2011, management will continue its focus on growing and investing in the core Citicorp

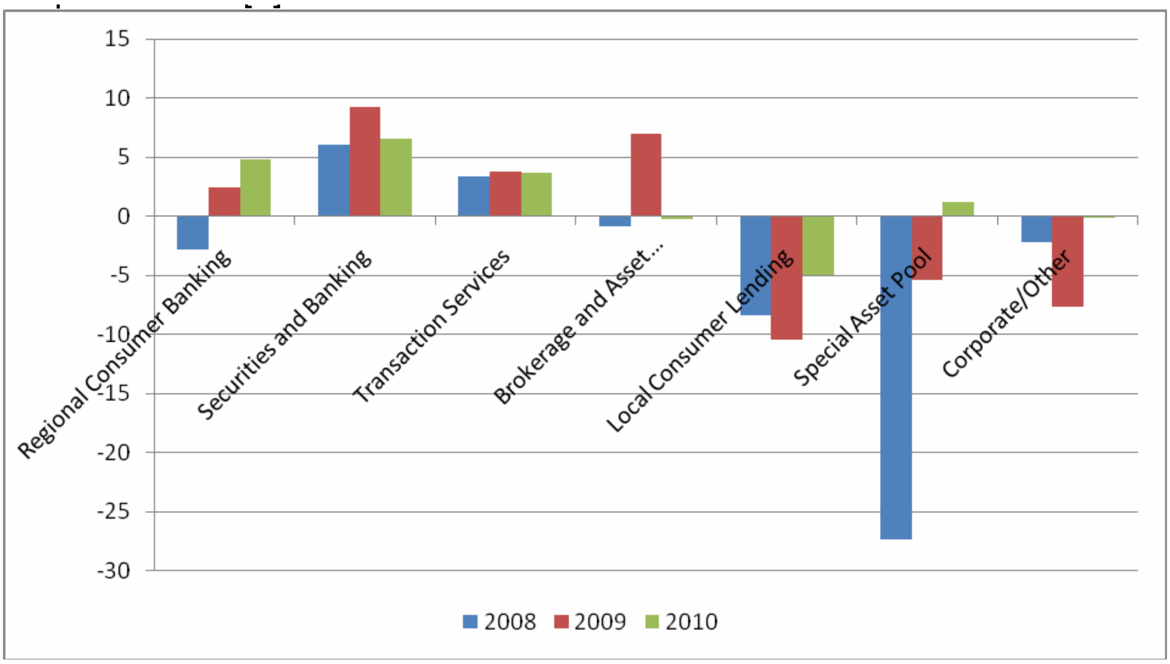

Chart 6. Net Income (Loss) Per Line of Business of Citigroup (dollars in billions)
Sourse: Based on data from Citigroup annual report

franchise, while economically rationalizing Citi Holdings. However, Citigroup's results will continue to be affected by factors outside of its control, such as the global economic and regulatory environment in the regions in which Citi operates. In particular, the macroeconomic environment in the U.S. remains challenging, with unemployment levels still elevated and continued pressure and uncertainty in the housing market, including home prices. Additionally, the continued implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Financial Reform Act), including the ongoing extensive rulemaking and interpretive issues, as well as the new capital standards for bank holding companies as adopted by the Basel Committee on Banking Supervision (Basel Committee) and U.S. regulators, will remain a significant sThece of uncertainty in 2011. Moreover, the implementation of the change in methodology for calculating FDIC insurance premiums, to be effective in the second quarter 2011, will have a negative impact on Citi's earnings. In Citicorp, Securities and Banking results for 2011 will depend on the level of client activity and on macroeconomic conditions, market valuations and volatility, interest rates and other market factors. Transaction Services business performance will also continue to be impacted by macroeconomic conditions as well as market factors, including interest rate levels, global economic and trade activity, volatility in capital markets, foreign exchange and market valuations. In Regional Consumer Banking, results during the year are likely to be driven by different trends in North America versus the international regions. In North America, if economic recovery is sustained, revenues could grow modestly, particularly in the second half of the year, assuming loan demand begins to recover. However, net credit margin in North America will likely continue to be driven primarily by improvement in net credit losses. Internationally, given continued economic expansion in these regions, net credit margin is likely to be driven by revenue growth, particularly in the second half of the year, as investment spending should continue to generate volume growth to outpace spread compression. International credit costs are likely to increase in 2011, reflecting a growing loan portfolio. In Citi Holdings, revenues for Local Consumer Lending should continue to decline reflecting a shrinking loan balance resulting from paydowns and asset sales. Based on current delinquency trends and ongoing loss-mitigation actions, credit costs are expected to continue to improve. Overall, however, Local Consumer Lending will likely continue to drive results in Citi Holdings. Operating expenses are expected to show some variability across quarters as the Company continues to invest in Citicorp while rationalizing Citi Holdings and maintaining expense discipline. Although Citi currently expects net interest margin (NIM) to remain under pressure during the first quarter of 2011, driven by continued low yields on investments and the run-off of higher yielding loan assets, NIM could begin to stabilize during the remainder of the year [3].

Regional Consumer Banking

Regional Consumer Banking (RCB) consists of Citigroup's the RCB businesses that provide traditional banking services to retail customers. RCB also contains Citigroup's branded cards business and Citi's local commercial banking business. RCB is a globally diversified business with over 4,200 branches in 39 countries around the world. During 2010, 54% of total RCB revenues were from outside North America. Additionally, the majority of international revenues and loans were from emerging economies in Asia, Latin America, Central and Eastern Europe and the Middle East. At December 31, 2010, RCB had $330 billion of assets and $309 billion of deposits.

Securities and Banking

Securities and Banking (S&B) offers a wide array of investment and commercial banking services and products for corporations, governments, institutional and retail investors, and high-net-worth individuals. S&B includes investment banking and advisory services, lending, debt and equity sales and trading, institutional brokerage, foreign exchange, structured products, cash instruments and related derivatives, and private banking. S&B revenue is generated primarily from fees for investment banking and advisory services, fees and interest on loans, fees and spread on foreign exchange, structured products, cash instruments and related derivatives, income earned on principal transactions, and fees and spreads on private banking services.

Transaction Services

Transaction Services is composed of Treasury and Trade Solutions (TTS) and Securities and Fund Services (SFS). TTS provides comprehensive cash management and trade finance and services for corporations, financial institutions and public sector entities worldwide. SFS provides securities services to investors, such as global asset managers, custody and clearing services to intermediaries such as broker-dealers, and depository and agency/trust services to multinational corporations and governments globally. Revenue is generated from net interest revenue on deposits in TTS and SFS, as well as from trade loans and fees for transaction processing and fees on assets under custody and administration in SFS.

Brokerage and Asset Management

Brokerage and Asset Management (BAM), which constituted approximately 8% of Citi Holdings by assets as of December 31, 2010, consists of Citi's global retail brokerage and asset management businesses. This segment was substantially reduced in size due to the sale in 2009 of Smith Barney to the Morgan Stanley Smith Barney joint venture (MSSB JV) and of Nikko Cordial Securities (reported as discontinued operations within Corporate/Other for all periods presented). At December 31, 2010, BAM had approximately $27 billion of assets, primarily consisting of Citi's investment in, and assets related to, the MSSB JV. Morgan Stanley has options to purchase Citi's remaining stake in the MSSB JV over three years starting in 2012.

Local Consumer Lending

Local Consumer Lending (LCL), which constituted approximately 70% of Citi Holdings by assets as of December 31, 2010, includes a portion of Citigroup's North American mortgage business, retail partner cards, Western European cards and retail banking, CitiFinancial North America and other local Consumer finance businesses globally. The Student Loan Corporation is reported as discontinued operations within the Corporate/Other segment for the second half of 2010 only. At December 31, 2010, LCL had $252 billion of assets ($226 billion in North America). Approximately $129 billion of assets in LCL as of December 31, 2010 consisted of U.S. mortgages in the Company's CitiMortgage and CitiFinancial operations. The North American assets consist of residential mortgage loans (first and second mortgages), retail partner card loans, personal loans, commercial real estate (CRE), and other consumer loans and assets.

Special Asset Pool

Special Asset Pool (SAP), which constituted approximately 22% of Citi Holdings by assets as of December 31, 2010, is a portfolio of securities, loans and other assets that Citigroup intends to actively reduce over time through asset sales and portfolio run-off. At December 31, 2010, SAP had $80 billion of assets. SAP assets have declined by $248 billion, or 76%, from peak levels in 2007 reflecting cumulative write-downs, asset sales and portfolio run-off.

Corporate/Other

Corporate/Other includes global staff functions (including finance, risk, human resTheces, legal and compliance) and other corporate expense, global operations and technology, residual Corporate Treasury and Corporate items. At December 31, 2010, this segment had approximately $272 billion of assets, consisting primarily of Citi's liquidity portfolio, including $87 billion of cash and deposits with banks [3].

Thirdly, let`s take a look at the financial data of Banco Santander (chart 7).

Secondary level (or business). This segments the activity of the operating units by the type

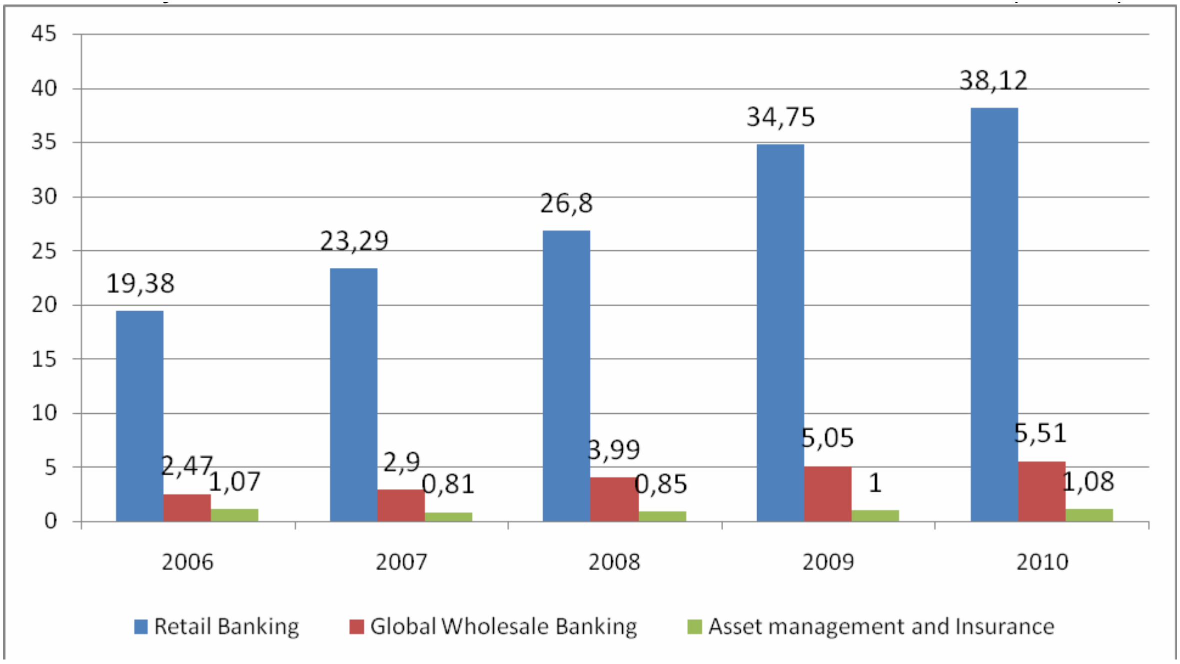

Chart 7. Total Net Revenue Per Line of Business of Banco Santander (euros in billions)
Sourse: Based on data from Banco Santander annual report

of business. The reported segments are:

• Retail Banking. This covers all customer banking businesses (except those of Corporate Banking, managed through the Global Customer Relationship Model). Because of their relative importance details are provided by the main geographic areas (Continental Europe, United Kingdom and Latin America) and Sovereign, as well as by the main countries. The results of the hedging positions in each country are also included, conducted within the sphere of each one's Assets and Liabilities Committee.

• Global Wholesale Banking (GBM). This business reflects the revenues from Global Corporate Banking, Investment Banking and Markets worldwide including all treasuries managed globally, both trading and distribution to customers (always after the appropriate distribution with Retail Banking customers), as well as equities business.

• Asset Management and Insurance. This includes the contribution of the various units to the Group in the design and management of mutual and pension funds and insurance. The Group uses, and remunerates through agreements, the retail networks that place these products. This means that the result recorded in this business is net (i.e. deducting the distribution cost from gross income). As well as these operating units, which cover everything by geographic area and by businesses (their totals are the same), the Group continues to maintain the area of Corporate Activities. This area incorporates the centralised activities relating to equity stakes in industrial and financial companies, financial management of the structural exchange rate position and of the parent bank's structural interest rate risk, as well as management of liquidity and of shareholders' equity through issues and securitizations [5].

As the Group's holding entity, this area manages all capital and reserves and allocations of capital and liquidity. It also incorporates amortisation of goodwill but not the costs related to the Group's central services except for corporate and institutional expenses related to the Group's functioning.

As for mergers and acquisitions of this bank, it can be demonstrated through the following

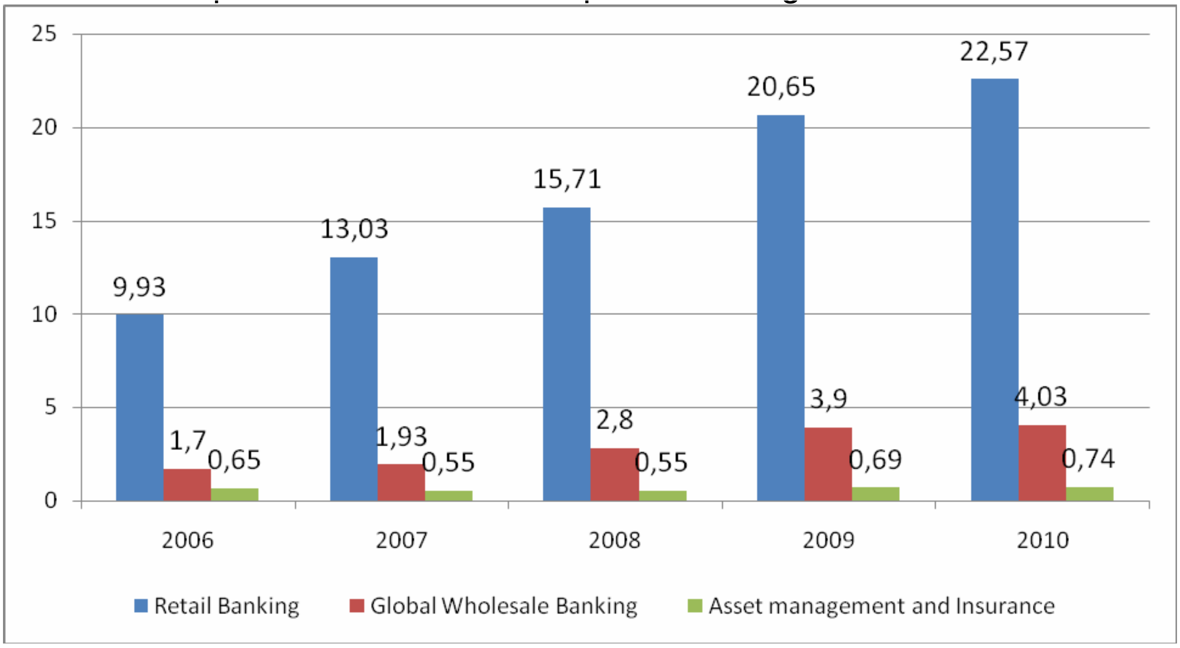

Chart 8. Net Income (Loss) Per Line of Business of Banco Santander (euros in billions)
Sourse: Based on data from Banco Santander annual report

facts:

• From the year 2000, the Group was joined by Banespa in Brazil, Grupo Serfín in Mexico and Banco Santiago in Chile. This consolidated the Group's position as the leading financial franchise in Latin America.

• In 2003, the Group set up Santander Consumer when it merged German company CC-Bank, the Italian Finconsumo, Hispamer in Spain and other Group companies. This new consumer banking franchise today has a presence in 12 European countries (Spain, the UK, Portugal, Italy, Germany, the Netherlands, Poland, the Czech Republic, Austria, Hungary, Norway and Sweden), in the USA, through Drive Finance, and it has recently struck an agreement to start up its first operation in Latin America, in Chile.

• In April 2004, it moved its Central Services in Madrid to the new headquarters, Santander City, where 6,800 people work today.

• That same year, in November, another major landmark was reached with the Group's takeover of Abbey, the sixth largest bank in the United Kingdom.

• In 2005, Santander reached agreement to take a 19.8% stake in Sovereign Bancorp, the 18th biggest bank in the USA.

• In 2006, Santander made record profits of € 7.596 billion, the biggest of any Spanish company, spurring heavy investment in retail banking and quality of service. "We want to be yThe bank" (Queremos ser tu banco) in Spain and other enterprising action in Portugal, at Abbey and in America are examples of this drive.

• In 2007, Santander celebrated its 150th anniversary as the twelfth largest bank in the world by stock market capitalisation, seventh by profits and the bank with the largest retail distribution network in the western world: 10,852 branches. Santander formed a consortium with the Royal Bank of Scotland and Fortis to launch a take-over bid for ABN Amro, through which the bank acquired Banco Real in Brazil, doubling its presence in the country.

• In 2008, Santander continued to grow, making important acquisitions in a strategic market for the bank, the UK. Through the incorporation of Alliance & Leicester and Bradford & Bingley, Santander expanded its high street network to 1,300 branches in the country and became the third largest bank in the UK by deposits. With profits of EUR 8,876 million, Santander became the third largest bank in the world by profits.

• In 2009, Santander entered the US retail banking market with the acquisition of Sovereign, which has 722 branches in the north east of America [5].

Finally, the Deutsche Bank`s financial data is regarded (chart 9).

The following business segments represent the Group's organizational structure as reflec-

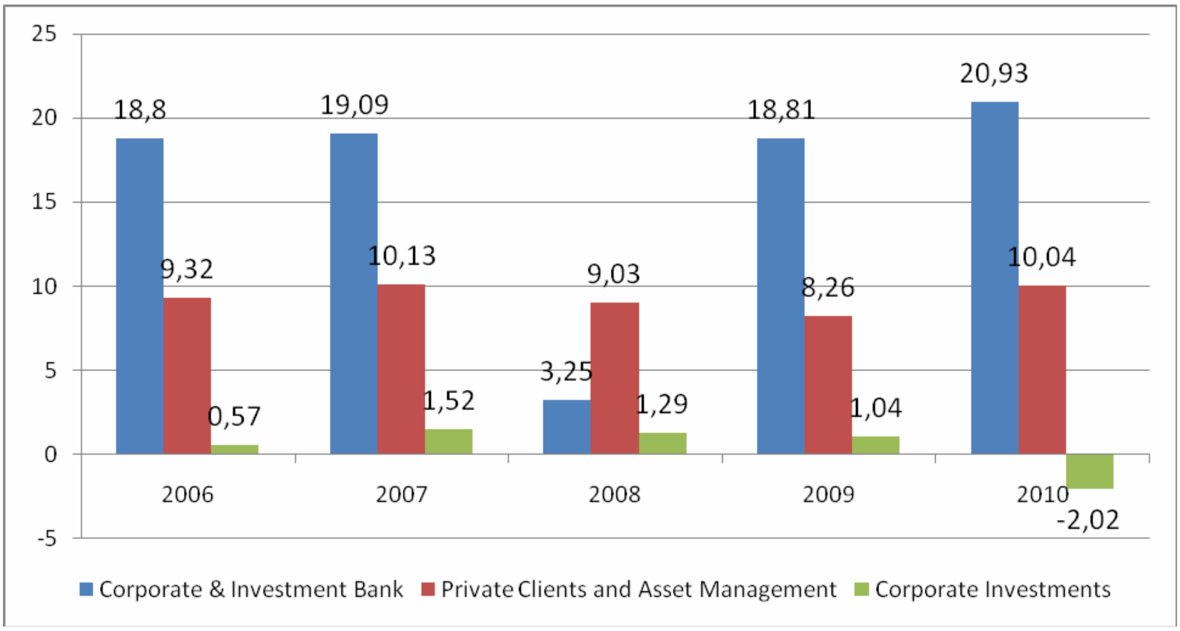

Chart 9. Total Net Revenue Per Line of Business of Deutsche Bank (euros in billions)
Sourse: Based on data from Deutsche Bank`s annual report

ted in its internal management reporting systems. The Group is organized into three group divisions, which are further subdivided into corporate divisions. As of December 31, 2010, the group divisions and corporate divisions were as follows:

The Corporate & Investment Bank (CIB), which combines the Group's corporate banking and securities activities (including sales and trading and corporate finance activities) with the Group's transaction banking activities. CIB serves corporate and institutional clients, ranging from medium-sized enterprises to multinational corporations, banks and sovereign organizations. Within CIB, the Group manages these activities in two global Corporate Divisions: Corporate Banking & Securities (CB&S) and Global Transaction Banking (GTB).

— CB&S is made up of the Markets and Corporate Finance business divisions. These businesses offer financial products worldwide, ranging from the underwriting of stocks and bonds to the tailoring of structured solutions for complex financial requirements.

— GTB is primarily engaged in the gathering, transferring, safeguarding and controlling of assets for its clients throughout the world. It provides processing, fiduciary and trust services to corporations, financial institutions and governments and their agencies.

Private Clients and Asset Management (PCAM), which combines the Group's asset management, private wealth management and private and business client activities. Within PCAM, the Group manages these activities in two global Corporate Divisions: Asset and Wealth Management (AWM) and Private & Business Clients (PBC).

— AWM is composed of the business divisions Asset Management (AM), which focuses on managing assets on behalf of institutional clients and providing mutual funds and other retail investment vehicles, and Private Wealth Management (PWM), which focuses on the specific needs of high net worth clients, their families and selected institutions.

— PBC serves retail and affluent clients as well as small corporate customers with a full range of retail banking products.

Corporate Investments (CI), which manages certain alternative assets of the Group and other debt and equity positions [6].

In this environment, we generated a net income of € 2.3 billion in 2010, compared to € 5.0

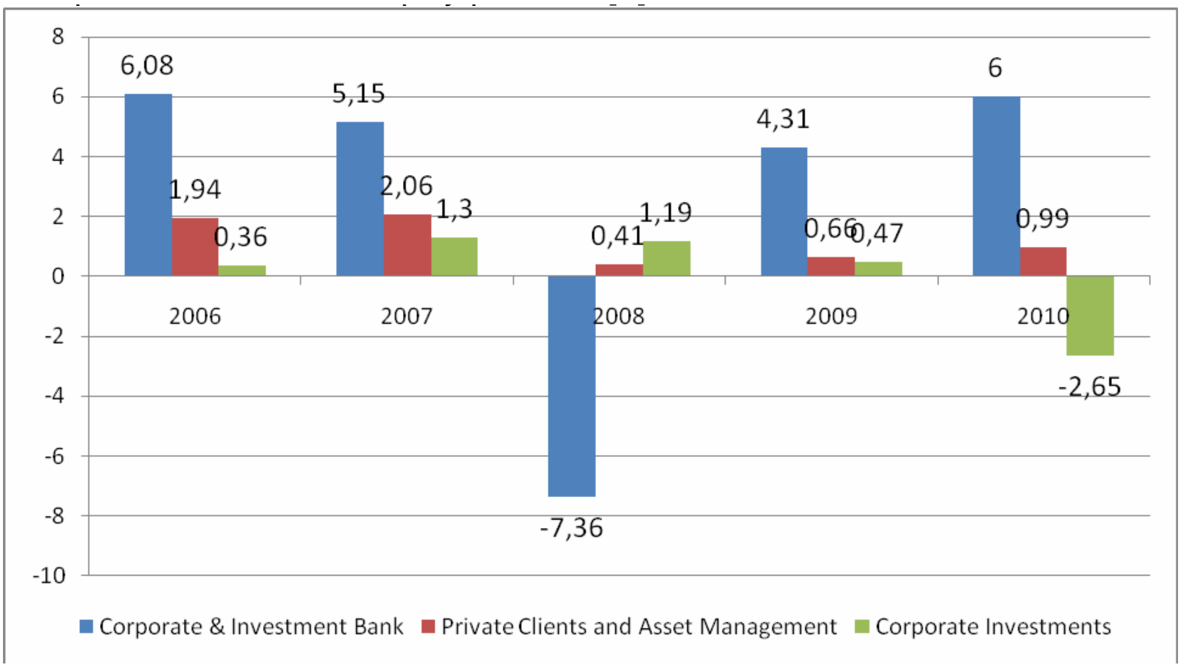

Chart 10. Net Income (Loss) Per Line of Business of Deutsche Bank (euros in billions)
Sourse: Based on data from Deutsche Bank`s annual report

billion in 2009, a solid result considering the impact of several significant factors. These factors include, firstly, certain valuation- and integration-related charges from the acquisitions of the commercial banking activities from ABN AMRO in the Netherlands, of Sal. Oppenheim/BHF-BANK and of Postbank, the latter including a charge of € 2.3 billion in the third quarter 2010. Secondly, during the year we invested in the integration of The CIB businesses, in The IT platform and in other business growth initiatives. Thirdly, deferred compensation expenses were significantly higher in 2010 reflecting changes in compensation structures implemented in 2009. Additionally, the aforementioned acquisitions increased The revenue and expenses run rates, as well as The balance sheet, risk weighted assets and invested assets. Moreover, a shift in foreign exchange rates, in particular between the U.S. dollar and the euro, contributed to an increase in The reported euro revenues and expenses, with an overall positive impact on net income [6].

As for mergers and acquisitions of this bank, it can be demonstrated through the following facts:

2002. Deutsche Bank con¬cludes the purchase of Scudder Investments Launch of the business units Private & Business Clients (PBC) and Private Wealth Management (PWM)

2003. Acqusition of the Swiss Private Bank Rued, Blass & Cie

2004. Opening of a branch office in Beijing Acquisition of the Russian investment bank United Financial Group (completed in 2006)

2006. Takeovers of Berliner Bank and Norisbank Branch openings in Dubai and Riyadh

2007. Launch of private & business banking in China

2009. Co-operation with Postbank

2010. Acquisition of Sal. Oppenheim [6].

Motives for conglomeration

In a world with perfect capital markets and perfect competition and no information or agency problems, there would be no need for financial conglomerates since they would not create any added value. However, such a world is a theoretical abstraction and financial conglomerates do exist because of cost and revenue synergies, diversification benefits and agency problems. Their existence also creates certain risks, most of which are not unique to conglomerates, but come more to the fore in such organisations because of their sheer size and complexity.

Cost and revenue synergies. Cost synergies can be due to efficiencies of scale or scope. A company may be able to reduce its average cost by providing the same product on a larger scale or by providing multiple products. Some delivery methods exhibit important economies of scale, which may have increased over time due to technological advancements. The same may also be true for tools of financial engineering and risk management. Distribution channels and customer databases, on the other hand, are examples of areas where efficiencies of scope can be realised. If the organisation or group becomes too large, inefficiencies may arise because of coordination problems. Efficiencies of scale or scope may also work on the revenue side. For example, multinational companies may only want to do business with financial companies of a minimum size. Scope efficiencies arise because of cross-selling opportunities resulting from consumption complementarity, the sharing of the reputation associated with a certain brand name, the possibility of developing a close customer relationship, and the preference of a customer to reveal private information to a single group. Revenue synergies are often mentioned as the main reason for the existence of bancassurance groups. Again, there is the risk that at a certain point the efficiencies turn into inefficiencies, for example when one moves away from the core business or when conflicts of interest arise.

Diversification. By diversifying, a company can reduce the volatility of its cash flows. This may in turn reduce the probability of financial distress, thus avoiding certain costs. In the scenario of a bankruptcy, there are direct (legal and administrative) as well as indirect costs (difficulty of running a company that is going through such a process). But even when the company is not entering bankruptcy, management may suffer because of increased conflicts of interest between bondholders and shareholders. Finally, diversification may also reduce the company's need for external finance. It has been argued that companies prefer internal finance because they want to avoid market discipline and the costs associated with issuing securities, or giving adverse signals to the market. Diversification allows companies to tap new sources of revenue, which can complement a stagnating or shrinking core business. For example, by engaging in fee-business such as insurance broking, investment banking or fund management, banks may offset the prevailing disintermediation trend. Banks that have a strong market position may choose to expand in other, related markets in order to avoid intervention by competition authorities [13].

Agency reasons. By engaging in mergers and acquisitions, managers may want to achieve personal goals which do not necessarily coincide with the objective of maximizing shareholder value. One such goal could be "empire building", if a manager's status and compensation are linked to the size of his company. Another goal could be to protect company-specific human capital by reducing the insolvency risk through diversification. Conglomeration also allows managers to complement their skills, thus making them more valuable to the organisation. Finally, management may want to shelter itself from market discipline and corporate control mechanisms, which can be achieved through more stable cash-flows (i.e. diversification) and less external finance.

Risks involved

Regulatory arbitrage. Since conglomerates are managed on a group-wide basis, transactions may be booked in certain entities or deals may be generated to exploit regulatory differences. Intra-group transactions can be set up to formally meet regulatory requirements, but at the same time circumvent the aims of those requirements. Examples which have attracted a lot of supervisory attention include “double or multiple gearing” and “excessive leveraging”. Double gearing refers to the use of the same capital by two (or more) regulated entities in the group. Excessive leveraging can occur when debt is issued by a parent company and the proceeds are down-streamed in the form of equity to regulated entities of the group.

Contagion. Difficulties in one group entity may spill over to other ones. Such a situation can result directly from economic links between entities, such as capital holdings, loans, guarantees and cross-default provisions. Indirect contagion, on the other hand, results from the behaviour of third parties (e.g. customers, investors) to a group entity in response to problems of an affiliated entity. It can result from mere association (e.g. use of common branding and marketing).18 Contagion is of particular concern when it affects regulated entities because of problems occurring in non-regulated entities. One may try to limit the contagion risk through the design of “firewalls”19 but there is the possibility these may become ineffective, especially in times of stress. For example, market pressure may lead a parent company to support its ailing subsidiary although it may have no legal requirement to do so.

Moral hazard. Moral hazard can work in several ways. First, a non-regulated entity may try to gain access to a bank’s safety net (such as deposit insurance and lender of last resort facilities) by being associated with it in a conglomerate. Second, the conglomerate may become so large that it is perceived to be “too big to fail” by market participants. The expectation that the conglomerate will be bailed out by public authorities may stimulate risky behaviour. Third, moral hazard can also work within the group as group entities may expect help from other group entities in the event of financial distress and so behave in a more risky way[14].

Lack of transparency. Because of the group’s size and complexity it may be difficult for markets and supervisors to obtain an accurate picture of its structure and risk profile. The legal and managerial structures of a group may vary (e.g. reporting according to business lines/ geographical areas, matrix structure). Due to the interaction between different group entities, the risk of the conglomerate is most likely to be different to the sum of the risks in the various entities on a stand-alone basis. Intra-group transactions can be used or abused to transfer assets from one entity to another and as a vehicle for cross-subsidisation. Another concern is that important risk positions may be built up which remain unnoticed because they are dispersed over many group entities. The group’s complexity may also make a work-out or winding-down of an ailing conglomerate very difficult. “Firewalls” refers to restrictions placed between a bank and its affiliates to protect against liabilities/losses. More specifically, it also refers to statutory and regulatory limitations on financial transactions between banks and their affiliates. Such limitations are meant to prevent the spread of financial difficulties within a banking group. The restrictions should in particular prevent the group from shifting losses from its non-bank entities to its insured bank entities and potentially to the deposit insurance fund. Moral hazard is the risk that the risk-taking behaviour of parties will increase because of the existence of certain arrangements or contracts.

Conflicts of interest. A conglomerate takes up a multiple of different roles in its customerdealing which may potentially conflict. The sharing of customer information between group entities may violate privacy laws. However, conflicts of interest also exist in the same organisation so the key issue is whether there are any incentives and opportunities in the organisation to exploit such conflicts of interest. Professional investors may understand such situations and take them into account in their decisions. Competition and fear of reputation loss may also act as a restraint. Other possible measures to limit the risk are disclosure, voluntary codes of conduct and internal structures/procedures designed to ensure that the different business areas are managed sufficiently independently.

Abuse of economic power. Financial conglomerates can lead to greater market concentration, less competition and, ultimately, a less efficient financial system. They can drawn on revenue from many operations and are therefore in a better position to fight competitors. The lack of competition can in turn have a negative effect on innovation. The traditional separation between commercial banking and investment banking in the United States has been defended on the basis of the argument that this model would stimulate competition and innovation within business lines. The concentration of economic power as a result of dominating different financial sectors may ultimately lead to groups that are "too big to discipline" or "too large to fail" [15].

Conclusion

Due to structural factors such as deregulation and the development of financial markets, the linkages between financial sectors in the EU, in particular the banking and insurance sectors, have increased over time. These linkages now have a multitude of different forms: distribution agreements, credit exposures, credit and operational risk transfers, shareholdings, etc. This paper focussed on a particular form of institutionalised relationship between financial sectors, the financial conglomerate, which is often created via shareholder links between banks and insurance firms. The combination of different financial services in one and the same group offers some clear revenue synergies through the exploitation of a common customer base and common distribution networks, which explains why this particular business model has become increasingly popular in the EU. In recent years, in the wake of the poor performance of financial markets, some groups have had to provide financial support to their cross-sector subsidiaries or have even disposed of them. Nevertheless, the business model exhibits strengths that are likely to underpin its continued long-term attractiveness. However, such mixed financial services groups also create certain risks to which the groups and public authorities have to respond appropriately. These risks relate in particular to the transmission of problems from one group entity to another one via intra-group exposures. Insufficient capital at the group level resulting from excessive leveraging and multiple gearing may result in financially vulnerable groups. At the macro-level, concerns relate in particular to the impact of such complex groups on financial markets, on payment and settlement systems and, more generally, on financial stability.

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