

## **Risk Measurement, Risk Management, and Capital Adequacy in Financial Conglomerates**

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Is there something special, with respect to risk and capital, about a financial conglomerate that combines banking, insurance, and potentially other financial and nonfinancial activities? To what degree is the risk of the whole less than the sum of its parts? This paper seeks to address these questions by evaluating the risk profile of a typical banking-insurance conglomerate, highlighting the key analytical issues relating to risk aggregation and raising policy considerations. Risk aggregation is the main analytical hurdle to arriving at a picture of composite risk. We propose a "building block" approach that aggregates risk at three successive levels in an organization (corresponding to the levels at which risk is typically managed). Empirically, diversification effects are greatest within a single risk factor (level I), decrease at the business line level (level II), and are smallest across business lines (level III). Our estimates suggest that the incremental benefits of diversification achievable at level III are modest, around 5-10 percent reduction in capital requirements, depending on the business mix.