Consolidated Supervision of Banks and Financial Conglomerates

A Handbook for Financial Regulators and Supervisors

VICTOR U. EKPU and CHIOMA N. NWAFOR

MINDSET RESOURCE CONSULTING

CONSOLIDATED SUPERVISION OF BANKS AND FINANCIAL CONGLOMERATES

A HANDBOOK FOR FINANCIAL REGULATORS & SUPERVISORS

VICTOR U. EKPU & CHIOMA N. NWAFOR

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LIST OF KEY ABBREVIATIONS

ASBA	-	Association of Supervisors of Banks of the Americas
BBPA	-	Building Block Prudential Approach
BCBS	-	Basel Committee on Banking Supervision
BHC	-	Bank Holding Company
BIS	-	Bank for International Settlements
CAMELS	-	Capital | Assets | Management | Earnings | Liquidity | Sensitivity to Market Risk
CORE	-	Capital | Organization Structure | Risk Management | Earnings & Liquidity
CRO	-	Chief Risk Officer
ERM	-	Enterprise Risk Management
FCA	-	Financial Conduct Authority
FCPR	-	Financial Conglomerate Performance Report
FHC	-	Financial Holding Company
FIRS	-	Federal Inland Revenue Service
FSB	-	Financial Stability Board
GAAP	-	Generally Accepted Accounting Principles
IAIS	-	International Association of Insurance Supervisors
IAS	-	International Accounting Standards
ICAAP	-	Internal Capital Adequacy Assessment Process
ICT	-	Information and Communications Technology
IDI	-	Insured Depository Institution
IFRS	-	International Financial Reporting Standards
IOSCO	-	International Organization of Securities Commission
IPV	-	Independent Price Verification Committee
KPIs	-	Key Performance Indicators
KRIs	-	Key Risk Indicators
LPC	-	Loan Policy Committee
MIS	-	Management Information System
MoU	-	Memorandum of Understanding
MRLCC	-	Market Risk, Liquidity, and Capital Committee
OTC	-	Over the Counter
PRA	-	Prudential Regulation Authority
RAF	-	Risk Appetite Framework
RBA	-	Risk-Based Aggregation Method
RBDM	-	Risk-Based Deduction Method
RMC	-	Risk Management Committee
TDT	-	Total Deduction Technique

PREFACE

Over the past two decades, the global financial services landscape has witnessed significant consolidation and internationalization of banking and financial services, leading to the emergence of mega banks and financial conglomerates. Financial groups in many jurisdictions now engage in multiple financial activities including retail banking, securities and investment banking, private banking, wealth banking, insurance, mortgage banking, pension fund custody, foreign exchange, asset finance, microfinance, and other activities that are deemed financial in nature. In addition to offshore subsidiaries, many financial conglomerates also have subsidiaries that carry on commercial and industrial activities such as retail, energy, telecoms, agriculture, and so on. Several factors explain the increasing tendency towards conglomeration. The main ones are deregulation of financial markets; advances in computing and informational technologies; evolution of advanced risk management methodologies; increasing competition and innovation; disintermediation; globalization; prospects for cost and revenue synergies; and diversification.

However, one of the proximate causes of the global financial crisis was the inadequate supervision and regulation of these large and substantially interconnected financial companies on a consolidated basis. The global crisis has also highlighted that risks to the financial system not only emanate from the banking sector, but also from other sectors within the system. Central banks and regulatory institutions worldwide have now come up policies to ensure the protection of depositors by "ring fencing" banking business from non - banking activities, and to shield the financial system from excessive risk-taking arising from non-core banking functions. But, as the shift towards a financial holding company model intensifies in many financial jurisdictions, regulators and supervisors also need to be informed and sensitized on how financial conglomerates work in practice, how holding companies should conduct their operations, report their affairs, and manage risk, amongst other issues.

The purpose of this handbook is to provide direction to financial services regulators and supervisors with regard to best practice prudential guidelines for managing, supervising and regulating financial holding companies. In particular, this hand book places specific emphasis on: (1) the qualitative consolidated supervision of holding companies, including guidelines for the group structure, governance and enterprise risk management framework for financial conglomerates, (2) the quantitative consolidated supervision of financial conglomerates, including consolidated financial reporting and analysis, capital adequacy assessment, examination of credit concentration, large exposures, connected party exposures and liquidity on a consolidated basis, (3) the rating system for evaluating financial conglomerates, and (4) supervisory challenges to the implementation of consolidated supervision and possible solutions, including cross border supervision of financial conglomerates.

One special feature of this handbook is that it includes in every chapter supervisory guidance and principles from the Basel Committee on Banking Supervision, Bank for International Settlements (BIS), and The Joint Forum on Financial Conglomerates (i.e. BCBS, IOSCO and IAIS), and other notable regulatory bodies such as the Federal Reserve System, Bank of

England and the Financial Stability Board (FSB) among others, to guide examiners on best practice standards in the supervision of financial conglomerates. This handbook also features some case studies and examples from selected financial groups across the world.

Regulators and supervisors of banks and other financial services institutions (e.g. securities and insurance sectors) will therefore find this handbook very useful to their examination process. Holding Company licensees and prospective licensees will also find this handbook beneficial in learning about the prudential requirements of their functional regulators.

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APRIL 2014

CHAPTER 1: OVERVIEW OF CONSOLIDATED SUPERVISION

1.1. WHAT IS CONSOLIDATED SUPERVISION?

Financial conglomerates have inherent risks which pose certain challenges to bank supervisors. For instance, difficulties in one entity within a group may spill over into other entities. Bank supervisors have particular concern where a non-bank entity within a group may have an adverse impact on a bank and possibly make demands on a government's safety net. A conglomerate's size and complexity may also make it difficult for markets and supervisors to obtain an accurate understanding of the group's structure and risk profile. In addition, the management of conglomerates on a group-wide basis can also result in the exploitation of regulatory differences among different entities within the group.

One way that banking supervisors have responded to these developments is by adapting their approaches so that regulatory supervision is closely aligned with the way financial organisations structure and manage their business activities. This has entailed a shift from a "legal entity" approach to supervision to a more "group wide" or "consolidated" approach to supervision, whereby all risks run by a banking group are considered. Consolidated supervision requires a clear understanding about the earnings, practices, governance and risks of each economic unit that belongs to the group and a detailed analysis of the impact of each one of them in the rest of the group. Thus, consolidated supervision entails effective "cross-functional" supervision whereby the financial condition and risks of other domestically regulated firms within the group under a common ownership are considered and effective "cross-border" supervision whereby the financial stability and risks of a financial institution's international operations abroad are understood. According to the Bank of England (cited in MacDonald, 1998), 'consolidated supervision facilitates the regulator's understanding of the strengths and risks across a financial group and addresses financial, management and operational deficiencies that may pose a danger to the safety and soundness of the group'. It represents a comprehensive approach to supervision, which takes account of all the risks that may affect a licensee regardless of whether these risks are carried in the books of the licensee or members of the financial group it controls.

1.2. EVOLUTION OF CONSOLIDATED SUPERVISION

The evolution of consolidated supervision 1979 when the Basel Committee on Banking Supervision (BCBS) issued a report on the "Consolidated Supervision of Banks' International Activities" (BIS, 1979) which recommended that supervisory authorities of banks with foreign subsidiaries, joint ventures and branches monitor the risk exposures of these banks on the basis of consolidated reports, reflecting their total business, regardless of the legal entities or countries in which it is conducted. Furthermore, in 1992, the BCBS issued "Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments" (BIS, 1992), which, among other things, recommended that supervisory authorities should not permit banks from foreign countries to open offices within their jurisdiction unless they are satisfied that the home country supervisor of an applicant bank supervises the new office and the parent bank on a consolidated basis. In September 1997, the BCBS stipulated in the "Core Principles for Effective Banking Supervision" that consolidated supervision of banking groups is an essential element of banking supervision and should be practiced on an on-going basis. This document was subsequently revised in October 2006 and September 2012. According to the BCBS document, the supervisor needs to

'supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide' (BIS 2012a).

Similarly, consolidated supervision of financial conglomerates has evolved in recent years due in part to the work undertaken by the Joint Forum on Financial Conglomerates (Basel Committee on Banking Supervision (BCBS), International Organization of Securities Commission (IOSCO) and the International Association of Insurance Supervisors (IAIS) (BIS, 2012b). Beginning In February 1979, the Joint Forum released several reports on the principles of supervision of financial conglomerates (with updates in 1999 and more recently in 2012). Not surprisingly there is considerable overlap between the issues relating to the supervision of financial conglomerates and the consolidated supervision of banking groups. As such, many of the principles outlined in the BCBS documents related to consolidated supervision of banks are consistent with the Joint Forum principles related to the supervision of financial conglomerates.

1.3. TYPES OF CORPORATE GROUPS SUBJECT TO CONSOLIDATED SUPERVISION

Financial groups vary in terms of their structure, size, range of activities, and complexity. In the context of consolidated supervision and regulation, three broad categories can be identified: banking groups, financial conglomerates and mixed activity groups.

1.3.1. A BANKING GROUP OR BANK HOLDING COMPANY (BHC)

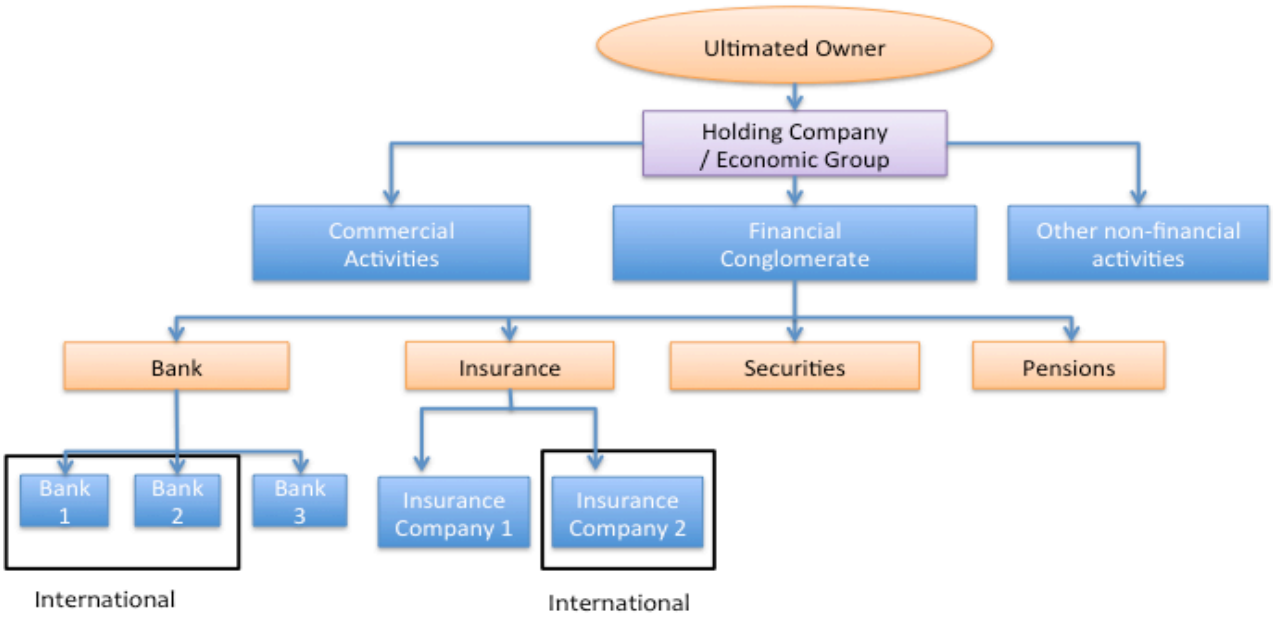
This kind of group emerges where a licensed bank establishes or acquires subsidiary companies or takes a controlling stake in a company in order to carry out particular activities. Several factors – legal, regulatory, commercial or fiscal – may determine the decision of a bank to operate through subsidiary companies. In some financial jurisdictions, banks are prohibited by law, prudential regulations or their own articles of association from investing in shares of commercial and industrial companies. As a general rule, banks tend to invest only in other companies, which carry on banking, or quasi-banking financial activities such as money transfers, leasing or trading in securities. In effect, a banking group might consist of a licensed bank with subsidiaries engaged in a range of specialized financial activities and possibly one or more subsidiary banks and other companies established in foreign countries. In some cases, a holding company rather than a licensed bank might head the group. The function of such a parent company would be to hold shares in the bank and other subsidiaries in the group, and to manage its investments. The holding company may also raise capital to support the group's activities. The extent to which the parent runs the group as if it were a single entity will vary from group to group. There may also be other non-trading holding companies at various intermediate levels within the group structure.

1.3.2. A FINANCIAL CONGLOMERATE OR FINANCIAL HOLDING COMPANY (FHC)

A financial holding company (FHC) or financial conglomerate refers to an organisation that owns or controls regulated financial institutions, typically banks or other deposit-taking institutions, insurance companies, and securities firms (Jackson, 1998). According to the Joint Forum (BIS, 2012b), a financial conglomerate or FHC is defined to mean 'any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (e.g. banking, securities, insurance, pensions) (See Figure

1.1). Following these definitions, it will be readily appreciated that many banking groups – for example, those formed in countries in which banks are allowed to own securities companies – also fall within this definition of 'financial conglomerate', and that there is considerable overlap between the issues relating to the supervision of financial conglomerates and the consolidated supervision of banking groups. These issues are also considered in the context of this handbook.

Figure 1.1. Holding Company with a Financial Conglomerate and Banking Group



Source: Association of Supervisors of Banks of the Americas (2007)

1.3.3. A MIXED ACTIVITY GROUP

A mixed activity group represents a third category of corporate groups subject to consolidated supervision and regulation. This is a group that controls commercial and industrial companies as well as banks (Dierick, 2004). An important factor behind the emergence of mixed activity groups has been a relatively large amounts of capital required for the establishment of new banks. In many countries – particularly developing countries, and the countries of Eastern Europe and the former Soviet Union – shortage of savings has meant that very often, large industrial or commercial outfits have been the only institutions capable of providing the initial amounts of capital, which the establishment of new banks requires. In other countries, large commercial companies have also diversified into commercial services: for example, large food retailing companies in the United Kingdom have seen opportunities to exploit their IT systems and network of outlets by offering banking services to their existing customer base (e.g. the Cooperative Group, Tesco, Sainsbury's, Marks & Spencer's, and so on). Whatever its origin, it is worth noting that a mixed activity group may often contain a sub-group of banks and other financial companies which operates as a single entity. Looked at in isolation, such a banking sub-group is somewhat different from the banking groups described above. Figure 1.1 depicts an example of a holding company with a financial conglomerate and a banking group as well as commercial activities also under the holding company.

1.4. ESSENTIAL CRITERIA FOR CONSOLIDATED SUPERVISION

Principle 12 of the BCBS Core Principles for Banking Supervision (BIS, 2012a) states a number of essential criteria for consolidated supervision of banks groups worldwide. These same principles are applicable to the consolidated supervision of financial conglomerates:

1. The supervisor understands the overall structure of the banking group and is familiar with all the material activities (including non-banking activities) conducted by entities in the wider group, both domestic and cross-border. The supervisor understands and assesses how group-wide risks are managed and acts when risks arising from the banking group and other entities in the wider group, in particular contagion and reputation risks, may jeopardise the safety and soundness of the bank and the banking system.

2. The supervisor imposes prudential standards and collects and analyses financial and other information on a consolidated basis for the banking group, covering areas such as capital adequacy, liquidity, large exposures, exposures to related parties, lending limits and group structure.

3. The supervisor reviews whether the oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is adequate having regard to their risk profile and systemic importance and there is no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. The supervisor also determines that banks' policies and processes require the local management of any cross-border operations to have the necessary expertise to manage those operations in a safe and sound manner, and in compliance with supervisory and regulatory requirements. The home supervisor considers the effectiveness of supervision conducted in the host countries in which its banks have material operations.

4 The home supervisor visits the foreign offices periodically; the location and frequency being determined by the risk profile and systemic importance of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.

5. The supervisor reviews the main activities of parent companies, and of companies affiliated with the parent companies, that have a material impact on the safety and soundness of the bank and the banking group and takes appropriate supervisory action.

6. The supervisor limits the range of activities the consolidated group may conduct and the locations in which activities can be conducted (including the closing of foreign offices) if it determines that: (a) the safety and soundness of the bank and banking group is compromised because the activities expose the bank or banking group to excessive risk and/or are not properly managed; (b) the supervision by other supervisors is not adequate relative to the risks the activities present; and/or (c) the exercise of effective supervision on a consolidated basis is hindered.

7. In addition to supervising on a consolidated basis, the responsible supervisor supervises individual banks in the group. The responsible supervisor supervises each bank on a stand-alone basis and understands its relationship with other members of the group.

1.5. RISKS FACING CONSOLIDATED ENTITIES

Financial conglomerates bring with them a number of regulatory and supervisory concerns, including but not limited to abuse of economic power; agency problems; imprudent intra-group transactions and exposures; contagion risk; moral hazard; regulatory arbitrage; conflicts of interest; complex corporate structures; and potential for risk management difficulties (Scott, 1994; FSA, 2007, BIS, 1995; 1999). In addition, the complexity in structure and size of many conglomerates heightens supervisory concerns in respect of contagion risk (within and between groups), and double /multiple gearing through intragroup holding of capital. Consolidated Supervision thus seeks to prevent or detect these risks facing consolidated entities:

1.5.1. ABUSE OF ECONOMIC POWER

Financial conglomerates can lead to greater market concentration, less competition and, ultimately, a less efficient financial system. They can generate 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".

1.5.2. CONTAGION RISK

This is the risk that financial difficulties encountered by a member of a conglomerate could have an adverse effect on the financial stability of the entire group and on the markets, it operates within (Scott, 1994; BIS, 1995). Risk spillovers may be due to economic links between entities (e.g. capital or credit exposures). Contagion risk can also refer to a situation whereby problems in a unit of an economic group can be perceived by market participants as problems in the whole economic group, due to common branding. For example, news of losses or falling profits in related companies may still weaken depositors' confidence in the bank and bring it under liquidity pressure. Particular cases exist where problems occurring in non-regulated entities affect regulated entities.

1.5.3. TRANSPARENCY OF LEGAL AND MANAGERIAL STRUCTURES

The size and highly complex structure of the group may make effective supervision and regulation difficult. 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-subsidization (Dierick, 2004). 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 workout or winding-down of an ailing conglomerate very difficult. Supervisors thus need to develop a thorough understanding of the legal and managerial structures, particularly when a group has

adopted a matrix management structure under which staff report to more than one manager or director (Central Bank of Barbados, 2012).

1.5.4. 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 differences in prudential regulations across sectors and regions. Intra-group transactions can be set up to formally meet regulatory requirements, but at the same time circumvent the aims of those requirements. Examples that have attracted a lot of supervisory attention include "double or multiple gearing" and "excessive leveraging" (BIS, 1995). Double or multiple gearing refers to capital coverage for multiple risks. It occurs when an entity holds capital issued by another entity within the same group and the capital is used simultaneously as a buffer against risk in the two entities. In such a situation the external capital of the group is geared up twice; first by the parent and then a second time by the dependant. The practice of double gearing overestimates the group's capital, as the sum of the capital of the group entities is higher than the consolidated capital. 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 in order to satisfy sectoral capital requirements (Yoo, 2010). Other common examples of regulatory arbitrage include:

- Intra-group transactions: moving activities or assets within the group to avoid prudential supervision by one supervisor compared to another
- Shifting activities to other jurisdictions with regulatory advantages, rather than using business criteria for investment decisions
- Shifting activities from regulated entities to unregulated entities
- Inter-group transactions: moving activities or assets from one intermediate group to another within a multi-group holding company

1.5.5. CONFLICTS OF INTEREST

A conglomerate takes up a multiple of different roles in its customer dealing which may potentially conflict. Conflicts of interest are inherent in virtually every transaction. For example, investment bankers eager to generate fees for mergers and acquisition transactions may be tempted to exaggerate their valuation of a target to increase the probability of the transaction. In addition, the sharing of customer information between group entities may violate privacy laws. For example, in the course of evaluating a loan, a bank-lending officer may discover proprietary information that is potentially of value to the bank's trust department. According to Herring and Santomero (1990), the broader the firm's array of products, the greater the chances that conflicts of interest will arise. Because conglomerates are involved in a wider range of transactions, they have a wider range of information. Although, this may be an important source of economies of scope, it may also be the source of abuse if the conglomerate makes use of the information to exploit the ignorance of counterparties.

However, conflicts of interest also exist in the same organization so the key issue is whether there are any incentives and opportunities in the organization 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. Another variant of conflicts of interest risk is *autonomy risk*. This is the risk that owners with material interest or stake in the group will influence financial transactions. These transactions are usually made outside the normal approval process. Conflicts of interest also arises where the interest of the group run counter to the interests of any of the financial institutions in the group and those of the depositors and other stakeholders.

1.5.6. MORAL HAZARD

Moral hazard describes a situation whereby the risk-taking behavior of related entities in a group tends to increase because of the existence of certain arrangement. For example, the risk that can exist when a non-regulated entity may try to gain access to a bank's deposit insurance (or other safety net) by virtue of being associated with the group. The conglomerate may also be considered by market participants as 'too big to fail', such as the expectations that the organization would not be allowed to fail but would be supported by government, leading to risky behavior either by the group or market participants.

1.6. OBJECTIVES OF CONSOLIDATED SUPERVISION

To address the risks facing consolidated entities, consolidated supervision provides a methodology to assess and monitor how effectively a banking group or financial conglomerate identifies, measures, monitors and controls risk; to recognize incipient problems; and to keep abreast with global trend and current best practice in supervision. Consolidated Supervision seeks to achieve the following objectives:

- To ensure that no banking or financial activity, and the associated risks no matter where located, escapes supervision.
- To understand the risks that emanate from relationships among the members of a corporate group, e.g. risks from owners; risks from intra-group exposures and their potential impact on the group and the licensed bank (s) - contagion
- To assess and track the risk of the group's activities wherever originated, booked and managed
- To confirm the adequacy of systems used to measure contribution to overall group risk and capital, i.e. to prevent the overleveraging of capital or 'double leverage' and regulatory arbitrage
- To spot advance indications of trouble and identify routes of risk contagion to mitigate its effect
- Ensure the integrity of group and solo capital, its effectiveness, location and transferability
- Understand where final decisions are made across a group and who makes them.

1.7. SOLO SUPERVISION VERSUS CONSOLIDATED SUPERVISION

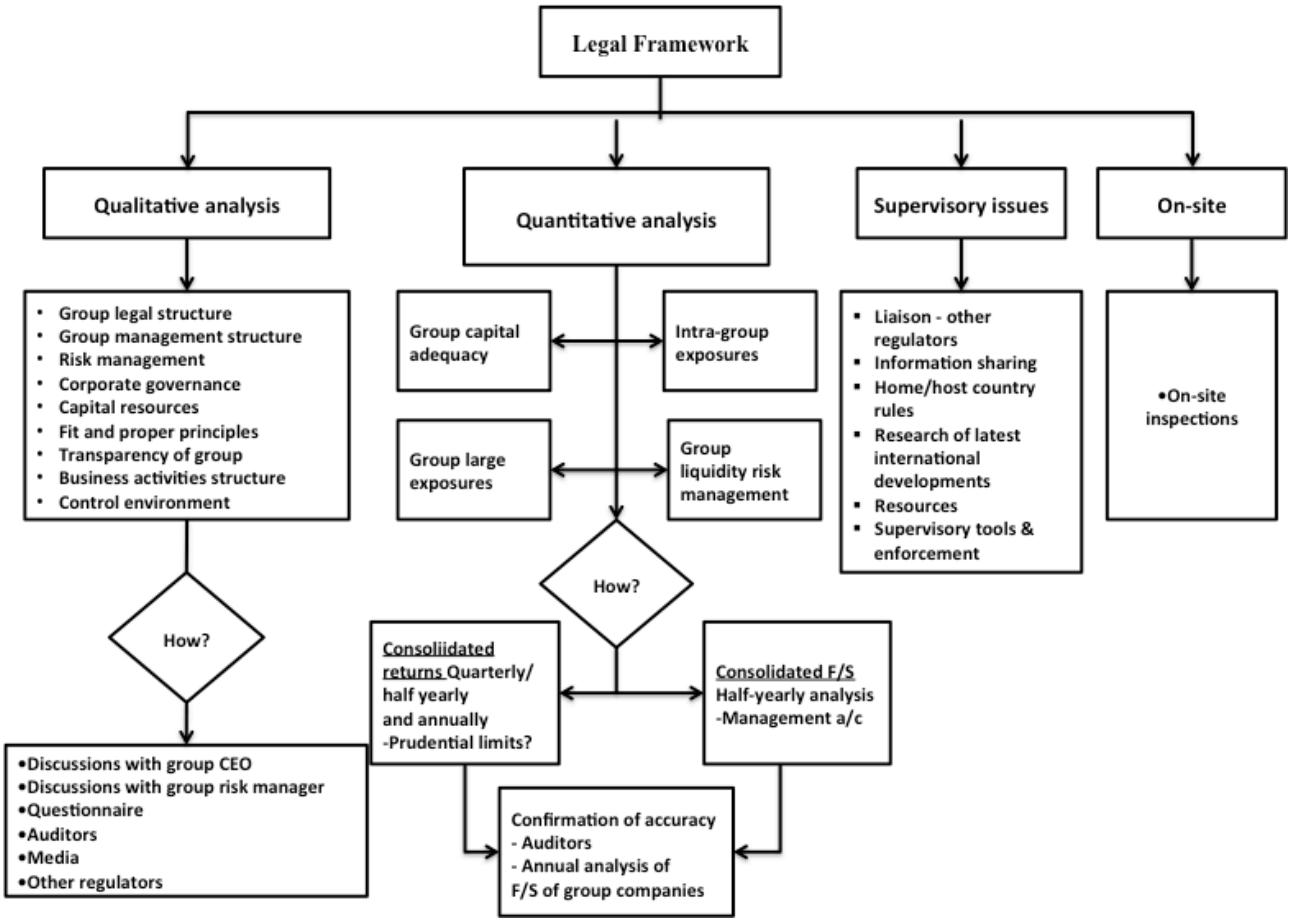
For the purpose of this handbook, there are two major approaches to Supervision: solo supervision and consolidated supervision. Solo supervision is an approach to supervising an individual legal entity within a group, e.g. banking, securities or insurance. As a fall out of the crisis, solo supervision is no longer acceptable in itself. Solo supervision must now be complemented with consolidated supervision. However, the application of consolidated supervision does not supersede the need for solo supervision at the level of individually licensed banks. Activities of other group companies and events elsewhere in the group could negatively impact a licensee in ways that cannot be detected solely through consolidated supervision. For example, intra-group relationships in the form of transactions between the bank and other group members can only be revealed

through solo supervision. Moreover, the adequacy of the licensee's capital can only be assessed on a solo basis. Hence, the Central Bank should continue to monitor licensees that are parent companies or financial holding companies (FHCs) on both a consolidated and solo basis (Central Bank of Barbados, 2012).

1.8. FORMS OF CONSOLIDATED SUPERVISION

Consolidated Supervision usually takes two forms: (1) qualitative consolidated supervision, and (2) quantitative consolidated supervision. Figure 1.2 clearly points out both aspects of consolidated supervision:

Figure 1.2: Consolidated Supervision Framework



Source: Adapted from Evert le Roux (2011)

1.8.1. QUALITATIVE CONSOLIDATED SUPERVISION[1]

This aspect of consolidated supervision examines the non-quantifiable elements of holding company operations that might pose a risk to the financial group, as it is imperative that the regulatory authority has a thorough understanding of the financial group (or sub-groups). Here the supervisor collects, reviews and analyzes qualitative information about the group's structures, activities, business strategy, corporate governance and risk management practices from both domestic and cross border operational perspectives. The aim is to evaluate material risks to the reputation or financial soundness of the parent group. To satisfy this objective, the holding

[1] See section 2 for details on the qualitative aspects of consolidated supervision.

company regulator will from time to time make several information requests including but not limited to:

- Organizational charts for the financial conglomerate
- Legal, managerial and governance structures within the financial conglomerate
- The conglomerate's strategic business plan, capital plan and policy documents
- The conglomerate's risk appetite and risk management processes
- Internal audit and compliance reviews of material parts of the group or covering keys activities
- Reports and management letters of external auditors
- Regulatory reports on each banking and non-banking subsidiary issued by the host supervisor
- Reports reviewed by senior management/board of directors at both group and subsidiary levels
- Details of personnel changes at the director and senior management levels of both the holding company and its subsidiaries
- Changes to internal systems and procedures

1.8.2. QUANTITATIVE CONSOLIDATED SUPERVISION[2]

This aspect of consolidated supervision looks at the quantifiable elements of the banking operations that allow the supervisor to assess financial condition and performance of the group. Quarterly prudential reports combine the assets, liabilities and off-balance sheet positions of the members of the group treating them as if they were a single business entity thereby allowing the supervisor to apply supervisory standards at the level of the whole group. Major components of quantitative assessment include the following:

- Consolidated financial reporting and analysis, including income and expenditure and balance sheet reports for the parent holding company only, for the banking and non-banking subsidiaries and for the consolidated organization as a whole
- Capital adequacy assessment
- Credit concentrations, large exposures, intra-group financial transactions and related party lending
- Liquidity risk management

1.8.3. RATING OF THE FINANCIAL GROUP[3]

The regulator compiles the information obtained from its qualitative and quantitative supervision to develop a risk assessment of the financial conglomerate in accordance with pre-determined supervisory guidelines. The main components of a rating system include:

- An assessment of the group's risk management (R): beginning with an assessment of risks emanating from each business line – regardless of whether risk activities are driven by domestic or cross-border operations
- An assessment of the financial condition (F) of the financial conglomerate as a whole including its constituent parts
- An assessment of the potential impact (I) of the parent company and its non-depository subsidiaries on subsidiary depository institutions
- An assessment of the subsidiary depository institutions (D), and then
- Arriving at a composite risk rating (C)

[2] See chapter 3 for details on the quantitative aspects of consolidated supervision.
[3] See chapter 4 for details on the rating system used in evaluating FHCs

CHAPTER 2: QUALITATIVE CONSOLIDATED SUPERVISION

2.1. UNDERSTANDING THE FINANCIAL CONGLOMERATE STRUCTURE

In order to carry out consolidated supervision, the supervisor of a financial conglomerate needs to first develop an understanding of the legal, operating and corporate governance structure of the organization and its primary strategies, business lines, risk management and internal control functions. This understanding will inform the development of a risk assessment and supervisory plan for the consolidated group. Typically, the information necessary to gain this understanding may be obtained from the organization's management, public reports, regulatory reports, surveillance screens, third party sources (e.g. credit rating agency and market analyst reports), as well as other relevant primary supervisors or functional regulators (e.g. the deposit insurance company, the securities and exchange commission, insurance commission, pensions commission, and so on).

2.1.1. UNDERSTANDING THE LEGAL AND MANAGERIAL STRUCTURE

Examination of the consolidated entity's group structure should include scrutinizing the group's legal and managerial structure to gain an understanding of inherent risks facing the financial group. Principle 11 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS 2012b) states that 'supervisors should seek to ensure that the financial conglomerate has a transparent organizational and managerial structure, which is consistent with its overall strategy and risk profile and is well understood by the board and senior management of the head company'. In order to carry out this task, the supervisor should examine the organogram of the financial conglomerate, which should indicate its subsidiaries, affiliates and other related legal entities clearly showing which of the entities in the group carries substantial risk. The chart should also show the extent of outside shareholders' interests in subsidiaries and participations. According to BIS (2012b), some of the elements to be considered for assessing the legal and ownership structure of the financial conglomerate may include: the identification of significant owners, including the ultimate beneficial owners, the transparency of their ownership structure, their financial information, and the sources of their initial capital and all other requirements of national authorities. The aim of this exercise is to evaluate the integrity, business conduct and financial soundness of the significant owners including their capacity to provide additional support when required.

Apart from the legal and ownership structure, the supervisor should also examine and scrutinize the management structure of the financial conglomerate, reflecting responsibilities of managers along legal, corporate and business lines. The chart should show the location of the supervised institution and its management in the financial conglomerate's business line structure. Supervisors should scrutinize the chart of the financial conglomerate for clear reporting lines between the supervised institution and all entities within the group. The aim of this exercise is to identify all material portfolios and significant business units[4] in the group. Significant business units can be identified by quantitative means; for example, a business unit might be regarded as significant if its annual profits/losses or risk-weighted assets represented 5% or more of the group's profits or

[4] A "business unit" is an organizational unit that generates income and is separately identified in the group's management information systems, and may not necessarily be a separate legal entity (MacDonald, 1998).

regulatory capital respectively (McDonald, 1998). Supervisors should seek to ensure that the structure of the financial conglomerate does not impede effective consolidated supervision. Supervisors may seek restructuring under appropriate circumstances to achieve this, if necessary. Where the need arises, supervisors should meet with the group management with a view to enhancing their understanding of the group structure.

In order to effectively assess the conglomerate's group structure and inherent risks, the supervisor should seek to examine and understand the following:

- The nature of the conglomerate's business and that of the all the units in the group, including material and non-material business activities
- The conglomerate's primary business strategies, including key revenue and risk drivers, primary business lines and product mix and how these impact on the group's risk profile
- The primary risks to which the group is exposed and the ways in which these risks are managed
- The conglomerate's budget and internal capital allocations
- Market share for revenue and customers served
- Key external trends, including competitive pressures
- Areas that are vulnerable to volatility in revenue, earnings, capital, or liquidity that represent material risks of the organization
- The group's institutional risk tolerance as well as key changes in strategic direction or risk profile
- The conglomerate's significant new business activities, areas of growth and emerging areas with potential to become primary drivers of risk and revenue
- The conglomerate's plans for expansion through mergers or acquisitions
- Domestic and foreign regulatory responsibilities for legal entities and business lines
- Key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates
- Material business lines operated across multiple legal entities for accounting or risk management purposes
- Whether the conglomerate has significant business presence in critical or key national or global financial markets, including core clearing and settlement activities
- The conglomerates corporate governance structure, including board of directors and executive level committees, senior management and management committees as well as key risk management and internal control functions
- Associated Management Information Systems (MIS) relied upon by the board, senior management and senior risk managers and committees
- Consistency of public disclosures with how the board and senior management assess and manage risks

2.1.2. LEGAL AND MANAGERIAL STRUCTURES: KEY SUPERVISORY ACTIONS

According to the Joint Forum (contained in BIS, 2012b), in examining the legal and managerial structure of a financial conglomerate, the supervisor should:

- Assess whether the financial group has an appropriate risk management system covering all aspects of its business and whether its internal controls, including group internal audit, are sufficiently rigorous

- Monitor changes among the other shareholders in a group's partly owned subsidiaries and participants, since this could signify a weakening or strengthening of the financial resources available to the group.
- Ensure that the board and senior management of the holding company are capable of describing and understanding the purpose, structure, strategy, material operations, and material risks of the financial conglomerate, including those of unregulated entities that are part of the financial conglomerate structure.
- Assess and monitor the financial conglomerate's process for approving and controlling structural changes, including the creation of new legal entities.
- For mixed activity groups, supervisors should make some assessment of the risks emanating from the commercial or industrial companies in the group. It is normally advisable to 'ring-fence' a bank (or banking sub-group) that belongs to a mixed activity group in order to isolate the bank's operations from those of the remainder of the group. This involves ensuring (1) that the bank management can operate independently of the group management and (2) placing severe limits on the exposure of the bank towards other group companies and volume of funding it receives from them.
- Where the financial conglomerate is part of a wider group, supervisors should require that the board and senior management of the head of the financial conglomerate have governance arrangements that enable material risks stemming from the wider group structure to be identified and appropriately assessed by relevant supervisory authorities.
- Supervisors should seek to ensure that there is a framework governing information flows within the financial conglomerate and between the financial conglomerate and entities of the wider group (e.g. reporting procedures).

2.2. CORPORATE GOVERNANCE IN FINANCIAL CONGLOMERATES

One of the primary areas of focus for consolidated supervision of large financial conglomerates is the adequacy of governance provided by the board and senior management. Broadly, corporate governance describes the processes, policies and laws that govern how a company or group is directed, administered or controlled. It defines the set of relationships between a company's management, its board, its shareholders, and other recognized stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. The culture, expectations, and incentives established by the highest levels of corporate leadership set the tone for the entire organization. They are also essential determinants of whether a banking organization is capable of maintaining fully effective risk management and internal control processes. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy (Federal Reserve System, 2013a).

Financial conglomerates are often complex groups with multiple regulated and unregulated financial and other entities. Given this inherent complexity, corporate governance must carefully consider and balance the combination of interests of recognized stakeholders of the ultimate parent, and the regulated financial and other entities of the group. Ensuring that a common

strategy supports the desired balance and that regulated entities are compliant with regulation on an individual and on an aggregate basis should be a goal of the governance system. This governance system is the fiduciary responsibility of the board of directors.

This section describes the elements of the governance system most relevant to financial conglomerates, and how supervisors should assess them. When assessing corporate governance across a financial conglomerate, supervisors may wish to apply the principles set out in this section in a manner that is appropriate to the relevant sectors and the supervisory objectives of those sectors.

Principle 10 of the Joint Forum's document on the *Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should seek to ensure that the financial conglomerate establishes a comprehensive and consistent governance framework across the group that addresses the sound governance of the financial conglomerate, including unregulated entities, without prejudice to the governance of individual entities in the group'. Supervisors should require that the corporate governance framework of the financial conglomerate specify minimum requirements for good governance of the entities under the financial conglomerate, which allow for the prudential and legal obligations of its constituent entities to be effectively met. The ultimate responsibility for the sound and prudent management of a financial conglomerate lies with the board of the head of the financial conglomerate.

2.2.1. PRIMARY EXPECTATIONS OF THE BOARD OF A FINANCIAL CONGLOMERATE

Generally, it is essential that the group's corporate governance framework should be properly aligned to the structure of the financial conglomerate and provide for the suitability of board members, senior management and key persons in control functions including their ability to make reasonable and impartial business judgments. The framework should notably include a strong risk management framework, a robust internal control system, effective internal audit and compliance functions, and ensure that the group conducts its affairs with appropriate independence and a high degree of integrity. The corporate governance framework should also address the financial soundness of the significant owners and how potential conflicts of interest, especially those relating to intra-group/insider transactions as well as remuneration, will be managed.

According to the Federal Reserve System (1999), the primary expectations of the board and its committees include:

- Selecting competent senior managers, ensuring that they have the proper incentives to operate the organization in a safe and sound manner, and regularly evaluating senior managers' performance
- Establishing, communicating and monitoring (e.g. by reviewing comprehensive MIS reports produced by senior management) institutional risk tolerances and a corporate culture that emphasizes the importance of compliance with the law and ethical business practices
- Approving significant strategies and policies
- Demonstrating leadership, expertise and effectiveness
- Ensuring the organization has an effective and independent internal audit function
- Ensuring the organization has appropriate policies governing the segregation of duties and avoiding conflicts of interest

- Ensuring that public disclosures: (1) are consistent with how the board and senior management assess and manage the risks of the organization (2) balance quantitative and qualitative information with clear discussions about risk management processes, and (3) reflect evolving disclosure practices for peer organizations

2.2.2. PRINCIPAL ELEMENTS OF GROUP GOVERNANCE

The Financial Services Regulation Coordinating Committee (2013) of Nigeria identifies the following principal elements in assessing a conglomerate's corporate governance structure:

- Composition of the Board and Senior Management of the group.
- Qualification and relevant experience of the Board and Senior Management.
- Independence of the Board.
- Accountability to the various stakeholders.
- Transparency of the supervised institution in the discharge of its mandate.
- Execution of transactions at arms' length, devoid of conflict of interest.
- Effective oversight of the Board over Senior Management.
- Documentation of business strategy including corporate values, lines of responsibilities and accountability among various cadres of employees in the supervised institution and all its subsidiaries/affiliates whether local or foreign.
- Separation of the Board headship from that of the management, and the need for more non-executive directors (including independent directors) than the executive directors.
- Directors who are knowledgeable in the business of the institution and financial matters generally.
- Existence of Board Committees such as Audit, Risk Management, Credit, Finance and General Purpose, etc.
- Management of the supervised institution should have a defined division of responsibilities.
- Board and Senior Management of the supervised institution should have a definite succession plan.
- Culture of compliance with internal policies and procedures as well as rules and regulations issued by each supervisor for all the members of the group.
- Regular management reporting and monitoring system as well as a comprehensive code of conduct for Directors, Management and Staff.
- Competent and independent Internal and External Auditors.
- The Board and management should ensure prudent management of the regulated entities.
- Existence of a whistle blowing policy and its effectiveness.
- Presence of Politically Exposed Persons (PEPs) on the Board.
- Full disclosure of all other material information.

2.2.3. ISSUES IN CORPORATE GOVERNANCE: REMUNERATION IN FINANCIAL CONGLOMERATES

Remuneration is a key aspect of any governance framework and needs to be properly considered in order to mitigate the risks that may arise from poorly designed remuneration arrangements (BIS, 2012b). The risks associated with remuneration should be reflected in the financial conglomerate's broader risk management framework. Remuneration plays important roles in the operations and profitability of an enterprise, including attracting skilled staff, promoting better organization-wide and employee performance, promoting retention, providing retirement security and allowing

personnel costs to vary with revenues. It is also clear, however, that ill-designed compensation arrangements can provide incentives to take risks that are not consistent with the long-term health of the organization, as the recent financial crisis has revealed. Such risks and misaligned incentives are of particular supervisory interest. As a fall out of the financial crisis, a number of regulators have introduced rules prohibiting incentive-based compensation arrangements that encourage inappropriate risks and could lead to material financial loss at covered institutions, including financial conglomerates. For example, the Financial Stability Board (FSB, 2009) issued nine (9) principles for sound compensation practices in financial organizations. These principles aim to ensure three (3) things:

I. Effective Governance of Compensation:
The board of directors of large financial groups should exercise good stewardship of their firms' compensation practices and ensure that compensation works in harmony with other practices to implement balanced risk postures.

II. Alignment of Compensation with Prudent Risk Taking:
An employee's compensation should take account of the risks that the employee takes on behalf of the firm. Compensation should take into consideration prospective risks and risk outcomes that are already realized

III. Effective Supervisory Oversight and Stakeholder Engagement in Compensation:
Financial conglomerates should demonstrate to the satisfaction of their regulators and other stakeholders that their compensation policies are sound. As with other aspects of risk management and governance, supervisors should take rigorous action when deficiencies are discovered.

In line with the FSB Principles, the Dodd-Frank Act of 2010 (US) also requires federal regulators to issue rules to prohibit incentive-based compensation practices that encourage risk taking in financial institutions. Under the rules, incentive-based compensation arrangements must: (1) balance risk and financial rewards[5], (2) be compatible with effective controls and risk management, and (3) be supported by strong corporate governance. For institutions with more than $50 billion in assets, at least 50% of incentive compensation for executive officers must be deferred for at least three years and adjusted for subsequent losses. The Joint Forum [i.e. BCBS, IAIS and IOSCO] has also has also re-iterated these principles, encapsulating them in its Principle 14 BIS (2012b): 'supervisors should require that the financial conglomerate has and implements an appropriate remuneration policy that is consistent with its risk profile. The policy should consider the material risks that organization is exposed to, including those from its employees' activities'. In summary, an appropriate policy aligns risk-takers' variable remuneration with prudent risk taking, promotes sound and effective risk management, and considers any other appropriate factors. The overarching objective of the policy should be consistent across the group but can allow for reasonable differences based on the nature of the constituent entities or units and domestic legal requirements.

[5] These rules suggest four ways to balance risk and rewards: (1) Risk adjustment of the rewards, (2) Deferral of payment, (3) Longer performance periods, (4) Reduced sensitivity to short-term performance

2.2.4. CORPORATE GOVERNANCE FRAMEWORK: KEY SUPERVISORY ACTIONS

In examining the corporate governance framework of financial conglomerates, supervisors should observe the following points:

- Supervisors should be satisfied of the suitability of board members, senior managers and key persons in control functions. In doing this, supervisors should require them to demonstrate their ability to perform the duties or to carry out the responsibilities required in their position. Competence can generally be judged from the level of professionalism (e.g. relevant experience within financial industries or other businesses) and/or formal qualifications.
- Supervisors should require that the board of the holding company has in place a framework for monitoring compliance with the strategy and risk appetite across the financial conglomerate.
- Supervisors should require that the board of the holding company regularly assesses the strategy and risk appetite of the financial conglomerate to ensure it remains appropriate as the conglomerate evolved.
- Where the financial conglomerate is part of a wider group, supervisors should assess whether the head is managing its relationship with the wider group and ultimate parent in a manner that is consistent with the governance framework of the financial conglomerate.
- Supervisors should require that a framework is in place which seeks to ensure resources are available across the financial conglomerate for constituent entities to meet both the group and their own entity's governance standards.
- Supervisors should require that the corporate governance framework of the financial conglomerate include a code of ethical conduct, which emphasizes a high degree of integrity in the conduct of its affairs.
- Supervisors should seek to ensure that the corporate governance framework appropriately balances the diverging interests of constituent entities and the financial conglomerate as a whole.
- Supervisors should require that the governance framework respects the interests of policy holders and depositors (where relevant) and should seek to ensure that it respects the interests of other recognized stakeholders of the financial conglomerate and the financial soundness of entities in the financial conglomerate.
- Supervisors should require that the governance framework includes adequate policies and processes that enable potential intra-group conflicts of interest to be avoided, and actual conflicts of interest to be identified and managed.
- Supervisors should require that a suitable remuneration policy consistent with established international standards is in place and observed at all levels and across jurisdictions in the financial conglomerate.

2.3. ENTERPRISE RISK MANAGEMENT (ERM) FRAMEWORK

Financial conglomerates, irrespective of their particular mix of business lines or financial sectors, are in the business of risk taking. Sound risk management is thus a crucial focus of supervision. This section provides principles and common practices for the sound and comprehensive management and supervision of risk management frameworks in financial conglomerates.

Principle 21 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should require that an independent, comprehensive and effective risk management framework, accompanied by a robust system of internal controls, effective internal audit and compliance functions, is in place for the financial conglomerate'. Supervisors are

required to ensure that a conglomerate's enterprise risk management (ERM) framework is comprehensive, consistent across entities supervised in all sectors and cover the risk management function, risk management processes and governance, and systems and controls.

Enterprise risk management (ERM) is the ability of an organization to understand, articulate and control the nature and level of risks taken in pursuit of its business strategies. When combined with accountability for risks taken and activities engaged in, ERM contributes to increased confidence by way of risk competence demonstrated by the organization's stakeholders. The risks facing any large financial services enterprise are numerous, including credit, liquidity, market, operational, strategic/business, reputational, compliance/legal, and regulatory. An effective risk management program that identifies, assesses, monitors, and manages risk exposure in the financial conglomerate is essential. As discussed in section 2.2, in order for an enterprise to develop and implement an effective risk management program, it requires a strong board of directors that appoints and monitors a qualified senior management team. The board must establish reasonable risk tolerances and limits to match the complexity of the organization. The enterprise must develop strong risk monitoring and management information systems to verify that activities are within its risk tolerances. The risk management program should follow board-approved policies and procedures, and management should implement a robust system of internal controls, including an independent audit function.

The first part of this section presents the risk management framework under the 'three lines of defense' approach and then proceeds to discuss the development and implementation of a risk appetite framework (RAF) in the second part.

2.3.1. RISK MANAGEMENT AND THE THREE LINES OF DEFENSE APPROACH

Before discussing how to manage group-wide risk using the three lines of defense approach, it is imperative to quickly review the different types of risks affecting banking and financial groups:

- *Strategic Risk:* This is the risk that a financial group's business strategy and objectives do not allow it to achieve its vision, mission and purpose
- *Credit Risk:* Borrower's inability or unwillingness to repay financial obligations as agreed. Includes both on and off-balance sheet commitments
- *Liquidity Risk:* The risk to ongoing operations arising from the inability to liquidate assets or obtain adequate funding to offset specific exposures
- *Market Risk:* Changes in the value of portfolios of financial instruments due to adverse movement in market rates or prices
- *Operational Risk:* Loss associate with inadequate or failed internal processes, people, systems, or external events (including legal liability and litigation)
- *Reputational Risk:* This is the risk of negative publicity or public opinion (either real or perceived) that may adversely impact on the group's brand image.
- *Regulatory Risk:* Failure to comply with laws, regulations, or standards or codes of conduct of self-regulatory organizations applicable to the banking organization's activities

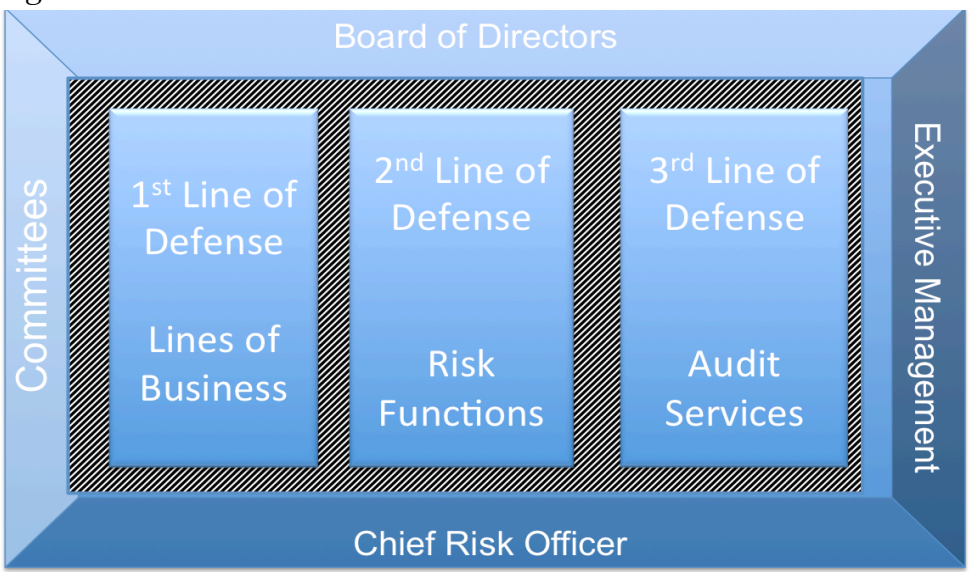
In the risk management component of a conglomerate's examination, supervisors should evaluate the ability of the holding company to identify, measure, monitor, and control risk. The complexity

of risk management will vary based on the size and complexity of the holding company's operations. Non-complex holding companies may have minimal risk management programs or rely on their subsidiary's risk management system. Complex and conglomerate holding companies should adopt formal risk management systems commensurate with their risk level. The most complex firms should implement enterprise-wide risk management programs.

According to the Institute of Internal Auditors (2013), risk is managed using three mutually supportive lines of defense (Figure 2.1):

- First Line of Defense: functions that own and manage risks
- Second Line of Defense: functions that oversee risks.
- Third Line of Defense: functions that provide independent control

Figure 2.1. Three Lines of Defense



Source: Adapted from IIA (2013)

1st Line of Defense: Lines of Business or Operational Management

Lines of Business are responsible for proactively identifying and managing the inherent risks of their businesses. Lines of business refer to all such business units that contribute to the earnings of the financial conglomerates. Examples include Corporate/Wholesale Banking, Commercial & Industrial Banking, SME Banking, Consumer/Retail Banking, Private/Wealth Banking, Mortgage Banking, Investment Banking/Securities, General Insurance, Life Insurance, Microfinance, Pensions, Treasury/Money Market, Foreign Exchange, Asset Finance (e.g. leasing, automotive finance), Oil & Gas Finance, Telecommunications Finance, I.T., etc. As the first line of defense, operational managers or heads of each of the business units will usually take ownership of all risk types emanating from their business operations. They also are responsible for implementing corrective actions to address process and control deficiencies.

2nd Line of Defense: Risk Management and Compliance Functions

Management establishes various risk management and compliance functions to help build and/or monitor the first line-of-defense controls. The specific functions will vary by organization and industry, but typical functions in this second line of defense include:

- *A risk management function (and/or committee)* that facilitates and monitors the implementation of effective risk management practices by operational management and assists risk owners in defining the target risk exposure and reporting adequate risk-related information throughout the organization. The Risk Management Organization is responsible for the oversight, measurement, monitoring, reporting of risk, and consistency of controls. Risk Management is examined for all risks individually and on a consolidated enterprise basis. Risk management functions usually include the following:
    - Risk identification
    - Risk measurement (including economic capital and stress testing)
    - Risk reporting and monitoring
    - Risk mitigation (including tolerances, limits, standards, prohibitions, pricing for risk, and hedging)
    - Financial and operational contingency planning

- *A compliance function* to monitor various specific risks such as noncompliance with applicable laws and regulations. In this capacity, the separate function reports directly to senior management, and in some business sectors, directly to the Board of Directors.

Management establishes these functions to ensure the first line of defense is properly designed, in place, and operating as intended. Each of these functions has some degree of independence from the first line of defense, but they are by nature management functions. As management functions, they may intervene directly in modifying and developing the internal control and risk systems. Therefore, the second line of defense serves a vital purpose but cannot offer truly independent analyses to the Board regarding risk management and internal controls.

The responsibilities of these functions vary on their specific nature, but can include:

- Supporting management policies, defining roles and responsibilities, and setting goals for implementation.
- Providing risk management frameworks.
- Identifying known and emerging issues.
- Identifying shifts in the organization's implicit risk appetite.
- Assisting management in developing processes and controls to manage risks and issues.
- Providing guidance and training on risk management processes.
- Facilitating and monitoring implementation of effective risk management practices by operational management.
- Alerting operational management to emerging issues and changing regulatory and risk scenarios.
- Monitoring the adequacy and effectiveness of internal control, accuracy and completeness of reporting, compliance with laws and regulations, and timely remediation of deficiencies

3rd Line of Defense: Internal Audit

Internal auditors provide the board of directors and senior management with comprehensive assurance based on the highest level of independence and objectivity within the organization. This high level of independence is not available in the second line of defense. Internal audit provides assurance on the effectiveness of governance, risk management, and internal controls, including the

manner in which the first and second lines of defense achieve risk management and control objectives. Internal auditors are responsible for evaluating the design and effectiveness of the risk management framework and its results.

The scope of internal audit usually covers:

- A broad range of objectives, including efficiency and effectiveness of operations; safeguarding of assets; reliability and integrity of reporting processes; and compliance with laws, regulations, policies, procedures, and contracts.
- All elements of the risk management and internal control framework, which includes internal control environment; all elements of an organization's risk management framework (i.e., risk identification, risk assessment, and response); information and communication; and monitoring.
- The overall entity, divisions, subsidiaries, operating units, and functions — including the business lines— as well as supporting functions (e.g., revenue and expenditure accounting, human resources, purchasing, payroll, budgeting, infrastructure and asset management, inventory, and information technology).

Establishing a professional internal audit activity should be a governance requirement for all organizations. This is not only important for larger and medium-sized financial organizations but also may be equally important for smaller financial groups, as they may face equally complex environments with a less formal, robust organizational structure to ensure the effectiveness of its governance and risk management processes.

Risk Management Governance

Risk management governance refers to the oversight of risk management activities in a corporation. Typically, this includes the board of directors, the chief risk officer, the board risk committees and the management sub-committees.

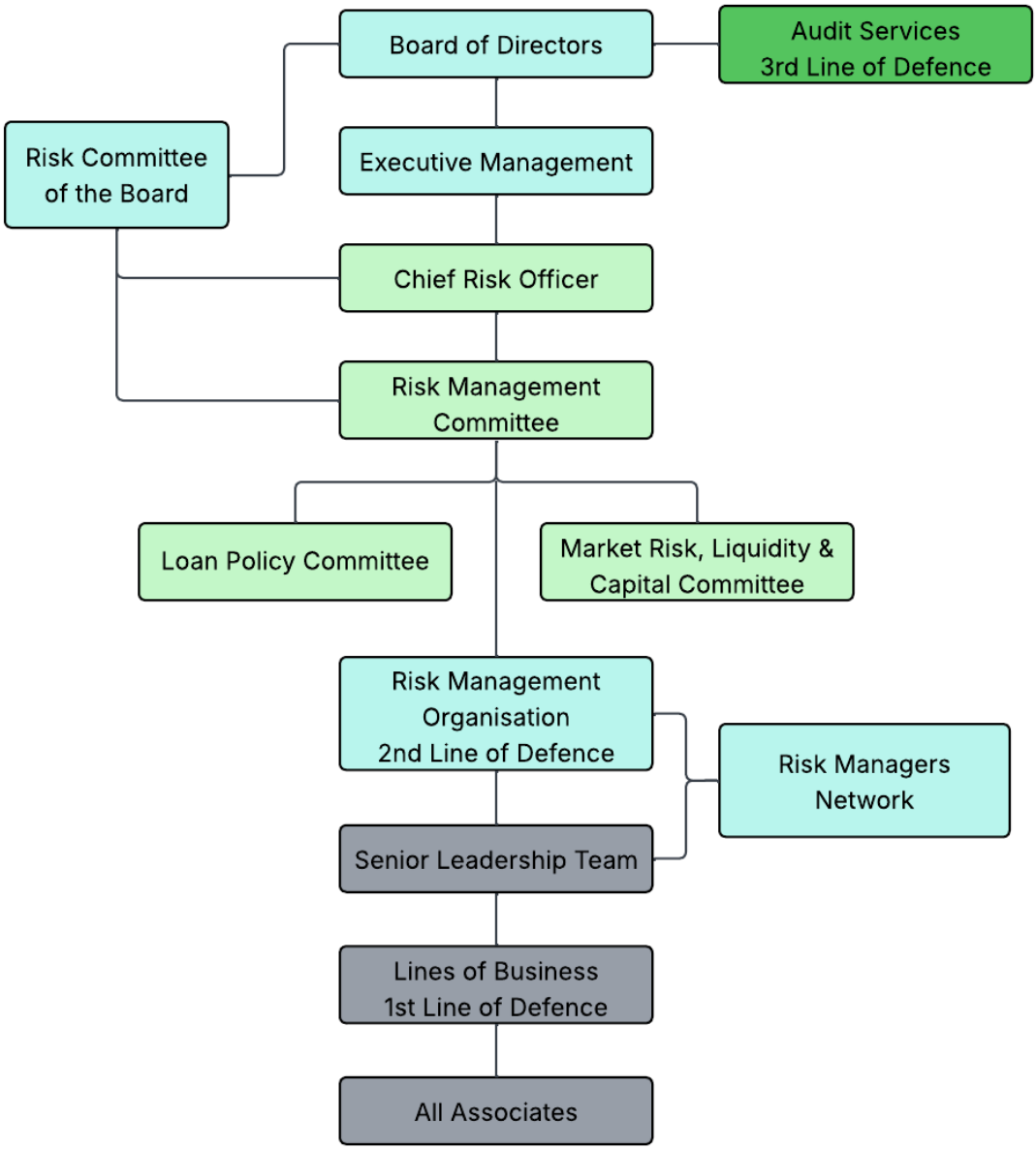
(1) The Board of Directors and Executive Management:

- The Board of Directors owns the oversight of risk management
- Executive Management owns risk, which includes design of the risk framework and accountability to the Board of Directors for risk outcomes
- The Chief Risk Officer is designated by the Executive Management to lead the Risk Management Organization which designs, organizes, and manages the risk framework
- The Executive Management-led Enterprise Risk Committees provide oversight and escalation of risks within the framework

(2) The Chief Risk Officer (CRO)

- The CRO is the executive accountable for enabling the efficient and effective governance of significant risks, and related opportunities, to a business and its various segments.
- The CRO has oversight over all kinds of risk in the Enterprise – credit risk, market risk, operational risk, liquidity risk, compliance risk, strategic risk and reputational risk
- The CRO is generally responsible for coordinating the organization's Enterprise Risk Management (ERM) framework
- CRO provides independent risk reporting to the Risk Committee of the Board

Figure 2.2. Risk Management Governance Framework



Source: BB&T Corporation (2013)

(3) The Risk Committee of the Board:

Typically, the risk committee of the board is usually chaired by an independent director appointed by the committee annually and has oversight over all of all risk-taking activities at the corporation. The board risk committee:

- Provides independent oversight over the executive management-led risk management committee
- Understands, communicates, monitors corporation's risk appetite and risk profile
- Stays abreast of regulatory requirements and industry standards related to risk management
- Provides input to management on risk appetite, risk profile, and regulatory requirements
- Develop corporate-wide strategies for identifying, assessing, controlling, measuring, monitoring and reporting risk
- Approves effectiveness of the corporation's risk management framework

(4) Risk Management Committee (RMC):

- The risk management committee is chaired by the Chief Risk Officer (CRO) and has oversight over the market risk, liquidity and capital committee (MRLCC) and the loan policy committee (LPC) as in the case of BB & T Corporation, USA (see Figure 2.2).
- RMC focuses on fully integrated view of risks across the corporation
- RMC develops corporate-wide strategies for identifying, assessing, controlling, measuring, monitoring and reporting risk

(5) Market Risk, Liquidity and Capital Committee (MRLCC):

- MRLCC is usually chaired by the corporation's treasurer and has oversight over the financial market, trading, capital, deposits, risk analytics and business intelligence
- MRLCC manages market risk while optimizing the conglomerate's net interest income (NII) and earnings per share (EPS)
- MRLCC optimizes the firm's balance sheet and deployment of capital as well as reviews capital adequacy

(6) Loan Policy Committee (LPC):

- LPC has oversight over the corporation's credit risk management (CRM), including retail and commercial credit administration
- LPC ensures that all major lending activity meets the corporation's standard lending policy
- The committee analyzes and subsequently approves or rejects any loan that the initial loan officer or relationship manager does not have the authority to approve. Assuming the loan meets the required criteria, the committee can agree to fund and disburse loan with a binding commitment.
- LPC is also responsible for periodic credit reviews of the firm's maturing loans. It also determines what collection action should be taken on past-due credit obligations
- LPC is usually chaired by the Chief Risk Officer (CRO) and is composed of senior level management staff

There are also sub-committees or management committees that handle some aspects of enterprise risk management (ERM) functions. Examples include:

(7) Capital and Scenario Sub-Committee:

- The capital and scenario committee has oversight over stress testing and the conglomerate's economic capital.
- It oversees the internal capital adequacy assessment process as well as provides sanctioned macroeconomic scenarios used for planning earnings, forecasting and stress testing activities.
- The conglomerate's capital planning manager or ERM Strategist usually chairs the committee.

(8) Independent Price Verification (IPV) Committee:

- This committee usually provides oversight to the enterprise-wide independent price verification function. IPV is a process for regular review of valuation of trading assets and liabilities against independently sourced instrument prices to ensure that the firm's trading positions are correctly valued and that appropriate corrections are applied where there are discrepancies.

- The IPV committee usually oversees the market-driven arms of the conglomerate's business including securities, foreign exchange, mortgage lending, pension fund, and so on.
- The Chief Market & Liquidity Risk Officer (CMLRO) usually chairs the IPV committee and also monitors and reports trading risk and balance sheet risk to the board through the CRO.

(9) Senior Risk Officers (SROs):
SROs are responsible for the oversight of different risk types and report to the CRO. Examples include:

- Chief Commercial Credit Officer
- Chief Retail Credit Officer
- Chief Operational Risk Officer
- Chief Market and Liquidity Risk Officer
- Chief Compliance/Regulatory Risk Officer

(10) Enterprise Risk Manager or ERM Strategist:
The Enterprise Risk Manager works with the CRO to:

- Develop the company's ERM policy and framework.
- Develop risk appetite, risk tolerance levels and key risk indicators (KRIs) with associated thresholds to monitor the associated risks.
- Conduct, facilitate and manage the annual corporate risk assessments, ensuring that results are reported accurately to Senior Management and to the internal Audit team.
- Monitor mitigation action plans, risk tolerance levels and KRIs at a corporate level as well as department level and report exceptions to CRO & the board for further actions.
- Plan and facilitate regular workshops with all business unit heads/senior risk officers to monitor and determine the status of enterprise-wide risk and appropriate mitigation actions.

2.3.2. DEVELOPING AND IMPLEMENTING A RISK APPETITE FRAMEWORK (RAF)

A clearly articulated statement of risk appetite and the use of a well-designed risk appetite framework to underpin decision-making are essential to the successful management of risk. The recent financial crisis demonstrated clearly that an effective risk appetite framework (RAF) is a crucial component of sound enterprise-wide risk management. Accordingly, both the financial services industry and the regulatory community are devoting a great deal of attention to this essential governance tool. Principle 23 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should require that the financial conglomerate establishes appropriate board approved, group-wide risk tolerance levels and a risk appetite policy'. The risk tolerance levels and risk appetite policy set the tone for acceptable and unacceptable risk taking and should be aligned with the financial conglomerate's business strategy, risk profile and capital plan.

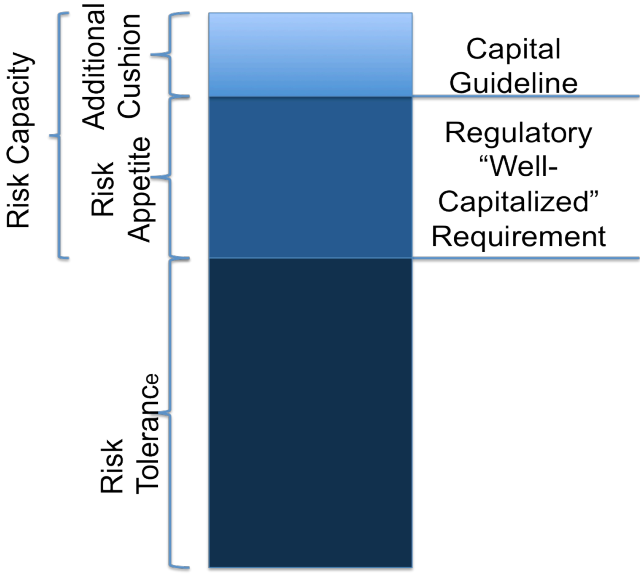
This sub-section evaluates current industry practices in the area of risk appetite and identifies the key stages and the technical and management challenges in the journey toward setting and monitoring adherence to appropriate boundaries for risk, within a sound risk appetite framework. It also brings industry expertise and sound practices to bear on examining how these challenges have been addressed in some financial conglomerates (including the analysis of real-life case studies).

Conceptual Definitions

The following definitions are consistent with the principles for an effective risk appetite framework as provided by the Financial Stability Board (2013):

- *Risk Appetite:* This is the aggregate amount and type of risk that a firm is able and willing to assume within its risk capacity in pursuit of its strategic business objectives. It is the amount of risk a firm is willing to take and remain capitalized above the risk tolerance through the business cycle. The financial conglomerate's risk appetite policy is reassessed regularly with respect to new business opportunities, changes in risk capacity and tolerance, and operating environment.
- *Risk Tolerance:* This is the typical measure of risk or threshold used to monitor exposure within or around the stated risk appetite. It is often expressed in acceptable/unacceptable outcomes or levels of risk. It reflects the acceptable variation in outcomes related to specific performance measures linked to objectives the entity seeks to achieve. It is more operational and related primarily to the company's targets.
- *Risk Capacity:* This is the maximum amount of risk a financial conglomerate is technically able to assume given its capital base, liquidity, borrowing capacity, and regulatory constraints.
- *Risk Appetite Framework:* This is the overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF.
- *Risk Appetite Statement:* This is the articulation in written form of the aggregated level and types of risk that a firm is willing to accept in order to achieve its business objectives. It includes qualitative statements as well as quantitative measures expressed relative to earnings, capital risk measures, liquidity and other relevant measures as appropriate

Figure 2.3. Risk Appetite, Risk Tolerance & Risk Capacity



Source: BB&T Corporation (2013)

- *Risk Limits:* These are quantitative measures based on forward looking assumptions that allocate the firm's aggregate risk appetite statement (e.g. measure of loss of negative events) to business lines, legal entities, specific risk categories, concentrations, etc
- *Risk Profile:* This is the point in time assessment of the firm's net risk exposures (after considering mitigants) aggregated within and across each relevant risk category based on forward looking assumptions

Sound Practices in Designing a RAF

According to the Institute of Risk Management (Anderson, 2011), in designing a risk appetite, it is important for the Board of Directors and Senior Management to think about the following questions:

- Has the board and management team reviewed the capabilities of the organization to manage the risks that it faces?
- What capacity does the organization have in terms of its ability to manage risks?
- How mature is risk management in the organization? Is the view consistent at differing levels of the organization? Is the answer to this question based on evidence or speculation?
- What specific factors should risk appetite consider in terms of the business context? Risk processes? Risk Systems? Risk management maturity?
- At which levels would it be appropriate for the board to consider risk appetite?
- What are the main features of the organization's risk culture in terms of tone at the top? Governance? Competency? Decision-making?
- How much does the organization spend on risk management each year? How much does it need to spend?
- Does an understanding of risk permeate the organization and its culture?
- Does each individual understand his or her role and responsibility for managing risk?
- At a managerial level, do you know what level of risk you should take? Do you know who the risk owners are? Do they have systems in place for measuring and monitoring risk?
- Is management incentivized for good risk management?

Essential Ingredients in Implementing a RAF

To implement a risk appetite framework (RAF), the following ingredients or factors must be taken into consideration:

- A *strong risk culture* is a prerequisite to eventually putting in place an effective RAF
- It is essential that the determination of risk appetite is *inextricable linked to strategy development and business plans*, otherwise there will be conflicts between the two – which could lead to the conduct of business activities with risky outcomes
- RAFs call for the *use of extensive judgment* on the part of Boards and management, in terms of where to begin, where to focus, and how to engage business leaders.
- An effective RAF acts as a *brake against excessive risk taking*
- A RAF does not supplant traditional risk management tools, but provides a context for the implementation of risk policies, limits and management information based on clear risk metrics
- Developing a RAF requires *significant time and intellectual resources.* It requires dialogue and communication among business leaders, not through 'top-down' decrees
- RAF implementation requires *broad and multi-dimensional view in making risk assessments*

- *Clarity regarding the ownership of risk is essential*. Business heads should have visible ownership of risk in their areas and incorporate risk explicitly in their business planning
- *Stress and scenario testing* are important components of a risk appetite framework. Consciously constraining aggregate risks in advance in such a way as to ensure a firm's survival under severe macroeconomic, market and liquidity stress scenarios is at the heart of settling risk appetite appropriately

Stages in Developing a Risk Appetite

According to the Institute of Risk Management (Anderson, 2011), there are at least seven (7) stages in developing a risk appetite (Figure 2.4):

(1) Sketch: This is the stage where the risk appetite evolves from organization's strategic business goals and objectives. This stage reflects the extent to which the organization is prepared to tolerate risks described by limits, indicators and process controls.

(2) Stakeholder Engagement: At this stage, those charged with the design of the risk appetite engage with a full range of stakeholders (e.g. the business units, shareholders, competitors, other market participants, customers, government, and the broader society)

(3) Develop: Here, the RAF is now well informed by background work, the preliminary sketch and the dialogue with relevant stakeholders

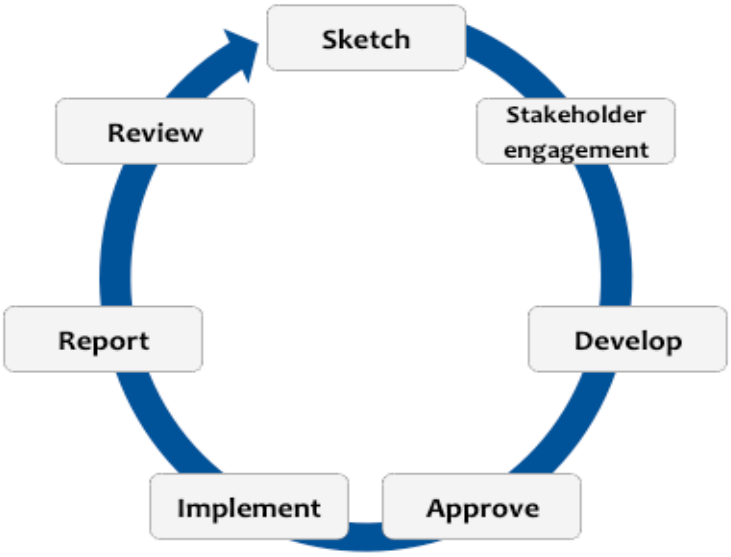
(4) Approve*:* After developing the risk appetite, approval is sought from the board and risk oversight committees as appropriate

(5) Implement: At the implementation stage, it is necessary to confirm that the metrics are right, while ensuring communication with those who need to work with the appetite is adequate and is embedded it into the fabric of the organization

(6) Report: After implementation, reporting of risk practices is done both internally and externally

(7) Review: Here, questions such as what worked well? what failed? what needs to be done differently next time? will be asked and the answers to these questions will feedback into the next planning period.

Figure 2.4: Stages in Developing a Risk Appetite



Source: Institute of Risk Management (Anderson, 2011)

According to the Institute of Risk Management (Anderson, 2011), there are five tests that Directors should apply in reviewing their organization's risk appetite statement:

- Do the managers making decisions understand the degree to which they (individually) are permitted to expose the organization to the consequences of an event or situation? Any risk appetite statement needs to be practical, guiding managers to make risk-intelligent decisions.
- Do the executives understand their aggregated and interlinked level of risk so they can determine whether it is acceptable or not?
- Do the board and executive leadership understand the aggregated and interlinked level of risk for the organization as a whole?
- Are both managers and executives clear that risk appetite is not constant? It changes as the environment and business conditions change. Anything approved by the board must have some flexibility built in.
- Are risk decisions made with full consideration of reward? The risk appetite framework needs to help managers and executives take an appropriate level of risk for the business, given the potential for reward.

Examples of Risk Appetite Statements

(1) Royal Bank of Canada (RBC):

A key element of RBC's RAF is self-imposed constraints and drivers, which influence the amount of risk undertaken and from which quantitative and qualitative limits are set. These are categorized into 7:

- Maintain a 'AA' rating or better
- Ensure capital adequacy by maintaining capital ratios in excess of rating agency and regulatory thresholds
- Maintain low exposure to 'stress events'
- Maintain stability of earnings
- Ensure sound management of liquidity and funding risk
- Maintain a generally acceptable regulatory risk and compliance control environment
- Maintain a risk profile that is no riskier than that of our average peer

(2) First Bank of Nigeria (FBN) Holding Company Plc:

According to FBN (2010), the Board of Directors sets the Bank's risk appetite annually, at a level that minimizes erosion of earnings or capital due to avoidable losses in the banking and trading books, or from frauds or operational inefficiencies. The Bank's appetite for risk is governed by the following:

- High-quality risk assets measured by three *Key Performance Indicators (KPIs)*:
  i. Ratio of non-performing loans to total loans;
  ii. Ratio of loan loss expenses to interest revenue; and
  iii. Ratio of loan loss provision to gross non-performing loans
- The broad objective is to be among the top three banks with respect to (i) and (ii) above and for (iii) to maintain a ratio that ensures that there are adequate provisions for all non-performing assets based on their levels of classification.
- Diversification targets are set for the credit portfolio, and limits are also set for aggregate large exposures.

- Losses due to frauds and operational lapses are pegged at a maximum of a specified percentage of gross earnings and in any case must be lower than the industry average.
- Financial and Prudential ratios targets are pegged at a level more conservative than regulatory requirements and better than the average of benchmark banks. These include liquidity ratios, deposit concentration limits and open position limits.
- The Bank aims at minimizing the following independent indicators of excessive appetite for risk:
    - Exception reporting by internal control officers, auditors, regulators and external rating agencies.
    - Adverse publicity in local and international press;
    - Frequent litigations;
    - Payment of fines and other regulatory penalties; and
    - Above average level of staff and customer attrition.
- The Bank will not compromise its reputation through unethical, illegal and unprofessional conduct. The Bank also maintains zero appetite for association with disreputable individuals and entities.

Quantitative and Qualitative Risk Limits

Effective risk appetite statement is a mix of quantitative limits/metrics and qualitative guidelines:

(1) Quantitative Limits: Here, the limits and metrics consistently monitored include:

- Revenue growth
- ROE
- Earnings per share (EPS)
- Stress tests
- RWA limits
- Capital market measures (e.g. VaR, trading limits)
- Liquidity ratios
- Single obligor concentration limits
- Industry concentrations
- Limits to certain country exposures

(2) Qualitative Guidelines: Qualitative statements are also aimed at setting risk limits and often relate to:

- The promotion of a robust risk culture
- Accountability for risk by the business lines
- Independent central risk oversight
- Avoidance of excessive concentrations, and
- Ensuring that risks are clearly understood, measurable and manageable
- Placing emphasis on the diversity, quality and stability of earnings
- Focusing on core businesses by leveraging competitive advantages
- Making disciplined and selective strategic investments
- Focus on long term shareholder value, including:
    - Sustainable earnings growth
    - Maintenance of adequate capital in relation to the bank's risk profile,

- Availability of financial resources to meet financial obligations on a timey basis at reasonable prices

Economic Capital and Stress Testing Considerations

Principle 26 of Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that '*supervisors should require, where appropriate, that the financial conglomerate periodically carries out group-wide stress tests and scenario analyses for its major sources of risk*'. In setting qualitative and quantitative limits, the financial group should ensure its economic capital is robust enough to cover the risks or possible losses of the firm under a severe stress scenario. Economic capital is the amount of risk capital, which a firm requires to cover the aggregate risks that it is running or collecting as a going concern. It is the amount of risk capital that is needed to secure survival in a worst-case scenario, and it is calculated as the amount of risk capital that the firm needs to ensure that its realistic balance sheet stays solvent over a certain period of time with a pre-specified probability. It is recommended that the regulators should encourage the financial groups to hold risk capital of an amount equal to at least the economic capital. The following factors are important in modeling an appropriate economic capital:

- Changes in key macroeconomic factors over time (e.g. unemployment, GDP, gross domestic investment, personal income, real estate prices, inflation, etc)
- Growth in earnings of the financial group and the banking/financial industry as a whole
- Impact of regional crisis or foreign exchange exposures (e.g. the euro debt crisis, etc)
- Performance of loans by risk grade and loan-to-value ratio (LTV)
- Model also incorporates interest rate risk, trading and operational risk assessments

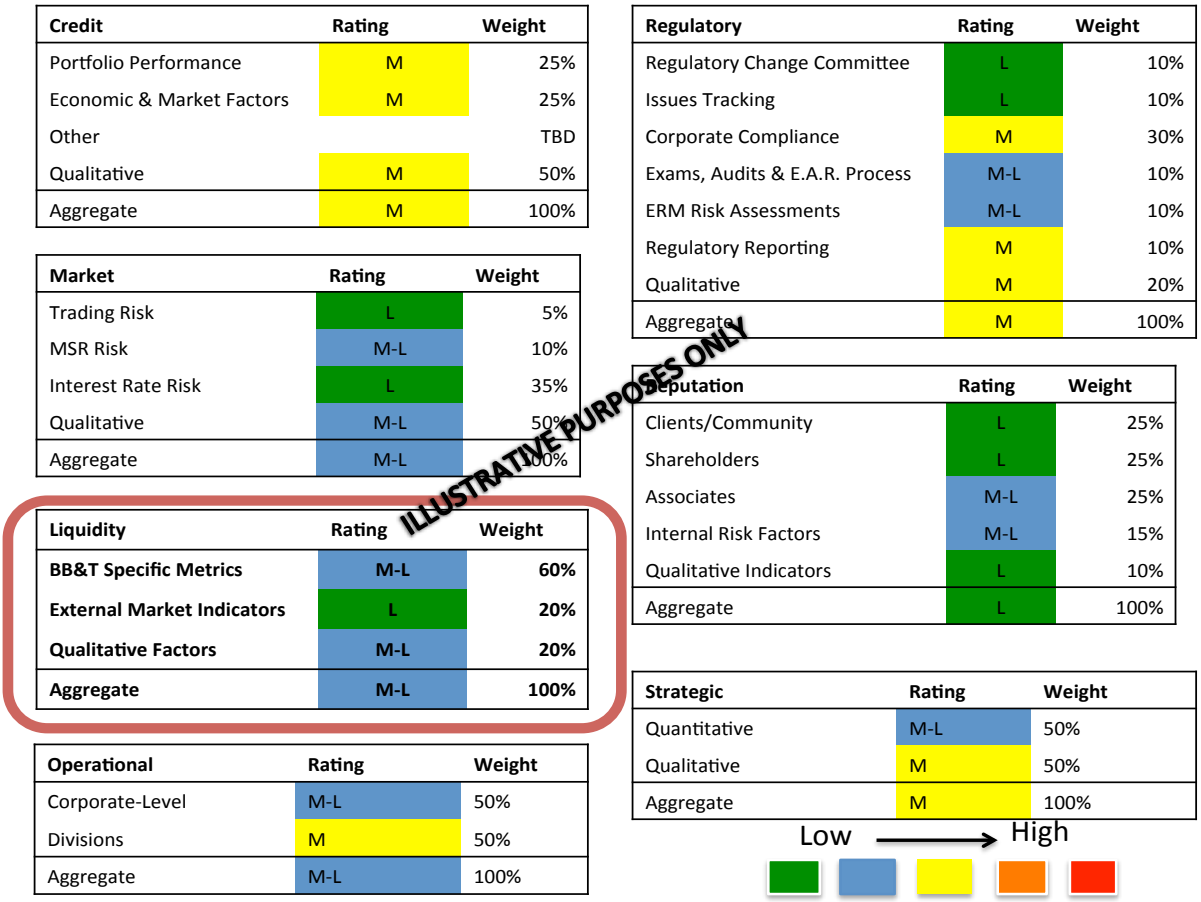
It is important that when conducting its stress tests, a financial conglomerate should have a good understanding of correlation between its respective sectors and the heterogeneity of risks that it is exposed to. According to the BIS (2012b), stress tests should be robust and should consider sufficiently adverse circumstances. The enterprise-wide stress test analysis should measure and evaluate the potential impact on individual entities. Attention should be paid to covering all risks, including off-balance sheet items. For example, a financial conglomerate's stress tests and scenario analyses should consider the risk that the financial conglomerate may have to bring back on to its consolidated balance sheet the assets and liabilities of off-balance sheet entities as a result of reputational contagion, notwithstanding the appearance of legal risk transfer. Where stress tests reveal a risk of business failure that is unacceptably high relative to the financial conglomerate's risk appetite or risk tolerance, the financial conglomerate should evaluate and adopt, where appropriate, effective arrangements, processes, systems or other measures to prevent or mitigate that risk.

Risk Appetite Aggregation

Principle 27 of Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should require that the financial conglomerate aggregate the risks to which it is exposed in a prudent manner'. Risk aggregation should include a clear understanding of assumptions and be robust enough to support a comprehensive assessment of risk. While it is possible that the diversification of activities within a financial conglomerate may reduce risk correlation, it is also realistic to think that membership of a financial conglomerate group may create "group risks" in the form of financial contagion, reputational contagion, ratings contagion

(where a subsidiary accesses capital through a parent's credit rating and then suffers stress following the utilization of the capital), double/multiple-gearing (use of same capital more than once within a group), excessive leveraging (upgrade in the quality of capital as it moves through a group), and regulatory arbitrage (it is important that risks are assessed at the financial conglomerate level as well as at the level of its constituent parts).

Figure 2.5. Risk Appetite Aggregation



Source: BB & T Corporation (2013)

Risk appetite is assessed by reviewing both quantitative and qualitative key performance indicators (KPIs) for each type of risk across all businesses. Assessments are then aggregated by sub-risk type and finally into the overall risk assessment (see Figure 2.5).

Challenges in Implementing Risk Appetite

In a report on the survey of firms by the Institute of International Finance (IIF, 2011), the following challenges were identified as key to the implementation of an effective risk appetite framework:

- Effectively cascading the risk appetite framework throughout the firm and embedding and integrating it into the operational decision-making process
- How to best express risk appetite for different risk types, some of which can be quantified in generally accepted ways, and some of which cannot be easily quantified
- Using the risk appetite framework as a driver of strategy and business decisions
- Achieving sufficient clarity around the concept of risk appetite and some of the terminology used (e.g. difference between risk appetite and risk limits)

- How to effectively relate risk appetite to risk culture
- How to make best use of stress-testing in the risk appetite process
- How to most effectively aggregate risks from different business units and/or different risk types, for risk appetite purposes

Addressing the Challenges In Implementing Risk Appetite

(1) Effective Communication of Risk Culture

Principle 22 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should require that the financial conglomerate have in place processes and procedures to engender an appropriate group-wide risk management culture'. The risk management culture should be led and driven by the board and senior management of the financial conglomerate. It is also important that senior management demonstrate an appropriate risk management culture that considers the entirety of the financial conglomerate's business (including regulated and unregulated, on and off-balance sheet). The governance structure as well as the risk management culture should support the requirement that the risk management function be independent, free from undue or inappropriate influence from the business line. The second line of defense (i.e. the risk function) should have sufficient stature within the organization to effectively challenge the business line, and to maintain its independent review of the financial conglomerate's broader risk management controls, processes and systems.

In ensuring effective communication of the risk management culture, financial conglomerates are encouraged to consider the following:

- Risk management considerations should be part of decision-making at all levels of a financial conglomerate, including at product design stage.
- Effective communication that makes risk appetite directly relevant to employees in the business units should be emphasized. The CEO needs to be personally involved in promulgating the message about risk appetite framework and what it means
- The use of internal values statements can be of some use in reinforcing risk culture in organizations
- There needs to be a demonstrable commitment to training and day to day experience in communicating risk appetite throughout the organization
- There also needs to be clarity in communications about where risk appetite fits alongside risk capacity or tolerance, that is, how much risk is technically possible to take, and the current level of risk being taken
- There also needs to be clarity regarding ownership of risk. Business unit heads are generally responsible for achieving consistency with the enterprise-wide risk stance
- Business leaders should adopt a strategy of continuous and open dialogue about risks in order to effectively embed risk appetite in the business lines
- Senior managers should espouse prudent risk taking and respect the independent role of the risk management function.

(2) Use of Internal Risk Values: Examples from BB&T Corporation, USA

- We believe managing risk is the responsibility of every associate
- Our lines of business are responsible for proactively identifying and managing the inherent risks of their businesses

- We manage risk using a balanced approach which includes *quality*, *profitability*, and *growth*
- We ensure appropriate return for risk taken
- We utilize accurate and consistent risk management practices
- We thoroughly analyze risk quantitatively and qualitatively with judgments clearly identified
- We believe high quality risk management results in a lower cost of capital
- We manage risk using a long-term perspective while monitoring short term results
- Liquidity is based upon the confidence of depositors, internal, and wholesale funding sources
- We utilize the diversification of both sources and maturities to avoid concentrations of funding
- We believe stored liquidity in unencumbered high-quality assets is necessary for contingency liquidity management
- We manage our investment portfolio as a source of high-quality collateral while earning an appropriate risk-adjusted return
- We do not engage in proprietary trading
- We avoid outsized risk concentrations and we don't "dabble"
- We believe highly effective risk management results in good regulatory relations
- We self-identify, self-disclose, and self-correct issues on a timely basis
- We align the interests of our associates to shareholders using balanced risk-taking incentive compensation arrangements

(3) Quantifying Material Risks:

- The RAF should capture and include all material risks, including those that are not easily quantified, such as operational and reputational risks
- In seeking to quantify risks, financial groups should endeavor to estimate the potential impact of risks on future earnings capacity for each risk with the goal of arriving at an overall indication of how large or small that risk is in comparison with other risks. For example, the effect of regulatory changes or sanctions on the revenue from individual business lines
- Another practice is to carry out regular assessment of the perceptions of various stakeholders (clients, shareholders, employees, and regulators) to give an indication of the reputational risk of the organization
- In aggregating risks across the firm, the *risk posture* of each business unit should be continuously reviewed so as to give an indication of how the organization is approaching risk overall - e.g. whether the individual business units are willing to take more, less or approximately the same amount of risk over the next planning period

Enterprise Risk Management Framework: Key Supervisory Actions

The following summarizes key prudential steps supervisors should follow in order to effectively conduct qualitative supervision of a financial conglomerate's ERM framework. Most of these action steps are contained BIS (2012b).

Risk Management Function

- Supervisors should require that financial conglomerates have in place adequate, sound and effective risk management processes and internal control mechanisms at the level of the financial conglomerate, including sound administrative and accounting procedures.

- Supervisors should require that risk management processes and internal control mechanisms of a financial conglomerate are appropriately documented and, at a minimum, consider the following:
    - Nature, scale and complexity of its business;
    - Diversity of its operations, including geographical reach;
    - Volume, frequency and size of its transactions;
    - Degree of risk associated with each area of its operation;
    - Interconnectedness of the entities within the financial conglomerate (using intra-group transactions and exposures reporting as one measure); and
    - Sophistication and functionality of information and reporting systems.
- Supervisors should require that the risk management function is independent from the business units and has a sufficient level of authority and adequately skilled resources to carry out its functions.

Risk Management Governance

- Supervisors should require that the risk management function generally has a direct reporting line to the board and senior management of the financial conglomerate.
- Supervisors should, where they consider it appropriate, require that a separate risk management committee at the board of directors' level is established by the financial conglomerate.
- Supervisors should require that the board of the holding company has overall responsibility for the financial conglomerate's group-wide risk management, internal control mechanism, internal audit and compliance functions to ensure that the group conducts its affairs with a high degree of integrity.
- Supervisors should require that the financial conglomerate has an established enterprise-wide risk management process for, among others, periodically reviewing the effectiveness of the group-wide risk management framework and for ensuring appropriate aggregation of risks.
- Supervisors should require that the risk management process cover identification, measurement, monitoring and controlling of risk types (e.g. credit risk, operational risk, strategic risk, liquidity risk) and these be linked where appropriate to specific capital requirements.

Examination of Internal Audit

In carrying out an examination of internal audit or independent control assessment, supervisors should consider the following aspects:

- Internal Audit Infrastructure Review:
    - Adequacy and independence of audit committee
    - The independence, professional competence and quality of the internal audit function
    - The quality and scope of the audit methodology
    - Audit plan and risk assessment process
    - Adequacy of audit programs
- Compliance Testing:
    - Testing activities for specific control functions or business lines
    - Assessment of internal audit's recent work
- Credit review

Risk Management Culture:

- Supervisors should require that financial conglomerates have in place processes and procedures for promoting an appropriate risk management culture including providing staff with risk management training, independence and appropriate incentives.
- Supervisors should require that a financial conglomerate's approach to engendering an appropriate risk management culture cover awareness of risks posed by unregulated entities and unregulated financial products.
- Supervisors should require financial conglomerates to provide appropriate risk management training to staff, and in particular to board members, senior management, and key persons in control functions.
- Supervisors should require financial conglomerates have in place whistle-blowing procedures that encourage staff members to come forward when they are aware of non-observance with established risk management and compliance procedures.

Risk Tolerance Levels and Risk Appetite Policy:

- Supervisors should require that key staff, senior management and the board of the head of the financial conglomerate be aware of and understand the financial conglomerate's risk tolerance levels and risk appetite policy.
- Supervisors should require that the financial conglomerate identify and measure against risk tolerance limits (and in line with its risk appetite policy) the risk exposure of the financial conglomerate on an on-going basis in order to identify potential risks as early as possible. This may include looking at risks by territory, by line of business, or by financial sector.

Risk Assessment for New Business:

- Supervisors should, where they consider it appropriate, review the risk assessment carried out by a financial conglomerate in the context of entering into new business.
- Supervisors should require that financial conglomerates not expand into new products unless they have put in place adequate processes, controls and systems (such as IT) to manage them.
- Supervisors should make sure that a financial conglomerate carries out the ongoing risk assessment after entering into new business areas.

Stress and Scenario Testing:

- Supervisors should require that stress tests are sufficiently severe, forward looking and flexible. They should cover an appropriate set of business activities and include a variety of different types of tests such as sensitivity analyses, scenario analyses and reverse stress testing.
- Supervisors should require the financial conglomerate to document its stress and scenario tests, including reverse stress tests. Stress tests should be conducted under a robust governance framework that encompasses policies, procedures, and adequate documentation of procedures as well as validation of results.
- Supervisors should require that the group-wide stress tests and scenario analyses conducted by the financial conglomerate are appropriate to the nature, scale and complexity of those major sources of risk and to the nature, scale and complexity of the financial conglomerate's business.
- Supervisors should require that group-wide stress tests and scenario analyses include a group-wide approach (which takes account of the interaction between different parts of the group and different risk types) and consider the results of sectoral stress tests.

- Supervisors should require that, when carrying out reverse stress tests, a financial conglomerate identifies a range of adverse circumstances that would cause its business to fail and assess the likelihood of such events crystallizing.

Risk Aggregation:

- Supervisors should require that financial conglomerates not make overly ambitious diversification assumptions or imprudent correlation claims, particularly for capital adequacy and solvency purposes.
- Supervisors should require financial conglomerates to have adequate resources and systems (including IT) for the purpose of aggregating risks.

CHAPTER 3: QUANTITATIVE CONSOLIDATED SUPERVISION

3.1. CONSOLIDATED FINANCIAL REPORTING AND ANALYSIS

A key aspect of quantitative consolidated supervision is the production of financial reports on a consolidated basis, and it is essential that supervisory authorities have legal powers to require banks and financial conglomerates to submit them. These reports combine assets, liabilities and off-balance sheet positions of the banks and their related companies, treating them in effect as if they were a single business entity. When supervisors have such reports, they can measure most of the financial risks which banking and financial groups incur and apply prudential standards, such as minimum capital ratios, at the level of a whole banking group or financial conglomerate. However, when introducing such reports, supervisory authorities need to give guidance to banks on (a) the scope of consolidation (this involves specifying the types of entity which should be included in consolidated prudential reports), and (b) methods of consolidation (this concerns the accounting techniques which banks should use when compiling consolidated reports)

3.1.1. SCOPE OF CONSOLIDATION

Since bank supervisors lack techniques for measuring the risks inherent in non-financial activities, consolidated prudential reports normally include only those related entities which carry on activities of a banking or financial nature. In this case, 'related entities' include all such subsidiaries and participations of a bank, together with 'parallel' or 'sister' banks and financial institutions which are controlled by the same shareholders as the bank itself. Risks inherent in non-financial group companies (such as commercial and industrial activities in a mixed activity group) are assessed qualitatively. A useful guidance on the classification of permissible financial-related activities is specified in box 3.1. The list of activities prescribed there are fairly comprehensive and prescribes those entities whose assets and liabilities have to be included in consolidated reports submitted to supervisors in a number of jurisdictions (e.g. EU, UK, and USA).

However, in many jurisdictions, insurance companies are not subject to financial consolidation into banking groups, even though insurance is clearly a financial activity. This is because the risks of insurance companies are different from those of banks. For example, in a general insurance company, the fundamental risk is uncertainty as to the amount of the company's liabilities. In a life insurance company, the main risk is that the value of assets will fall without any corresponding reduction in the actuarial value of liabilities. These risks are different from those faced by banks – mainly credit, liquidity, market and operational risk. Hence, a balance sheet, which combined the assets and liabilities of banks, would not provide a suitable basis for measuring banking risks and applying banking ratios. It is therefore advisable to omit insurance companies from consolidated reports. Nevertheless, it is still possible to measure on a consolidated basis the capital adequacy of a financial conglomerate, which includes an insurance company (this is discussed in section 3.2).

BOX 3.1. SUNDRY LIST OF PERMISSIBLE ACTIVITIES UNDER FINANCIAL CONGLOMERATE STRUCTURE

Financial Conglomerates may engage in activities that are 'financial in nature' or incidental to a financial activity. According to the Bank of England (cited in McDonald, 1998), companies undertaking one or more of these activities are classified as 'financial':

- Ancillary Banking Services: (defined as 'undertaking the principal activity of which consists in owning and managing property, managing data processing services, or any other similar activity which is ancillary to the principal activity of one or more credit institutions')
- Lending (including consumer credit, mortgage credit, microfinance, factoring, and financing of commercial transactions)
- Financial Leasing
- Money Transmission Services (Western Union, Money Gram, etc)
- Issuing and Administering means of payment (e.g. credit cards, travellers' cheques and banker's drafts)
- Guarantees and commitments
- Trading for own account or account of customers in:
    - Money market instruments (cheques, bills, CDs, etc)
    - Foreign exchange (including Bureau De Change)
    - Financial futures and options
    - Exchange and interest rate instruments
    - Transferable securities
- Participation in securities and the provision of services relating to such issues
- Advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating mergers and the purchase of undertakings
- Money broking
- Portfolio management and advice
- Safekeeping and administration of securities (e.g. pension fund administration and custody)

It is also advisable to exclude holding companies at the top of a banking group from consolidation, if they are non-operating (that is, if they do not themselves carry on any financial activity). Nonetheless, they exercise control over the group's activities and are likely to play a central role in raising any new capital from external sources, which is needed to support the group's activities (typically a holding company will issue new shares on the capital market and 'downstream' the funds to other subsidiaries in the group). In this case therefore, it seems appropriate to include non-operating holding companies in consolidated reports, particularly in cases where the majority of subsidiaries are engaged in banking and other financial activities. However, in cases where the holding company controls a mixture of financial and non-financial companies, the argument for consolidating the holding company seems less compelling.

A suitable benchmark for deciding such cases would be to determine the 'balance of business' within the group: this could be done, for example, by calculating the total assets of the banking and financial entities within the group. If the resulting figure exceeded 50% of the group total, the

holding company might be consolidated with the assets and liabilities of the financial members of the group. A result lower than 50% would indicate a mixed activity group rather than a banking or financial group. In this case, it might not be appropriate to consolidate the holding company. It would, however, still be necessary to consider whether the group's banking and financial companies constituted a distinct banking/financial sub-group and whether consolidated reports should be compiled in respect of that sub-group alone.

In cases where the bank is controlled by a bank or financial conglomerate authorized in a foreign country, it is not normally necessary or appropriate to extend consolidation 'upwards' to include the foreign parent bank. In such situations, however, it is important to establish that the worldwide financial conglomerate in question is subject to *comprehensive consolidated supervision* (CCS) by the authorities in the country where it is authorized and has its head office.

In certain circumstances it may be advisable to allow banks to omit financial subsidiaries from their consolidated reports. Apart from the special case of insurance companies, which has been discussed above, there may be other similar cases where inclusion could cause consolidated reports to be misleading or inappropriate. For example, financial entities should be excluded if they are established in countries with exchange controls or other regulations, which would prevent the repatriation of capital realized from their sale or liquidation. Also, in the interests of administrative efficiency, it may be worthwhile to allow banks to exclude very small subsidiaries: in some countries, banks establish subsidiaries which have only the minimum amount of share capital required by company law and keep these companies on the 'shelf' until they need one for a special purpose. Such subsidiaries can be excluded by means of a *de minimis* exemption (i.e. of exemption of investments of minimum importance or material value): for example, if the aggregate amount invested in these subsidiaries is less than 1% of the parent bank's own capital and reserves. The assets and liabilities of related non-financial entities (i.e. commercial and industrial activities) are not, of course, consolidated and the group's investments in such entities appear as a single asset item in the consolidated prudential report.

3.1.2. METHODS OF ACCOUNTING CONSOLIDATIONS

Many countries have accounting regulations that require companies with subsidiaries to publish consolidated financial statements. A number of countries have now adopted the International Financial Reporting Standards (IFRS) for the preparation of financial returns. Specifically, IFRS 10 *Consolidated Financial Statements* outlines the requirements for the preparation and presentation of consolidated financial statements, requiring entities to consolidate entities it controls, while IFRS 12 covers disclosure of interests in other entities. The methods of consolidation to be adopted by banking groups or FHCs depend on the different types of ownership that arise in a group. The Centre for Central Banking Studies, Bank of England (in MacDonald, 1998) and the Reserve Bank of Zimbabwe (2007) identify four (4) methods of consolidation, which are now reviewed below:

Full Consolidation Method (or Line by Line Method)

This method of accounting consolidation is applied in the case of a **subsidiary.** That is, where the licensee is the majority owner or controls 50% of shares or greater in another financial institution, the licensee is required to fully consolidate this entity in its consolidated returns by revealing the full amount of profits earned by the parent and its subsidiaries together. This makes possible a

more accurate evaluation of the group's business performance and condition. Consolidated financial reports can be compiled using IFRS 10 and 12, with amendments where appropriate (for example, the exclusion of non-financial companies and insurance companies in the group from consolidation).

In a consolidated balance sheet, the full balance sheet values of the assets and liabilities of the parent company and its subsidiaries are combined in a *line-by-line* basis. All intra-group assets and liabilities are eliminated. The share capital of the consolidated subsidiaries is also excluded in order to avoid double counting of capital. In the case of subsidiaries that are less than 100% owned by the parent company, the consolidated balance sheet also contains a liability item **'minority interests'.** This represents the percentage portion of the net assets of the subsidiaries, which belongs to the other 'minority shareholders' in these companies.

The approach mostly followed in compiling consolidated financial statements is **'acquisition accounting'**. If a company acquires an existing company as a subsidiary by way of purchase, the parent company initially records the investment in its own accounts at purchase cost. During the subsequent consolidation process, the assets and liabilities of the subsidiary are written up or down to their current market value, and any difference between the purchase cost and the revalued net assets of the subsidiary give rise to an item of positive or negative goodwill in the consolidated balance sheet. The pre-acquisition reserves of the subsidiary are not included in the consolidated balance sheet.

Acquisition accounting also applies when a company establishes a new subsidiary – as in example in Tables 3.1 and 3.2 – but no goodwill arises in such cases and there are obviously no pre-acquisition reserves that have to be excluded. The alternative accounting method is **'merger accounting'** or **'pooling of interests'**, which is allowed in some countries in cases where two companies merge as the result of their shareholders exchanging their existing shares for shares in a new combined enterprise. Under merger accounting, there is n revaluation of assets and liabilities, and the pre-merger reserves of both companies are included in the consolidated balance sheet.

Equity Method (or Net Capital Value Method)
This method is used in the case of an **associate** or where the investor group establishes participations in the investee company. Participations can be defined as investments in the share capital of other companies, which permit the investor to exercise significant influence – but not control – over the investee's operations (MacDonald, 1998). This relationship should be accurately reflected in consolidated financial statements.

In many jurisdictions (e.g. Singapore, Barbados, Zimbabwe, South Africa, etc), where a licensee does not have majority share ownership or control but has significant influence (at least 20% but less than 50% of ownership) it will use **'equity accounting'** to account for its participations. The Equity Method means a method of accounting by which an equity investment is initially recorded at its cost value (the cost of acquisition) and subsequently adjusted to reflect the investor's share of the net profit or loss of the investee (enterprise in which the investment was made). The investor's share in the results of economic activity of the said enterprise shall be reported in the income statement.

From a supervisory perspective, it is important to note that a banking group may not be able to liquidate a participation quickly. For example, a bank may wish to dispose of a participation in order to liberate capital, which it needed in its own balance sheet. However, the sale of a participation could be difficult to achieve without the support of the other shareholders. Moreover, it would not be possible for the bank, acting in isolation as a minority shareholder, to realize its participation by putting the investee company into voluntary (solvent) liquidation.

It is possible to practice *full consolidation of participations* in banks and financial companies, treating them as if they were subsidiaries. Full consolidation allows the supervisors to see the total amount of assets and liabilities over which a banking group exercises control or influence. This approach does, however, have two major disadvantages. Firstly, a consolidated balance sheet constructed in this way will contain certain assets and liabilities which the parent company does *not control*, and it is normal accounting practice to consolidate fully only in cases where a parent company has control. Secondly, the exercise of a 'majority' of other shareholders will distort the amount of minority interests included in the consolidated balance sheet. Since minority interests are treated as capital in the calculation of consolidated capital rations, full consolidation of participations will overstate the amount of capital which a banking group has *under its control and* could allow the group to accumulate excessive assets. It would, of course be possible to deduct the (so-called) minority interests arising on the consolidation of participations from the figure for capital used in calculation of the consolidated capital ratio. However, this would be a rather artificial solution to the problems arising from full consolidation. On the balance, therefore, the full consolidation of participations is likely to be inappropriate, except in cases where the benefit of bringing the total risks of a participation into the capital adequacy calculation is thought to overweigh the disadvantage of inflating consolidated capital.

Table 3.1: Individual Balance Sheet of Subsidiaries of Prudent Banking Group
Prudent Bank has established 2 subsidiaries. It owns 100% of the share capital of Prudent Loans Company (a non-bank financial company whose principal activity is consumer credit) and 75% of Reliance Bank (another bank). The individual balance sheets of the 3 entities in the group are as follows:

	PRUDENT BANK	PRUDENT LOANS CO.	RELIANCE BANK
ASSETS			
Cash	50	45	40
Balances at central bank	200	-	100
Balances at commercial banks	400	225	300
Government bonds	650	440	610
Loans to customers	1,500	1,350	900
Amounts due from related companies	100	300	-
Shares in subsidiaries	80	-	-
Premises	20	-	50
	3,000	**2,360**	**2,000**
LIABILITIES			
Customer's deposits	2,400	-	1,300

Borrowing from banks	50	2,200	600
Amounts due to related companies	300	100	-
Share Capital	200	35	60
Reserves	50	25	40
	3000	**2,360**	**2,000**

Source: Adapted from MacDonald (1998)

Table 3.2: Consolidated Balance Sheet of Prudent Banking Group

This illustrates the process of compiling a consolidated balance sheet for the Prudent Banking Group. Intra-group assets and liabilities have been eliminated. A new line-minority interests – is required to reflect the 25% of the net assets of Reliance Bank which are not owned by Prudent Bank

	PRUDENT BANK	PRUDENT LOANS CO.	RELIANCE BANK	CONSOLIDATED BALANCE SHEET
ASSETS				
Cash	50	45	40	135
Balances at central bank	200	-	100	300
Balances at commercial banks	400	225	300	925
Government bonds	650	440	610	1,700
Loans to customers	1,500	1,350	900	3,750
Premises	20	-	50	70
	2,820	**2,060**	**2,000**	**6,880**
[Amounts due from related companies]	[100]	[300]		
[Shares in subsidiaries]	[80]			
	3,000	**2,360**	**2,000**	
LIABILITIES				
Customer's deposits	2,400	-	1,300	3,700
Borrowing from banks	50	2,200	600	2,850
Minority interests			[25]	25
Share Capital	200			200
Reserves	50	25	30*	105
	2700	**2,225**	**1,995**	**6,880**
[Amounts due to related companies]	[300]	[100]	-	
[Shares capital of subsidiaries]	3,000	[35]	[45]*	
	3,000	**2,360**	**2,000**	

Source: Adapted from MacDonald (1998)

*These figures represent Prudent Bank's 75% share of the capital and reserves of Reliance Bank

The Fair Value Method

This method is applied in accordance with IFRS 9 for recognition and measurement of financial instruments (including shareholdings below 20% through the fair value accounting option). In the

balance sheet, the aggregate amounts of the financial holding company's investments must be shown under separate headings as either (i) listed investments; and/or (2) unlisted investments. Shareholding below 20% is also considered minority investment and is deducted from capital.

Pro-rata / Proportionate Consolidation Method
This method is applied in respect of a member of the banking group that is jointly controlled by the supervised bank and one or more banks or non-bank financial institutions as partners provided that there are no constraints on any one part to inject additional capital. Pro-rata consolidation method means a reporting method under which a partner's percentage share in each of the assets, liabilities, incomes and expenses of a jointly controlled economic unit is individually combined with the corresponding items or reported as individual items in the partner's financial reports. Here the financial report is prepared in accordance with the IFRS 11 standard on joint arrangements. The standard outlines the accounting by entities that jointly control an arrangement. Joint control involves the contractual agreed sharing of control and arrangements subject to joint control are classified as either a *joint venture* (representing a share of net assets and equity accounted) or a *joint operation* (representing rights to assets and obligations for liabilities, accounted for accordingly).

3.1.3 CONSOLIDATED FINANCIAL ANALYSIS

According to the Federal Reserve System (2013a), the analysis of financial condition of a banking group or a financial conglomerate is usually conducted in four primary parts, namely: (1) parent only, (2) subsidiary bank(s), (3) nonbank subsidiary (ies), and (4) consolidated organization. These are examined in great detail below.

In view of the fact that all holding companies are not structured in the same organizational and financial manner, it is important that examiners be flexible in their approach and be judicious in their use of ratio analysis and peer group comparisons. The analysis is intended to determine the financial strengths and weaknesses of an organization and the impact of conditions at the parent company and nonbank subsidiary that could adversely affect the condition of the banking subsidiary. The goal of the central bank as a regulatory agency is to safeguard and protect the soundness of commercial banks. The central bank oversees holding company banking and nonbanking activities to assure the continued safety and soundness of individual banks and the industry as a whole.

The analysis of financial factors resulting from the inspection of a financial conglomerate is essentially a finding of facts and an expression of judgment. In conducting an appraisal of a holding company's condition, the financial analysis of the organization, based on a "building block" or "component" approach (see section 3.2), should provide the examiner with a solid foundation from which to proceed. In order to complete the analysis, it is first necessary to accumulate sufficient information concerning the parent company, bank and nonbanking subsidiary (ies) and the consolidated organization. A final analysis should not be attempted until these integral parts have been thoroughly reviewed.

The completion of the financial analysis will culminate with the preparation of a rating for the bank holding company. Chapter 4 of this handbook comprehensively deals with the rating system used in evaluating FHCs.

3.1.3.1. PART I: PARENT ONLY ANALYSIS

Analysis of the parent company financial condition will be examined under three main aspects: (1) Debt Servicing Capacity (i.e. Cash Flow), (2) Leverage, and (3) Liquidity

[1] Parent Company Debt Servicing Capacity (Cash Flow)

The cash flow analysis involves the following key parts:

(1) Analysis of a standardized *Cash Flow Statement* for Parent Companies, which includes computation of the cash earnings coverage ratios and analyses;
(2) Analysis of *Earnings Cash Flow Coverage Ratios*, which is used to measure the parent company's ability: (a) to pay its fixed charges, including interest costs, lease expense, income taxes, retirement of long-term debt (including sinking fund provisions), and preferred stock cash dividends, and (b) to pay common stock cash dividends.
(3) Guidelines for supervisory determination of parent company debt servicing capacity.

The cash flow statement page of the examination report presents the cash earnings and the cash expenditures of the parent company. Within the statement are the key components to be used in the "Fixed Charge Coverage Ratio," which measures the parent company's ability to meet its fixed obligations, and a "Common Stock Cash Dividend Coverage Ratio" which measures the ability of the remaining, or residual, earnings to cover common stock dividends.

Cash Flow Statement

The cash flow statement is an effective tool used in understanding how a particular financial holding company operates. Its primary objective is to summarize the financing and investing activities of the holding company, including the extent to which the entity has generated funds (externally and internally) during the period. The cash flow statement is related to both the income statement and the balance sheet and provides information that otherwise can be obtained only partially by interpreting each of those statements.

An analysis of past cash flow statements can supply important information regarding the uses of funds, such as internal asset growth or acquisitions, as well as data on the sources of funds used and the financing needs of management. A projected cash flow statement will focus on the need for future funds, its applications, and the sources from which they are likely to be available. Specifically, the analysis of the cash flow statement is necessary for a thorough understanding of a holding company and the nature of its operations to the extent that it provides information on such areas as:

1. Utilization of funds provided by operations;
2. Use of funds from a new debt issue or sale of stock;
3. Source of funds used for acquisitions or additional capital contributions;
4. Means of payment of a dividend in the face of an operating loss;
5. Means of debt repayment and stock redemption.

Earnings Cash Flow Coverage Ratios

While the cash flow statement provides an overall perspective of a holding company's utilization of available funds, it does not, by itself, indicate possible or actual difficulties the parent company may have in meeting its fixed obligations from internally generated funds. Fixed obligations or fixed charges are those recurring expenses which must be paid as they fall due, which includes interest expense, lease expense, sinking fund requirements, scheduled debt repayments and preferred dividends. One ratio that may be used to calculate the strength of a parent company's earnings to meet its fixed charges or obligations is the Fixed Charge Coverage Ratio (FCCR). The components of the ratio are included on the "Cash Flow Statement (Parent)" page. The Fixed Charge Coverage Ratio (FCCR) measures the parent company's ability to pay for fixed contractual obligations if management is to retain control of the organization, thereby satisfying the expectation of creditors and preferred stockholders. Net income after taxes is used in the formula. Interest and lease expenses are already deducted to arrive at the net income figure and must be added back to obtain the earnings available to pay such charges. Interest expense is usually the largest component among all "fixed charges," and the ability to pay this expense from earnings cash flow is critical to an assurance of continued refunding of the parent company's debt. It measures not only the extent to which net cash operating earnings covers the debt servicing requirements of the parent company, but the capacity to pay income taxes and preferred stock cash dividends as well, thereby meeting the expectations that creditors and preferred shareholders have for the protection of their respective interests. The need for *better than a 1:1 coverage* is therefore critical.

Another important formula, required to be calculated is the Common Stock Cash Dividend Coverage Ratio (CSCDCR), which measures the ability of the parent company to pay common stock cash dividends. The CSCDCR will show, in turn, whether the residual cash earnings of the parent company are sufficient to pay the common stock cash dividend and, if not, the amount that must be provided from other sources of cash, such as the liquidation of assets or additional borrowings, to cover the shortfall. Typically, a holding company should not maintain its existing rate of cash dividends on common stock unless: (1) the holding company's net income available to common stockholders over the past year has been sufficient to fully fund the dividends; and (2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. A holding company whose cash dividends are inconsistent with the above criteria is to give serious consideration to cutting or eliminating its dividends. The need for *at least a 1:1 coverage* is therefore critical.

The two ratios are calculated as follows:

FCCR = (After tax cash income) /(interest expense + lease & rental expense + contractual long-term debt retired + preferred stock dividend payments)

CSCDCR = After tax cash income - [Contractual long-term debt retired + preferred stock dividend payments]/Common Stock Dividend Payments

Note that the Cash Flow Statement (Parent) page presents only cash items included in the parent's income and therefore the analyst can use its income figures without any need to adjust for noncash items.

Both the Fixed Charge Coverage and the Common Stock Cash Dividends Coverage ratios are considered inadequate at less than 1:1. If a holding company is generating funds, which provide at least dollar-for-dollar coverage, no criticism need be made. However, the examiner should be aware that these ratios, as well as others, are merely guidelines and good judgment must prevail. A ratio of 1.02:1 may pass the test, but it is only barely adequate. No criticism may necessarily be warranted for the period covered by the 1.02:1 ratio, but it may be indicative of a deteriorating trend over the past few years. Accordingly, an appropriate comment concerning the trend may be warranted.

When reviewing these ratios, it should be kept in mind that certain components in the numerator can to some degree be altered at the discretion of management. For example, by altering the dividends paid by bank subsidiaries, the amount of funds available to the parent to cover fixed charges can be increased or decreased. For this reason, the fixed charge and funds flow ratios should be analyzed in conjunction with a review of the dividend payout ratios of the subsidiary banks. Cash flow ratios that otherwise appear adequate may be a cause for concern if the banks are paying out dividends that are too high in relation to capital or overall condition. Analysts should evaluate the bank dividend payout ratios in light of the bank's capital and financial condition. Only in this way can the analyst gain a better understanding of the quality of the parent's cash flow and its potential effect on bank subsidiaries. Ratios of less than 1:1 coverage show that internally generated funds are not sufficient to meet a parent company's needs. In many cases, the examiner may find low coverage ratios, yet all fixed charges were paid as agreed. Had they not been, the company would have incurred severe financial difficulties long before the start of the inspection. Therefore, when less than adequate ratios appear and obligations are paid on time, the examiner must determine what other source of funds was utilized to make up the shortfall and to permit the timely payment of obligations.

Supervisory Determination as to Adequacy of Parent Company Cash Flow

A supervisory determination about the adequacy of parent company cash flow, and its use as a measure of parent company debt servicing capacity, requires more information than just the results of the Fixed Charge Coverage and Common Stock Cash Dividend Coverage Ratios. The typical major parent company does not generate an earnings cash flow by conducting banking operations itself, although it nevertheless may incur a heavy external debt on behalf of its operating subsidiaries that are the generators of the actual earnings cash flow. Therefore, the parent company earnings cash flow may not be indicative of the actual earnings power of the entire banking organization. For example, the cash earnings of the parent company may be kept low by management to avoid local income tax liability and/or to increase leveraged lending volumes at the subsidiary level. Conversely, cash earnings may be forced to the parent company through imprudent levels of upstream cash dividend payments, which eventually will endanger the operating subsidiaries and the parent itself.

A supervisory determination about the adequacy of parent company cash flow must take place at two levels: (1) by analyzing the results of the two coverage ratios using the net earnings cash flow realized by the parent company, and (2) by analyzing the effect that upstream cash flow to the parent company has had, and can be expected to have, on the financial condition of the bank subsidiaries and the significant nonbank subsidiaries. The latter focus should be on significant nonbank subsidiaries whose capital and dividend policies are subject to separate regulation—such

as securities—or subsidiaries with significant external funding, whose creditors presumably monitor capital and dividend policies of the subsidiary.

Specific Guidelines for Debt Servicing Capacity

The specific guidelines for debt servicing capacity are as follows:

1. The adequacy or inadequacy of parent company cash flow, and thereby the capacity to sustain the parent company's debt, is determined ultimately from the results of the Fixed Charge and Common Stock Cash Dividend Coverage Ratios, and the related analysis of the effects of upstream cash flow on the financial condition of the key subsidiaries.

2. For those parent companies with material amounts of long-term debt, coverage ratios in excess of 1:1 will not necessarily be considered sufficient to sustain the parent company's leverage unless: first, the Tier 1 capital positions of the bank subsidiaries are considered adequate; second, that the holding company's consolidated Tier 1 capital position is considered adequate; and third, the parent's liquidity is judged adequate. If that is not the case, then a critical comment on the "Examiner's Comments" page should be made regarding the potentially excessive leverage of the parent, as well as that of its subsidiaries. A specific period of time should be established for the management of the holding company to submit a capital improvement program acceptable to the System. Moreover, where the capital positions, bank and consolidated, are considered adequate but the dividend payout ratios are excessive, it is indicative of a potential future debt-servicing problem and should be brought to management's attention. Since the earnings level may not be sustainable, corrective action must be taken within a specified period of time.

3. For coverage ratios of less than 1:1, there is a presumption of a critical comment on the "Examiner's Comments" page of the examination report unless the shortfall is prudently planned[6] insignificant in amount and/or the trend of earnings cash flow and dividend policies clearly point toward a return to sufficient parent company earnings cash flow coverage.

a. In circumstances where the Tier 1 capital position of any bank subsidiary is considered inadequate, a written program of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

b. In circumstances where the Tier 1 consolidated capital position of the holding company is considered inadequate, a written program of corrective action should be required, including the steps necessary to reestablish positive earnings cash flow coverage at the parent company.

c. In circumstances where the Tier 1 capital position of each bank subsidiary and the consolidated Tier 1 capital position of the holding company is considered adequate, but there is a developed trend of inadequate earnings cash flow coverage at the parent company level or excessive dividend payouts from the subsidiaries, a written program of corrective action should be required to reestablish and maintain a positive earnings cash flow at the parent company.

Sources of Funds to Make up Shortfalls

Basically, there are three source categories, other than current earnings, that could be used to make up any deficit: (1) liquidation of assets, (2) proceeds from a stock offering, or (3) borrowed funds.

[6] A planned cash flow shortfall might typically occur when the parent elects to reduce (or not increase) dividends from subsidiaries because it anticipated an excess cash or liquid asset position from certain external sources (i.e., stock or debt issuance, dividend reinvestment plans, or tax refunds) sufficient to cover the deficiency.

These sources must be thoroughly analyzed to determine the extent they were and could still be utilized. It must be kept in mind that the use of these sources cannot permanently eliminate a shortfall in the flow of funds from current operations. These alternative sources only alleviate temporarily the effects of a shortfall. Nevertheless, a deficit could have been intentionally allowed to occur because the holding company knew of funds coming from these alternate sources. For example, the parent knew of an impending stock sale and cut dividends from subsidiaries significantly. In future years, dividends from subsidiaries could be restored to normal proportions, bringing the ratios up to adequate levels.

At this point, it must be determined what, if any, criticism is necessary when an unplanned shortfall is made up by any of these alternate sources. The necessity of liquidating assets to meet cash needs may warrant a critical comment. The parent's advances to subsidiaries and its investment in marketable securities are considered temporary investments. That is, the holding company may reasonably expect to sell its securities and be repaid on its advances to subsidiaries within a reasonably short period of time. In the case of advances to a problem subsidiary, repayments may not be forthcoming. Nevertheless, if the parent does receive partial payments, such funds are available to meet cash needs. The concern to the examiner is the extent to which such temporary investments can be relied upon before they are fully exhausted. If the continued liquidation of those investments to meet cash needs has fully exhausted the assets or will do so in the near future, then appropriate critical comments are warranted. Such comments should stress that the liquidation of the investment portfolio and the advances to subsidiaries can no longer be considered a reliable source of funds.

Another method that may be used by a holding company to overcome a flow of funds deficiency is the **sale of capital stock**, which is an effective source for generating permanent funds for the parent. However, it must be recognized that the primary reason for the stock offering was something other than covering the shortfall (i.e., debt repayment, capital contributions to subsidiaries, acquisitions). Therefore, it cannot be relied upon as a consistent annual source to supplement internally generated funds from operations. Also, it should be realized that the sale of stock will increase future funding requirements as additional dividends will have to be paid. Consequently, where no significant improvement in internal operations is contemplated in future periods, an appropriate comment is warranted indicating the potential problem.

Holding companies also compensate for inadequate funds flow with **borrowed money**. Although not a permanent source of funds, *long-term debt* is a source similar to the sale of stock. Its main purpose, however, was not to cover the shortfall. Long-term debt cannot be considered as a reliable, consistent annual source, and moreover, its existence creates new funding requirements. *Short-term debt* is perhaps the most commonly used source to cover a deficit cash flow from operations, and its use is of serious concern from a supervisory viewpoint. Unlike long-term debt and equity issues, short-term borrowings (i.e., bank loans, commercial paper) are readily available to holding companies, which can and do rely on this source year after year for support. As a consequence, this indebtedness increases fixed charges and where material improvement in earnings does not develop, the shortfall could increase in subsequent periods thereby necessitating even larger borrowing requirements. This practice may jeopardize the parent's liquidity position since short-term liabilities rise without a corresponding increase in liquid assets as the borrowed

funds are used to pay expenses. Here, an appropriate comment is warranted indicating the problems.

[2] Parent Company Leverage

Holding Company financial leverage is the use of debt to supplement the equity in a company's capital structure. It is anticipated that funds generated through borrowings will be invested and earn a rate of return above their cost so that the net interest margin generated will improve the company's net income, providing a higher rate of return on stockholders' equity which has otherwise remained constant. Since no creditor or lender would be willing to extend credit without the cushion and safety provided by the stockholders' equity, this borrowing process is also referred to as "trading on equity." That is, utilizing the existence of a given amount of equity capital as a borrowing base. Stockholders and management often view leveraging as a favorable financial alternative because if owners have provided only a small portion of total financing, much of the financial risk will be borne by the lenders, alleviating the need of the stockholders to assume the total risk. In addition, by raising funds through long-term debt, the owners gain the benefits of maintaining control of the firm with a limited investment rather than diluting existing ownership via the sale of additional capital stock.

There are, however, some unfavorable aspects in this type of financing. As a holding company substitutes debt for equity, keeping its asset size constant, its leverage ratio will increase. The increase in leverage increases the probability that a company may go into default since a larger portion of the income stream generated by earning assets must then be used to meet increased fixed charges (interest expense). (This assumes that increases in future earnings are not anticipated. While earnings may be sufficient to meet fixed interest expenses at the time the debt is issued, it is possible that future earnings will not be sufficient to meet the increased expenses.) In addition, utilization of leverage reduces management flexibility in making future decisions because lenders impose restrictive covenants that may limit future debt issues, limit dividend payments, or impose constraints on specific operating ratios. However, not all of the effects of increased leverage are unfavorable. Additional long-term debt may have the favorable effect of extending maturities on obligations and may improve liquidity.

Leverage ratios measure the contribution of owners compared with the financing provided by lenders. Companies with low leverage ratios generally have less exposure to loss when the economy is in a recession, but they may also have lower expected returns when the economy booms. Firms with high leverage ratios run the risk of large losses but also have a chance of earning high rates of return on equity and assets. Thus, if a company earns more on the borrowed funds than it pays in interest, the return to the owners is increased. For example, if the company earns 10 percent on assets and debt costs 8 percent, there is a 2 percent differential accruing to the stockholders. However, if the return on assets falls to 7 percent, the differential between that figure and the cost of debt must be made up from total profits.

A holding company is composed of at least two tiers, parent and subsidiary, and each tier may issue long-term debt in its own name. Several different types of long-term debt instruments are utilized by holding companies. Corporations make use of instruments such as debentures, convertible debentures, term loans, capital notes and mortgage notes. While most issues are generally sold to

the public, in some cases, issues of subsidiaries have been placed directly with another subsidiary, the parent company, or perhaps with an unaffiliated banking institution. Alternatively, issues presently held on the books of the parent may have been originally issued by one of the subsidiaries and later transferred to the parent. These transfers have often occurred at the time of the formation of the holding company when the parent assumed debt of the subsidiaries.

The proceeds of parent company long-term debt may be advanced to banking subsidiaries as debt or invested in banking subsidiaries as equity. When parent debt is issued, and the proceeds are advanced to subsidiaries as debt, a condition of "*simple leverage*" exists. When such proceeds are invested in subsidiaries as equity, a condition of "*double leverage*" is said to exist since the increase in the subsidiary bank's capital base will allow the bank to increase its own borrowings[7]. In effect, the parent's capital injection, which was funded by debt, provides the bank with greater debt capacity, thereby allowing the bank to borrow additional funds on its own. Therefore, the original borrowing by the parent has, in effect, been compounded when the bank borrows based on its newly injected equity.

If the parent debt is reinvested as equity in a bank, the servicing of interest and principal is usually provided by dividends paid to the parent by the bank subsidiaries. The bank dividends, however, may become restricted based on the bank's earning power, which may not provide for sufficient retention of earnings to support its asset growth. Problems may be less severe when parent debt is downstreamed as debt to the bank subsidiary. When the terms and maturities of the indentures match, the obligation of a bank to meet its interest and principal payments to the parent are contractual and represent fixed charges (interest is tax deductible), which will continue up to the maturity of the note. When funds are downstreamed as equity and the bank typically issues dividends to its parent, it is easier to restrict the flow of funds from the bank than if the funds were downstreamed as debt which results in bank payments of interest expense.

Examination Considerations

Generally, it is not the examiner's responsibility to criticize the method of term financing used by a holding company. The examiner, however, should be familiar with the various types of leveraging and the possible ramifications that they may have on a holding company structure. While the use of ratios may show an excessive leverage position, indicating vulnerability, it is primarily the corporation's earning power that dictates the acceptable level of debt. Accordingly, the examiner should compute a holding company's ability to meet its fixed charges (as detailed in the preceding section) to determine the appropriateness of the leverage position. If the company's earnings do not support the present fixed charge requirements, or if a declining trend is noted, appropriate comments are warranted.

[7] Parent company "total leverage" may be defined as the relationship between equity at the parent level and the total assets of the parent company. Such assets typically consist of investments in bank and nonbank subsidiaries, advances to affiliates, deposits with bank affiliates and securities. A useful related measure of parent company leverage is 'investment leverage" which may be defined as the relationship between parent equity and its equity investments in subsidiaries. Since the equity that has been invested in subsidiaries can, and often is, further leveraged by external borrowings of such subsidiaries, this type of parent company investment leverage can lead to what is referred to as "double leverage."

[3] Parent Company Liquidity

Liquidity is generally defined as the ability of a company to meet its short-term obligations, to convert assets into cash or to obtain cash, or to roll over or issue new short-term debt. "Short term" is generally viewed as a time span of up to a year. Since a holding company does not have the full range of asset and liability management options available to it that a bank does in managing its liquidity position, the holding company needs to have a sufficient cushion of liquid assets to support maturing liabilities. Certain assets that would not normally be considered current may be readily sold to avert a liquidity squeeze. For example, a holding company may be participating in long-term loans originated by a finance company subsidiary. If these loans are of good quality, the parent's share may be sold at little or no discount to that finance company subsidiary, another subsidiary, or an unaffiliated company to obtain the needed cash. Consequently, the breakdown of assets segregating those that are current would not necessarily be indicative of liquid assets, given the nature of holding company investments. Therefore, liquid assets are defined as those assets that are readily available as cash or that can be converted into cash on an arm's length basis without considerable loss. Liquidity problems are usually a matter of the degree of severity. A less serious liquidity problem may mean that the company is unable to take advantage of profitable business opportunities. A more serious lack of liquidity may mean that a company is unable to pay its short-term obligations and is in default—this can lead to the forced sale of long-term investments and assets and, in its most severe form, to insolvency and bankruptcy.

Supervisory Approach to Analyzing Parent Company Liquidity

For holding companies with asset size in excess of $ 1 Billion or material amounts of debt outstanding (or the equivalent measure used in the local financial jurisdiction), the analytical approach to parent company liquidity will include the following key elements:

1. Evaluate parent company liquidity by analyzing the contractual maturity structure of assets and liabilities, extending this analysis to consider the underlying liquidity of the parent's intercompany advances and deposits. Any judgment of adequate parent company liquidity must be keyed to a finding that the parent has adequate liquid assets, on an underlying basis, to meet its short-term debt obligations.
2. Estimate the underlying liquidity of parent liabilities and assets, giving particular attention to interest-bearing deposits in and advances to subsidiaries. Emphasis should be placed on asset quality and the liquidity profile of the bank and key nonbank subsidiaries. The estimates are to be reflected in a statement of "Parent Company Liquidity Position" as restated data, with appropriate explanations as to the basis for the restatement.
3. Use the five contractual and estimated underlying maturity categories on the statement of "Parent Company Liquidity Position" to slot in data. The data categories are:
    a. Up to 30 days,
    b. Up to 90 days,
    c. Up to one year,
    d. One to two years, and
    e. Beyond two years.

The schedule provides for the use of effective remaining maturity categories for the parent company's short-term assets and liabilities, highlighting funding surpluses or deficits at key specified periods of time. *Examiners have the option of including the statement in the examination report in order to substantiate or clarify particular judgments.*

4. Review the framework for evaluating funding mismatches as tool for assessing the parent's overall liquidity position:
   a. The position may be evaluated by the analysis of the underlying liquidity gaps (appearing on the bottom of the schedule).
   b. In the 0–30-day time frame, a net positive gap is expected and reflects the parent's ability to tide over a temporary market disarray
   c. Though for most large organizations, a shortfall may be evident in the 31–90-day period, the overall 0-90 days is expected to reflect a positive position.
   d. A significant shortfall in the 91-day to 1-year period is expected to be covered by a contingency funding plan.
5. Ascertaining whether an organization with significant funding activities has in place:
   a. Internal parent liquidity management policies that address and limit the use of short-term funding sources to support various subsidiaries, and
   b. An internal contingency plan for maintaining parent liquidity under adverse situations. Where no plan exists, a plan acceptable to the corporation's directors should be required.

3.1.3.2. PART 2: ANALYSIS OF SUBSIDIARY BANK(S)

In making the determination as to the condition of the holding company under examination, an examiner must, as part of the examination procedures, analyze the financial condition of the bank(s) owned by the holding company. Such an appraisal is obviously of paramount importance when one considers that the bulk of the consolidated assets and earnings of a holding company are represented by the bank(s). The examiner must incorporate in the analysis, results of the most recent commercial examination of the subsidiary bank(s).

Therefore, for meaningful results, the analysis of the subsidiary bank(s) should commence after the results of the latest examination of the bank(s) have been obtained. The primary areas of concern are (1) the quality and adequacy of the bank's capital (C); (2) the quality of the bank's assets (A); (3) the capability of the board of directors and management (M) to identify, measure, monitor, and control the risks of the bank's activities and to ensure that the bank has a safe, sound, and efficient operation that is in compliance with applicable laws and regulations; (4) the quantity, sustainability, and trend of the bank's earnings (E); (5) the adequacy of the bank's liquidity (L) position; and (6) the bank's sensitivity (S) to market risk—the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect the bank's earnings, capital, and liabilities that are subject to market risk.

The examiner's analysis of the bank must consider and determine whether certain key facets of a bank's operations meet minimum standards and conform, where required, to bank regulatory restrictions. The examiner should be especially alert to any exceptions or violations of applicable statutes or regulations that could have a materially adverse effect upon the financial condition of the organization. In addition, the examiner should also consider the conclusions drawn as to the extent of compliance and the adequacy of internal bank policies that contribute to the overall analysis of the bank's condition.

[1] Analysis of Banks (Capital)

One area of vital importance in the evaluation of a bank's condition is capital adequacy. The examiner should give due consideration as to whether the bank has sufficient capital to provide an adequate base for growth and a cushion to absorb possible losses, thereby providing protection to depositors. In this regard, the examiner should apply the capital adequacy guidelines specified by the Regulator that include risk-based and leverage measures that are used for evaluating capital adequacy of banks during solo supervision.

[2] Analysis of Banks (Asset Quality)

The quality of a bank's assets is another area of major supervisory concern. Supervisors consider the appraisal and evaluation of a bank's assets to be one of the most important examination procedures. It will be established by the bank examiner during the examination of a subsidiary bank to what degree its funds have been invested in assets of good quality that afford reasonable assurance of ultimate collectability and regularity of income. The examiner should have further determined that a subsidiary bank's asset composition is compatible with the nature of the business conducted by the bank, the type of customer served, and the locality. The holding company examiner is expected to comment upon the total classifications determined by the bank examiner in relation to the bank's capital. Consideration should also be given to the severity of the classifications. If the classified assets are considered not to possess a significant loss potential, favorable consideration should be accorded this factor.

Past due ratios should also be evaluated. In this respect, it is essential that trends be observed. Although a particular lending department's delinquent outstandings or an institution's overall past due percentage is presently considered reasonable, a noticeable upward trend may be worthy of comment to management. Excessive arrearages in any area warrant an examiner's comment in the examination report. Management should take appropriate action to improve any undesirable past due levels. In determining an organization's asset quality, the total classification ratio is an important indicator to review. The total classification ratio is calculated by adding the total dollar value of classified assets divided by the sum of tier 1 risk-based capital plus the allowance for loans and lease losses (ALLL). Another yardstick employed by examiners is the weighted classification ratio, which takes into consideration the severity of a bank's classified assets. In rating asset quality, the weighted classification ratio is designed to distinguish the degree of risk inherent in classified assets by ascribing weights to each category of classification thereby providing another measure of the impact of risk on bank capital.

The following weights are to be used:

Classification	Weights
Substandard	20%
Doubtful	50%
Loss	100%

The weighted classification ratio is calculated by taking the aggregate of 20 percent of assets classified substandard and value impaired (net of allocated transfer risk reserve), 50 percent of doubtful, and 100 percent of loss divided by the sum of tier 1 risk-based capital plus the ALLL. In addition to the total and weighted classifications ratios, examiners should also evaluate the

adequacy of loan loss valuation reserves as compared to weighted classifications. Loss potential inherent in weighted classified assets **must be offset** by valuation reserves and equity capital or appropriate comments should be made. Another tool that should be considered in evaluating asset quality is the **bank's internal classification list**, if the bank's lending procedures and management are adequate.

[3] Analysis of Banks (Earnings)
Comparison of earnings trends with other banks of similar size, along with an analysis of the quality of those earnings, is an effective initial approach in determining whether or not a bank's earnings are satisfactory. The Regulator should tabulate comprehensive surveys of bank earnings by peer group size. The results should be sufficiently detailed to permit various methods of comparison of the earnings of a specific bank with those in its peer group.

One ratio used as a means of measuring the quality of a bank's earnings is its **return on average assets – ROAA** - (i.e. net income after taxes divided by average total assets). If the ratio is low or declining rapidly, it could signal, among other things, that the bank's net interest income or margin is declining or that the bank is experiencing increased loan losses. A bank's current earnings should be sufficient to allow for ample provisions to offset anticipated losses. Various factors to be considered in the determination of such losses include a bank's historic loss experience, the adequacy of the valuation reserve, the quality and strength of its existing loans and investments and the soundness of the loan and administrative policies of management.

In assessing a bank's earnings performance capabilities and the quality of those earnings, an examiner should consider any **special factors** that may affect a particular bank's earnings. For example, a bank located in an urban area of a large city may find it difficult to earn as much as a bank of similar size located in a rural community or a small city. The urban bank is usually subjected to a higher level of operating expenses, particularly in salaries and local taxes. Moreover, its proximity to the large city and the competition afforded by bigger banks may necessitate lower rates of interest on loans as well as higher rates of interest on deposits. Consideration should also be given to the adequacy of the loan loss provisions as referred to above, the inclusion of any capitalized accrued interest into interest income, or the nature of any large non-operating gains when analyzing earnings. Further consideration should be given to the general nature of a bank's business or management's mode of operation. A bank's deposit structure and its resulting average interest paid per dollar of deposits may differ widely from that of other banks of a similar size and consequently, its earnings may be substantially below average as a direct result of the difference. For example, the maintenance of a high volume of interest-bearing time accounts in relation to total deposits is a major expense and is quite often the cause for certain banks falling below the average earnings of comparably sized banks.

A bank's earnings should also be more than sufficiently adequate in relation to its current dividend payout rate. It is particularly important that a bank's dividend rate is prudent relative to its financial position and not be based on overly optimistic earnings scenarios. The percentage that should be retained in the capital accounts is not clearly established. One thing is certain, the need for retained earnings to augment capital will depend on the adequacy of the existing capital structure as well as the bank's asset growth rate. Dividend payout rates may be regarded as

exceeding prudent banking practices if capital growth does not keep pace with asset growth. Prudent management dictates that a curtailment of the dividend rate be considered if capital inadequacy is obvious and greater earnings retention is required.

Analysis of **net interest margins** is of growing importance. A comparison should be made of a bank's ability to generate interest income on earning assets relative to the interest expenses associated with the funds used to finance the earning assets.

[4] Analysis of Banks (Liquidity)

Liquidity is generally defined as the ability to meet short-term obligations, to convert assets into cash or obtain cash, or to roll over or issue new short-term debt. Various techniques are employed to measure a bank's (depository institution) liquidity position. The bank examiner considers the bank's location and the nature of its operations. For example, a small rural bank has far different needs than a multibillion-dollar money market institution.

In addition to cash assets, a bank will hold for liquidity purposes a portion of its investment portfolio of securities that are readily convertible into cash. Loan and investment maturities are generally matched to certain deposit or other liability maturities. However, the individual responsible for a bank's money management must be extremely flexible and have alternate means to meet unanticipated changes in liquidity needs. To offset these needs, other means of increasing liquidity may be needed, which might include increasing temporary short-term borrowings, selling longer-term assets, or a combination of both. Factors that the "money management" officer will consider include the availability of funds, the market value of the saleable assets, prevailing interest rates and the susceptibility to interest-rate risk, and the bank's earnings position and related tax considerations. Although most small banks may not have a "money manager," they too must monitor their liquidity carefully.

One of the most common methods used by large banks to increase liquidity is to use additional borrowings. Some of the other basic means of improving liquidity include the use of direct short-term credit available through the discount window from the Central Bank, money market purchases and the use of loans from correspondent banks.

Sound Liquidity Risk Management

All banks are affected by changes in the economic climate, and the monitoring of economic and money market trends are crucial to liquidity planning. Sound financial management can minimize the negative effects of these trends while accentuating the positive ones. Sound liquidity risk management requires the following elements:

- Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk.
- Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk.
- Comprehensive liquidity-risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution.

- Active management of intraday liquidity and collateral.
- An appropriately diverse mix of existing and potential future funding sources.
- Adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments that can be used to meet liquidity needs in stressful situations.
- Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements.
- Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity-risk management process.

Information that a bank's management should consider in liquidity planning includes:
1. Internal costs of funds,
2. Maturity and repricing mismatches in the balance sheet
3. Anticipated funding needs, and
4. Economic and market forecasts.

In addition, bank management must have an effective CFP that identifies minimum and maximum liquidity needs and weighs alternative courses of action designed to meet those needs. Some factors that may affect a bank's liquidity include:
1. A decline in earnings,
2. An increase in nonperforming assets,
3. Deposit concentrations,
4. A downgrade by a rating agency,
5. Expanded business opportunities,
6. Acquisitions,
7. New tax initiatives, and
8. Assured accessibility to diversified funding sources, including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings.

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Contingency planning starts with an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high-probability/low-impact events that can occur in day-to-day operations to low-probability/high impact events that can arise through institution specific or systemic market or operational circumstances. Responses to these events should be assessed in the context of their implications for an institution's short-term, intermediate term, and long-term liquidity profile. A fundamental principle in designing a CFP that addresses each of these liquidity tenors is to ensure adequate diversification in the potential sources of funds that could be used to provide liquidity under a variety of circumstances. Such diversification should focus not only on the number of potential funds providers but also on the underlying stability, availability, and flexibility of funds sources in the context of the type of liquidity event these sources are expected to address.

Analysis of Liquidity
A bank's liquidity must be evaluated on the basis of the bank's capacity to satisfy promptly its financial obligations and its ability to fulfill the reasonable borrowing needs of the communities it

serves. An examiner's assessment of a bank's liquidity management should not be restricted to its liquidity position on any particular date. Indeed, the examiner should also focus his or her efforts toward determining the bank's liquidity position over a specific time period. The examiner's evaluation should also encompass the overall effectiveness of the institution's asset-liability management and liquidity risk management strategies. Factors such as the nature, volume, and anticipated takedown of a bank's credit commitments should also be considered in arriving at an overall rating for liquidity.

If the bank examiner has commented on a liquidity deficiency at a subsidiary bank, the holding company examiner should consider these findings in the overall analysis of financial factors.

3.1.3.3. PART 3: ANALYSIS OF NON-BANK SUBSIDIARIES

Generally, a banking subsidiary of a financial holding company is not liable for debts of any other subsidiary of the holding company unless it is contractually obligated through guarantees, endorsements, or other similar instruments. This apparent legal separation may induce false confidence that banks are insulated from problems that may befall other subsidiaries of the holding company. If a nonbank subsidiary of a financial holding company finds itself in serious financial trouble, several results are possible. The holding company may work as it was intended, in that debts of the failing subsidiary are isolated and not transferred to other subsidiaries so that at worst, the subsidiary and the parent (the holding company) fail. In this instance, other subsidiaries, including bank subsidiaries, are unharmed, and after a change in management or ownership, they continue in operation. There is no loss of confidence in the bank by its depositors. However, this is not necessarily the result.

Failure of a nonbank subsidiary may lead to a lack of confidence in the affiliated bank's ability to continue in business, which might precipitate a run on the bank's deposits. The failure of a major nonbank subsidiary then may place its affiliated bank in serious financial trouble. The examiner should assess the impact that the failure or the potential failure of a nonbank subsidiary may have on an affiliated bank with a similar name.

Usually, a financially distressed nonbank subsidiary is aided by the holding company, which will do everything in its power to rescue it from failure. At a minimum, refusal to do so would undermine confidence in the strength of the holding company. Refusal to aid its nonbank subsidiary might even result in a rise in the interest cost of the holding company's future debt in the capital markets and, more than likely, preclude issuance of commercial paper.

A holding company has considerable discretion in choosing how to assist one of its troubled subsidiaries. Because the bank is usually the largest subsidiary, the holding company may attempt to draw upon the resources of the bank to aid the nonbank subsidiary. The bank can transfer a substantial portion of its capital through dividends to the parent company, which may pass these funds on to the troubled nonbank subsidiary. Also, the nonbank may attempt to sell part of its portfolio to the bank subsidiary to improve liquidity. The Regulator should limit the sale of nonbank subsidiary loans to the bank affiliate unless it is satisfied that the bank had an opportunity to appraise the credit at the inception of the loan. Therefore, the examiner should

closely analyze the off balance-sheet activity of the nonbank subsidiary, particularly activity relating to the sale of loans shortly after they are made.

Analysis of Financial Condition and Risk Assessment
Because of the potentially damaging effect on the parent company or its bank subsidiary, the examiner should conduct a detailed analysis of the financial condition and perform a risk assessment of the nonbank subsidiaries. The loss to the holding company may not be confined to the equity in and advances to the subsidiary. The contingent liabilities arising from the nonbank subsidiary's external borrowings are quite often a large multiple of the parent's investment. Particular attention should be directed to holding companies that have made massive capital injections in order to rescue a failing subsidiary or to satisfy the external debt obligations of the subsidiary.

For each financial holding company with nonbank activities, examiners should prepare a written risk assessment of each active nonbank subsidiary, addressing the financial and managerial concerns outlined below. This assessment should be performed with the same frequency required for full-scope inspections. The purpose of this assessment is to identify subsidiaries with a risk profile that warrants an on-site presence. In formulating this assessment, the examiner should consider all available sources of information including, but not limited to:

- Findings, scope, and recency of previous inspections;
- Ongoing monitoring efforts of surveillance and financial analysis units;
- Information received through first-day letters or other pre-inspection communications;
- Regulatory reports and published financial information; and,
- Reports of internal and external auditors.

The risk assessment should address each nonbank subsidiary's funding risk, earnings exposure, operational risks, asset quality, capital adequacy, contingent liabilities and other off balance- sheet exposures, management information systems and controls, transactions with affiliates, growth in assets, and the quality of oversight provided by the management of the financial holding company and nonbank subsidiary. The examiner should give particular attention to appraising the quality of a nonbank subsidiary's assets because asset problems therein may lead to other financial problems in the nonbank subsidiary and the parent company or bank affiliates. Examiners are expected to document in the examination work papers their assessment of the overall risk posed by each nonbank subsidiary and to summarize their assessment of nonbank activities in the financial holding company examination report.

[1] Credit Extending Non-banks (Asset Classifications)
The examiner has four alternatives with respect to asset classifications. An appraisal of the degree of risk involved in a given asset leads to a selection. The examiner can either "pass" the asset or adversely classify the asset "substandard," "doubtful" or "loss," depending on the severity of deterioration noted.

Generally, a passed credit has those characteristics that are recognized as being part of a normal risk asset; the degree of risk is not unreasonable, the loan is being properly serviced and is either

adequately secured or repayment is reasonably assured from a specific source. A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the nonbank subsidiary will sustain some loss if the deficiencies are not corrected. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified loss are considered uncollectible and of such little value that their continuance as recordable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer reserving against this basically worthless asset even though partial recovery may be effected in the future.

Although most regulators do not apply bank standards when classifying nonbank assets, the classification categories are the same. Examiners of FHC nonbank subsidiaries must appraise the assets in light of industry standards and conditions inherent in the market.

[2] Credit Extending Non-banks (Earnings)

When analyzing the earnings of a nonbank subsidiary, the examiner should address two primary questions: (1) Is the return on assets (ROA) commensurate with the risk associated with the assets? (2) What is the impact of earnings and trends on the parent company and affiliate banks? While a nonbank subsidiary operating at a loss may be in less than satisfactory condition, the loss may not necessarily result in a major adverse impact on the consolidated earnings. The nonbank subsidiary's total assets may be insignificant in relation to the consolidated assets of the FHC, but operating losses may result in a significant reduction in its consolidated earnings position.

In some cases, industry statistics will be available for comparative purposes. However, a favorable comparison should not necessarily be taken as depicting a satisfactory earnings condition. Actions by the parent company could influence the earnings of its subsidiaries. For example, management and/or service fees can be adjusted in order to alter the subsidiary's earnings to desired levels. Also, if the parent company is funding the subsidiary, the cost of funds to the subsidiary can be adjusted above or below the parent's cost of funds thus affecting net income. In addition, an undercapitalized subsidiary with only a marginal return on assets could show a better return on equity than the adequately capitalized independent counterpart experiencing a good return on its assets. As important as return on equity is as a measure of performance, for nonbank subsidiaries, particularly those that are thinly capitalized, absolute level of earnings or return on assets provide a more meaningful measure of earnings performance.

The cash return to the parent from its investment in and advances to a subsidiary less its costs to carry the assets and related expenses should exceed the cash return available from an investment of a similar amount in securities in order to justify retaining the subsidiary. If it seems that an alternative employment of funds would be more rational, the examiner should inquire as to management's plans to improve subsidiary earnings.

Questions to be answered in analyzing the earnings of credit-extending nonbank subsidiaries include:
1. What is the impact on the parent company and affiliate banks of a nonbank subsidiary operating at a loss?
2. Is the return on assets commensurate with the risk inherent in the asset portfolios for those nonbank subsidiaries operating profitably?
3. Are intercompany management/service fees appropriate? From a supervisory perspective, management and service fees should have a direct relationship to and be based solely upon the fair value of goods and services received.
4. Is the subsidiary required to reimburse the parent for the parent's interest expense on borrowed funds, the proceeds of which have been treated as "advances to subsidiaries?"
5. Is the quality of the subsidiary's earnings sound? For example, is the company understating the provision for loan losses, relying upon non-operating gains or capitalization of accrued interest?

Special attention should be directed by the examiner to the computation of the company's net interest margin (interest income–interest expense, divided by average earning assets). A study of company yields on investments should provide a measure of the company's ability to invest its funds in earning assets that provide a rate of return above the company's cost of funds. As net interest margins narrow, the company may find it more difficult to generate sufficient income to meet operating expenses.

When discussing growth in earnings, the examiner should clearly differentiate between increases due to increased net interest income on a constant base of earning assets as compared to an increase in the earning asset base with a concurrent proportional increase in net interest income. Any improvement in net interest income as a percentage of earning assets may reflect favorably on management's ability to invest its funds at favorable yields or its ability to find less expensive sources of funds.

[3] Credit Extending Non-banks (Leverage)
As a general rule, credit-extending nonbank subsidiaries are funded by the proceeds of parent company borrowings through instruments such as commercial paper or medium to long-term debt or a combination thereof. Equity generally represents only a small portion of funding resources. There are instances, however, where nonbank subsidiaries of a holding company will arrange direct funding from external sources (e.g. in some US states where tax advantages are associated with direct external funding).

Heavy reliance on borrowed funds by a nonbank subsidiary together with its limited capital position often results in a highly leveraged financial condition that is quite sensitive to changes in money market cost of funds. An examiner should consider what a change in the company's cost of funds might do to its net interest margin and earnings.

Many FHCs operate on the premise that a nonbank subsidiary needs little capital of its own as long as the parent company is adequately capitalized. Implicit in this operating practice is management's belief that the parent could act as a source of financial strength to its subsidiary in the event of difficulty at the subsidiary level. However, experience has indicated that in many cases,

once trouble has developed in the subsidiary, the parent is hesitant to direct additional funds to the subsidiary, arguing that it is best to limit losses and exposure and it is imprudent for the parent to inject additional capital at this time. Given this experience, it is often considered appropriate for an examiner to comment on a subsidiary's extended leveraged position, indicating to management that the company has little, if any, capital "cushion" with which to absorb any asset "shrinkage" or loss. The examiner may then conclude and possibly recommend that additional capital be provided for the credit-extending nonbank subsidiary so that its leverage may be reduced and its capital structure altered to reflect more closely an independent organization in the same or similar industry.

Funding should be reviewed to determine that the subsidiary (or the parent) is not mismatching maturities by borrowing short-term funds and applying them to long-term assets that are not readily convertible into cash. A mismatch of maturities can lead to serious liquidity problems.

A primary concern of the holding company examiner is to determine whether the nonbank subsidiary has the capacity to service its debt in an orderly manner. Does the credit-extending nonbank subsidiary have sufficient liquidity and how much will it have to rely on the parent company for funds to retire debt to unaffiliated parties? Factors to be considered include:

1. The subsidiary's asset quality and its ability to convert assets into cash at or near current carrying value. Consider the maturities of borrowings and whether they align with the scheduled assets that will be converted to cash.
2. The subsidiary's and the parent's back-up bank lines of credit available in the event commercial paper cannot be refinanced.
3. The parent company's ability to require its bank or other nonbank subsidiaries to upstream extra dividends to support the illiquid position of one or more of its nonbank subsidiaries.

[4] Credit Extending Non-banks (Reserves)

The purpose of a credit-extending nonbank subsidiary's reserve for bad debts is to provide for known and potential losses in its assets. Although there is no specific formula for measuring the adequacy of a reserve for bad debts, prudence dictates that the reserve account should be maintained at a "reasonable" level. What is reasonable depends on the quality of the subsidiary's assets, its collection history and other facts. However, from a supervisory perspective, the reserve for bad debts should at least provide total coverage for all assets classified "loss" and still be sufficient to absorb future, unidentified, "normal" losses, that are estimated based on the "doubtful" and "substandard" classifications and the company's historic experience. Valuation reserves for a going concern are not considered adequate unless they can absorb 100% of identified losses and still have a balance sufficient to absorb future losses from continued operations.

Examiners should recommend the maintenance of valuation reserves sufficient to offset classified losses and may recommend (as opposed to require) that management charge-off the losses to the reserve account. The charge-off of classified losses is considered appropriate in order to assure that financial statements accurately reflect the company's financial condition. The Central Bank has the responsibility to monitor the financial holding company's nonbank subsidiary statements for accuracy and completeness. Failure by management to reflect accurately the financial condition of

the subsidiary and/or parent company could result in a formal corrective action to require charge-offs or other adjustments to financial statements.

[5] Non-Credit Extending Non-banks

The noncredit-extending nonbank subsidiaries provide services or financial products other than extensions of credit. Some of these companies are general and life insurance agencies, investment underwriting companies, management consulting firms and financial advisory companies.

The operations of some insurance firms are conducted on the premises of the bank subsidiaries by personnel who often serve as officers or employees of the bank. These companies usually incur little or no liabilities and require only nominal capitalization because risk is limited. However, their commission income is often substantial and a steady source of funds for the parent company. Nevertheless, insurance "underwriters" typically have strong capital bases, good liquidity and profitable operations. Furthermore, their operating risks are generally stable and predictable. Management consulting firms and investment advisory companies usually require little capitalization and no funding and generate favorable earnings. Of the noncredit-extending subsidiaries, insurance and securities underwriters are generally the only companies requiring capital and funding in significant amounts.

However, all subsidiaries are subject to some level of risk, which could impact on the FHC. In the case of insurance underwriters, insurance benefits paid could exceed actuarial estimates. Such a situation, however rare, could necessitate financial support from the parent company. In addition, contingent liabilities, resulting from legal actions or failure to perform, could be a large multiple of a subsidiary's capital and may affect the parent.

Earnings

In analyzing these subsidiaries, the examiner should consider the following:

1. Are any noncredit-extending subsidiaries operating at a loss or incurring low levels of earnings? If so, what is the cause and does it have a material impact on consolidated earnings?
2. Does the loss result in the subsidiary's reliance on the parent company or bank subsidiary(ies) for financial support? If so, in what form is the support provided?
3. If a loss has been incurred, has management initiated corrective measures? If not, why not?
4. Are the fees charged by the parent for services rendered limited to their fair market value? The answer to this question will almost always depend on information supplied by management. Management should be aware of the fair market rates charged by their competitors for similar services rendered.
5. Are the rates charged affiliates commensurate with the services provided and similar to rates charged nonaffiliated customers?

Risk Exposure

In noncredit-extending subsidiaries, risk exposure, of any meaningful magnitude, is often related to possible losses arising from legal actions for failure to perform services as contracted. The examiner should determine that the subsidiaries are being operated effectively by experienced and competent personnel under the direction of satisfactory management. The examiner should further determine that parent company management exercises appropriate controls over the activities of the subsidiary. Because of potential liability, the examiner should ascertain whether the

subsidiaries have adequate insurance coverage (i.e., errors and omissions, public liability, etc.). The examiner should be alert to any contingent liabilities that would have a significant impact on the parent company. For example, the parent company might guarantee the payment of debt or leases for the subsidiary.

3.1.3.4. PART 4: ANALYSIS OF CONSOLIDATED ORGANIZATION

[1] Consolidated (Earnings)
For purposes of an analysis of earnings, analysts of holding companies have placed considerable weight on consolidated FHC financial data. Consolidated data, however, can be very misleading since bank assets and revenues are large in relation to their profit margins. On the other hand, the volume of nonbank assets is generally not nearly as large, but profit margins (or losses) tend to be much more substantial. The organizational structure of a holding company is of prime importance and must first be taken into consideration before attempting to analyze consolidated earnings. As an example, in the case of non-operating shell bank holding companies with no nonbank subsidiaries, the earnings of the bank subsidiary should be nearly identical with consolidated earnings for the organization. Therefore, in these instances, the views and ratings of the applicable bank regulatory agency would normally be accepted and would apply to consolidated earnings of the FHC. This treatment would not apply to one-bank and multi-bank holding companies with substantial credit-extending nonbank subsidiaries. These holding companies require an in-depth analysis of earnings because of the adverse impact that a poorly operated subsidiary can have upon the consolidated earnings of the FHC.

In order to properly analyze consolidated earnings, it is best to review and study a consolidating statement of income and expense for the purpose of determining each entity's contribution to earnings. It is important to recognize that there need be no direct correlation between the asset size of a subsidiary and its relative contribution to total consolidated earnings. For example, a subsidiary accounting for a minute portion of consolidated assets could substantially negate satisfactory earnings of its larger asset base affiliates because of poor operations and sizeable losses.

When evaluating consolidated earnings, it is important to review the component parts of earnings for prior interim or fiscal periods for comparative purposes in order to determine trends. Considerable attention is to be focused on the various income and expense categories. The net interest income (difference between interest income and interest expense) of a company is highly revealing, as it will give an indication of management's ability to borrow at attractive rates and employ those funds with maximum profitable results.

Items having a significant impact on earnings include the noncash charge, "provisions for loan losses" and the volume of nonaccrual and renegotiated or restructured credits. A large provision for loan losses is made necessary by poor quality assets, which result in large charge-offs to valuation reserves. In order to replenish the reserve for loan losses to adequate levels to provide ample coverage against known and potential losses, large amounts of revenues must be "set aside." Nonperforming and renegotiated credits either provide no income or provide a reduced rate of income to the extent that the assets are no longer profitable relative to the cost of funds and the cost of doing business. In situations where earnings are below average or unsatisfactory, a

comment concerning the amount of provision for loan losses and volume of nonperforming loans is warranted in the financial analysis.
Other items of significance include taxes, particularly where tax arrears are indicative of insufficient earnings, and extraordinary or nonrecurring items. Extraordinary gains or losses are not the result of the normal operations of a company and should be analyzed independently from operating earnings. Generally, extraordinary items result from the sale of current or fixed assets. When significant amounts are involved, examiners should determine the underlying reasons behind such transactions.

After an analysis has been made of the pertinent components of earnings, analyze the "bottom line" or net income of the consolidated company. Generally, analysts relate net income to several benchmarks in order to evaluate performance. The ratios of earnings as a percentage of average equity capital or average assets are most widely used. Conclude the analysis with a comparison of a company's ratios in relation to its peer group.

Comparatively low earnings relative to its peer group may reflect problems and weaknesses such as lax or speculative credit practices (resulting in nonearning assets or loan losses), high interest costs resulting from excessive debt, or rapid expansion into competitive industries subject to wide variations in income potential.

Earnings on a consolidated basis are the best measure of performance. Moreover, while the earnings of individual subsidiaries must not be ignored, the ability of holding company management to control the level of reported earnings in any one subsidiary reaffirms the practicality of using the consolidated approach to analyze holding company profitability.

Essentially, the following points summarize areas that should be considered when analyzing consolidated earnings:

1. The return on consolidated assets and equity capital, as well as historical trends and peer group comparisons.
2. The ability of earnings to provide for capital growth, especially when taking into consideration recent and planned asset and deposit growth.
3. The "quality" of earnings is affected by the sufficiency of the provision to loan loss reserves and the asset quality of the organization. A high level of earnings that did not include sufficient provisions to the loan loss reserve during a period of high charge-offs may result in reductions in the reserve balance and thereby call to question the merits of high earnings in the face of declining reserve balances.
4. The ability of management to prepare realistic earnings projections in light of the risk structure and quality of assets.

[2] Consolidated (Asset Quality)
The evaluation of asset quality based on classifications of "substandard, doubtful and loss," is one of the most important elements to be taken into consideration when performing a financial analysis of a holding company because of the severe impact that poor quality assets can have on the overall condition of the organization. Procedures to measure asset quality of banks involve the use of the

relationship of weighted classified assets to Tier 1 capital funds and total classifications to total capital funds. Accordingly, consolidated asset quality could be based on the relationship of aggregate weighted classified assets of the parent company, bank subsidiary (ies) and nonbank subsidiary (ies), to Tier 1 capital.

However, a problem encountered when viewing asset quality on a consolidated basis is the fact that there is usually a large timing difference between the dates of examinations of the banking subsidiaries and their non-bank counterparts. Therefore, the aggregating of classified bank and non-bank assets from reports prepared at different times, reduces the currentness and validity of conclusions drawn. This problem can only be eliminated by conducting joint examinations on same dates with other functional regulators.

Despite the shortcoming of using classification information from different dates, an examiner may determine that there is a sufficient measure of validity in using the data and may present an analysis based on consolidated weighted classifications. For example, if there are a small number of bank subsidiaries and if the examination dates are near a common point in time, timing differences may be inconsequential. Or, if a review of several years of a bank's examinations reveals a relatively constant or stable level of classifications, then the timing of the most recent examination would not invalidate use of the analytical tool. As such, the technique may be employed when circumstances permit.

Other factors to be considered in determining asset quality include the levels of nonaccrual and renegotiated loans, other real estate owned and past due loans. While these assets may not be subject to classification, they usually represent former or emerging problem loans. Moreover, in the aggregate, they may represent a significant proportion of the asset portfolio. If such is the case, they should be taken into consideration when the examiner determines his overall rating of asset quality.

It is difficult to rely on the adequacy of consolidated reserves because they are "fractured" and protect portfolios in different organizations and may not be interchangeable or transferable. The reserve of each entity in the corporate structure must be reviewed or analyzed individually. For example, if consolidated reserves appear inadequate, there is no consolidated reserve account per se that could be increased to adequate proportions. Consequently, the inadequacy would have to be identified at the parent or subsidiary level. Conversely, if consolidated reserves appear to adequately cover the aggregate of all "loss" and a certain portion of "doubtful," it does not insure that all subsidiaries have adequate reserves. Nevertheless, despite the shortcomings of using consolidated reserves, the analyst should not hesitate to calculate and present a measure of the relationship of consolidated reserves to consolidated loans.

[3] Consolidated (Capital Adequacy)

The management of a holding company should ensure that the FHC has sufficient capital resources to absorb group-wide losses and to continue to operate in a sound and viable manner. Basel II expects financial groups to have an internal capital adequacy assessment process (ICAAP) for assessing their overall capital adequacy in relation to the risk profile and organizational strategy. The parent company should be in a position to aggregate, assess and control the material risks of

the individual institutions belonging to the group. It is expected that the plan would encompass varying economic scenarios and stress testing that take account of all parts of the group and the different environments in which the group operates.

The consolidated capital for the group is determined by adding the individual capital positions of each group entity to give the total capital position and then deducting the book value of investments/participations within the group to avoid double gearing of capital within the group. As consolidated supervision is a complement to solo supervision, and does not replace it, a parent/FHC will be required to maintain minimum capital requirements on a solo basis also. Capital is not available to buffer risk in two organizations simultaneously; therefore, the portion of the parent's externally generated capital that has been down-streamed/invested in subsidiaries is not eligible for inclusion in the capital adequacy computation. The parent company is expected to ensure that:

- Each regulated entity in the group meets the regulatory capital requirement to which it is subject under solo supervision; and
- The group overall has capital which is available and sufficient to buffer against a range of losses.

The Basel Committee on Banking Supervision under Basel II Capital Accord sets a minimum capital ratio of 4% for Tier I and 8% for combined Tier I and Tier II. Supervisors apply these ratios to banks both on a solo and consolidated basis as a minimum standard. The supervisor however has the right to require that, on a consolidated basis, an institution maintain capital levels in excess of these ratios depending on the nature, scope and complexity of operations. In determining the consolidated capital adequacy ratio, the supervisor should consider the following:

- The location of capital within the group in order to ensure that reliance is not placed on surplus capital that is not freely transferable because it is locked into some companies or countries, due to regulatory constraints;
- The degree of risk diversification in the group as a whole compared to that of the FHC; and
- Any risks that arise on a group basis but are not considered within the factors influencing the ratio appropriate for the licensee in the group.

The assessment of a holding company's consolidated capital is examined in great detail in section 3.2.

[4] Consolidated (Funding and Liquidity Risk Management)

The Central Bank expects supervised financial institutions and FHCs to manage liquidity risk using processes and systems that are commensurate with their complexity, risk profile, and scope of operations. Liquidity risk-management processes and plans should be well documented and available for supervisory review. FHCs are expected to manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. Appropriate liquidity risk management is especially important for FHCs since liquidity difficulties can easily spread to both depository and non-depository subsidiaries, particularly in cases of similarly named companies where customers may not always understand the legal distinctions between the holding company and subsidiaries. For this reason, FHCs should ensure that liquidity is sufficient at all levels of the organization to fully accommodate funding needs during periods of stress.

Liquidity risk-management processes and funding programs should take into full account the institution's lending, investment, and other activities and should ensure that adequate liquidity is maintained at the parent holding company and each of its subsidiaries. These processes and programs should fully incorporate real and potential constraints, including legal and regulatory restrictions, on the transfer of funds among subsidiaries and between subsidiaries and the parent holding company. FHC liquidity should be maintained at levels sufficient to fund holding company and affiliate operations for an extended period of time in a stressed environment when access to normal funding sources is disrupted, without having a negative impact on insured depository institution subsidiaries.

Material nonbank subsidiaries, such as broker dealers, are expected to have liquidity management processes and funding programs that are consistent with the subsidiaries' complexity, risk profile, and scope of operations. A nonbank subsidiary that directly accesses market sources of funding and/or manages specific funding programs should pay particular attention to:

- Maintaining sufficient liquidity, cash flow, and capital strength to service its debt obligations and cover fixed charges;
- Assessing the potential that funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions; and
- Ensuring the adequacy of policies and practices that address the stability of funding and integrity of the institution's liquidity risk profile as evidenced by funding mismatches and the degree of dependence on potentially volatile sources of short-term funding.

The 'management and supervision of liquidity risk in financial conglomerates' is examined in great detail in section 3.4.

3.2. CONSOLIDATED CAPITAL ADEQUACY ASSESSMENT

The purpose of capital adequacy assessment is to ensure that the Financial Holding Company (FHC) holds sufficient capital that is required to absorb losses. Principle 15 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should require that the financial conglomerate: (i) maintains adequate capital on a group-wide basis to act as a buffer against the risks associated with the group's activities; (ii) develops capital management policies that are approved and regularly reviewed by the board, and that include a clearly and formally documented capital planning process that ensures compliance with capital requirements on a group-wide and regulated entity basis; and (iii) considers and assesses the group-wide risk profile when undertaking capital management'.

The objectives of this section are to provide banking, securities and insurance supervisors with principles and measurement techniques that are aimed at achieving the following:

- Examination of a Holding Company's internal capital planning and management process
- Assessment of capital adequacy on a group-wide basis for heterogeneous financial conglomerates;
- Identification of situations that can result in an overstatement of group capital, which can have adverse effect on the regulated financial entities.

Basel II and other regulatory regimes (e.g. the US Federal Reserve) require banks and large financial conglomerates to develop and maintain a capital plan supported by a robust process for assessing their capital adequacy. The internal capital adequacy assessment process (ICAAP) involves mechanisms for assessing the conglomerate's overall capital adequacy in relation to the group risk profile and organizational strategy. The parent company should be in a position to aggregate, assess and control the material risks of the individual institutions belonging to the group. It is expected that the plan would encompass varying economic scenarios and stress testing that take account of all parts of the group and the different environments in which the group operates.

The parent company must be adequately capitalized to be able to sustain both banking and non-banking entities. The capital adequacy requirements we consider in this section should apply on a consolidated basis. The Consolidated entity includes all the subsidiaries within the FHC where IFRS principles permit pro-rata or full consolidation. The exception in this case is insurance subsidiaries or other regulated financial institutions whose leverage is inappropriate for deposit-taking institution and because of size, would have a material impact on the leverage of the consolidated entity. For the definition of the components of capital, supervisors have to bear in mind its ability to absorb losses. This section recognizes the existence of capital adequacy rules in each sector (for example, the Securities and Exchange Commission (SEC) and the Insurance Commission are in charge of the regulation of capital market operations and the insurance businesses) and does not seek to impose specific techniques for the assessment of capital adequacy. Rather, it sets out techniques that can complement existing approaches to the assessment of capital adequacy.

3.2.1. CAPITAL MANAGEMENT POLICIES AND PLANNING

According to the Joint Forum (cited in BIS, 2012b), supervisors should require that the financial conglomerates' capital management policies, and the processes used to devise and implement these policies, are prudent, robust and consider additional risks associated with unregulated activities and additional complexities related to cross-sectoral activities.

Capital Policy

One of the main tools in capital planning for financial groups is the capital policy. **Capital policy is the principles and guidelines used by a holding company for capital planning, capital issuance, and usage and distributions.** A capital policy should include internal capital goals; quantitative or qualitative guidelines for dividends and stock repurchases; strategies for addressing potential capital shortfalls; and internal governance procedures around capital policy principles and guidelines. The capital policy, as a component of a capital plan, must be approved by the financial conglomerate's board of directors or a designated committee of the board. It should be a distinct, comprehensive written document that addresses the major components of the conglomerate's capital planning processes and links to and is supported by other policies (risk-management, stress testing, model governance, audit, and others). A capital policy should provide details on how a FHC manages, monitors, and makes decisions regarding all aspects of capital planning. The policy should also address roles and responsibilities of decision makers, process and data controls, and validation standards. Finally, the capital policy should explicitly lay out expectations for the information included in the FHC's capital plan.

Specifically, the capital policy of a financial conglomerate should address the following:

- The main factors and key metrics that influence the size, timing, and form of capital distributions
- The analytical materials used in making capital distribution decisions (e.g., reports, earnings, stress test results, and others)
- Specific circumstances that would cause the FHC to reduce or suspend a dividend or stock repurchase program
- Factors the FHC would consider if contemplating the replacement of common equity with other forms of capital
- Key roles and responsibilities, including the individuals or groups responsible for producing the analytical material referenced above, reviewing the analysis, making capital distribution recommendations, and making the ultimate decisions.

Financial conglomerates should establish a minimum frequency (at least annually) and other triggers for when its capital policy is reevaluated and ensure that these triggers remain relevant and current. The capital policy should be reevaluated and revised as necessary to address changes to organizational structure, governance structure, business strategy, capital goals, regulatory environment, risk appetite, and other factors potentially affecting a FHC's capital adequacy. FHCs should develop a formal process for approvals, change management, and documentation retention relating to their capital policies.

Capital Goals and Targets

FHCs should establish capital goals aligned with their risk appetites and risk profiles as well as expectations of internal and external stakeholders, providing specific goals for the level and composition of capital, both current and under stressed conditions (Federal Reserve System, 2013b). Internal capital goals should be sufficient to allow a FHC to continue its operations during and after the impact of stressful conditions. As such, capital goals should reflect current and future regulatory capital requirements, as well as the expectations of shareholders, rating agencies, counterparties, creditors, supervisors, and other stakeholders. FHCs should also establish capital targets above their capital goals to ensure that capital levels will not fall below the goals during periods of stress. Capital targets should take into consideration forward-looking elements related to the economic outlook, the FHC's financial condition, the potential impact of stress events, and the uncertainty inherent in the capital planning process. The goals and targets should be specified in the capital policy and reviewed and approved by the board.

In developing their capital goals and targets, particularly with regard to setting the levels of capital distributions, FHCs should explicitly consider general economic conditions and their plans to grow their on- and off- balance sheet size and risks organically or through acquisitions. FHCs should consider the impact of external conditions during both normal and stressed economic and market environments and other factors on their overall capital adequacy and ability to raise additional capital, including the potential impact of contingent exposures and broader market or systemic events, which could cause risk to increase beyond the FHC's chosen risk tolerance level. FHCs should have contingency plans for such outcomes. Additionally, FHCs should calculate and use several capital measures that represent both leverage and risk, including quarterly estimates of regulatory capital ratios (including tier 1 common ratio) under both baseline and stress conditions.

FHCs with weaker practices in this area did not clearly link decisions regarding capital distributions to capital adequacy metrics or internal capital goals.

Capital Contingency Plan

According to the Federal Reserve System (2013b), FHCs should outline in their capital policies specific capital contingency actions they would consider to remedy any current or prospective deficiencies in their capital position. In particular, a FHC's policy should include a detailed explanation of the circumstances—including deterioration in the economic environment, market conditions, or the financial condition of the FHC—in which it will reduce or suspend a dividend or repurchase program or not execute a previously planned capital action. The policy also should define a set of capital triggers and events that would correspond with these circumstances. These triggers should be established for both baseline and stress scenarios and measured against the FHC's capital targets in those scenarios. These triggers and events should be used to guide the frequency with which board and senior management will revisit planned capital actions as well as review and act on contingency capital plans. The capital contingency plan should be reviewed and updated as conditions warrant, such as where there are material changes to the FHC's organizational structure or strategic direction or to capital structure, credit quality, and/or market access.

Capital triggers should provide an "early warning" of capital deterioration and should be part of a management decision making framework, which should include target ranges for a normal operating environment and threshold levels that trigger management action. Such action should include escalation to the board, potential suspension of capital actions, and/or activation of a capital contingency plan. Triggers should also be established for other metrics and events that measure or affect the financial condition or perceived financial condition of the firm—for example, liquidity, earnings, debt and credit default swap spreads, ratings downgrades, stock performance, supervisory actions, or general market stress. Contingency actions should be flexible enough to work in a variety of situations and be realistic for what is achievable during periods of stress. The capital plan should be prepared recognizing that certain capital-raising and capital-preserving activities may not be feasible or effective during periods of stress. FHCs should understand market capacity constraints when evaluating potential capital actions that require accessing capital markets, including debt or equity issuance and also contemplated asset sales. Contingency actions should be ranked according to ease of execution and their impact and should incorporate the assessment of stakeholder reactions (e.g., impacts on future capital-raising activities).

Capital Management: Key Supervisory Actions

According to the Joint Forum (cited in BIS 2012b), supervisors should follow the following action steps in regulating a financial conglomerate's capital management policies and plans:

- Supervisors should require that the financial conglomerate proactively manage its capital through a rigorous, board-approved, comprehensive and well documented process to ensure it maintains adequate capital within the group and its constituent entities.
- Supervisors should require that financial conglomerate's capital management policies include a process to arrive at board and management decisions regarding capital management (including dividend distributions, capital instrument issuances, redemptions and repurchases) and that such decisions reflect robust capital planning and incorporate stress scenario outcomes.

- Supervisors should require that the financial conglomerate's capital management policies include a requirement for the board of directors of the holding company to review and approve the capital management plan at least annually, or more frequently if conditions warrant.
- Supervisors should require that there exists an independent review process, e.g. involving an internal audit unit within the financial conglomerate, to ensure the integrity of the overall capital management process of the financial conglomerate, taking into consideration requirements at individual entities within the financial conglomerate.
- Supervisors should require that the capital planning process include capital adequacy goals with respect to degree and type of risk exposure, taking account of the conglomerate's strategic focus and business plan.
- Supervisors should require that the capital planning process take into consideration the group-wide risk profile and appetite, and the possible negative impacts to its capital position from the material entities and relevant business risks to which it is exposed.
- Supervisors should require that the capital planning process identify and measure all material risks potentially requiring capital. Both on- and off-balance sheet risks as well as the activities and exposures of any unregulated entities within the group should be considered. Risks should be considered not only in isolation but also in aggregate.
- Supervisors should require that the capital planning process determine quantifiable internal capital targets, along with practicable plans for achieving and maintaining these targets under both normal and stressed conditions. This should include processes to alert management of potential breaches.
- Supervisors should require that the capital planning process identify the actions that management is expected to take when its capital position falls below, or is anticipated to fall below, it's internal capital target.
- Supervisors should require that the capital planning process take into consideration the availability of capital across entities within the group. This should include the regulatory, legal and other impediments to the transfer of capital across entities, sectors and jurisdictions in which the financial conglomerate operates.
- Supervisors should ensure that intra-group guarantees, prospective capital injections, and future management actions are excluded from the determination of internal capital targets.
- Supervisors should require that the capital planning process consider the current and forecast business and macroeconomic environment. It should incorporate forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the group's capital position.

3.2.2. OBJECTIVES OF CONSOLIDATED CAPITAL ADEQUACY MEASUREMENT

In undertaking its risk assessment, the financial conglomerate and its regulated entities should assess risks across the group. The risks should include those undertaken across the financial conglomerate, including by unregulated entities such as special purpose vehicles and other off-balance sheet entities, holding and intermediate holding companies. Principle 16 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (cited in BIS, 2012b) states that 'supervisors should require that the capital adequacy assessments undertaken by the financial conglomerate consider group-wide risks, including those undertaken by unregulated entities within a financial conglomerate, and that these assessments soundly address third party participations and minority interests'.

Supervisors should have the power to impose specific capital requirements on the financial conglomerate for material risks in constituent entities when calculating group-wide capital requirements, particularly in situations where their assessment is that the total requirement for the conglomerate ought to be higher than the sum of that for individual component businesses. Such situations would include, for example, complexity of the group structure, which could lead to contagion risk across entities. In assessing the capital adequacy of financial conglomerates on a group-wide basis, supervisors should pay particular attention to the level of the underlying resources for loss absorption, the quality of those resources, and the degree to which resources are available to support the operations of entities within the group.

The measurement techniques that will be used in the assessment of financial conglomerates should be designed to achieve the following objectives amongst others:

- Detection of double or multiple gearing: this is a situation where the same capital is used simultaneously as a buffer against risk in two or more legal entities;
- Identification of situations where the FHC issues debt and down streams the proceed in the form of equity, which can result in excessive leverage;
- Develop a robust framework in order to address the risks being accepted by unregulated entities within the FHC that are carrying out activities similar to the activities of entities regulated for solvency purposes (e.g. leasing, factoring, reinsurance) etc.

Detection of Double or Multiple Gearing

An acceptable capital adequacy measurement technique for a holding company should be designed to detect and provide for situations of double or multiple gearing, in which the same capital is used simultaneously as a buffer against risk in two or more legal entities. Principle 17 of Joint Forum's *Principles for the Supervision of Financial Conglomerates* (cited in BIS, 2012) states that 'supervisors should require that capital adequacy assessment and measurement techniques consider double or multiple gearing'.

Double gearing occurs whenever one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet. In that situation, external capital of the group is geared up twice; first by the parent and then a second time by the dependent. Multiple gearing occurs where the dependent in the previous example down streams regulatory capital to a third-tier entity and the parent's externally generated capital is geared up a third time. Multiple and double gearing are associated with a parent (the FHC) down streaming capital to its subsidiaries although it can also take the form of an entity holding regulatory capital issued by an entity above it in the group's organization chart (up streamed capital) or by a sister affiliate. Supervisors need to pay attention to the implications of double or multiple gearing in the entities that they supervise, irrespective of whether those entities hold capital issued by the FHC, a subsidiary or an affiliate.

When double or multiple gearing is present, assessment of consolidated capital that is based on measures of solo capital are likely to overstate the external capital of the group. Supervisors have to bear in mind that only capital issued to external (non-group) investors provides support to the group, although some forms of internally generated capital may provide support for individual companies on a solo basis. Therefore, assessments of group capital should exclude intra-group

holdings of regulatory capital. The corporate structure of FHCs implies that it is inevitable that at least one legal entity will own shares and possibly other capital instruments issued by other entities within the group. Such structures are not necessarily unsound from a commercial perspective however; some may pose a prudential concern. For instance, large intragroup holdings of capital can allow difficulties in one entity to be transmitted to other entities within the group. Examples of three capital adequacy measurement techniques for ensuring that the assessment of the group's capital adequacy is not overstated are described in sub-section 3.2.3

Identification of Excessive Leverage

Principle 18 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (cited in BIS, 2012b) states that 'supervisors should require that capital adequacy assessment and measurement techniques address excessive leverage and situations where a parent issues debt and down-streams the proceeds in the form of equity to a subsidiary'.

Excessive leverage can occur when a parent issues debt (or other instruments not acceptable as regulatory capital in the downstream entity) and down-streams or passes the proceeds to a dependant in the form of equity or other elements of regulatory capital. In this situation, the effective leverage of the dependant may be greater than its leverage calculated on a solo basis. While this type of leverage is not necessarily unsafe or unsound, excessive use can constitute a prudential risk. For example, if undue pressure is placed on the regulated entity to pay dividends to the parent company so the latter can service its debt. Another similar problem that supervisors should be aware of is a situation where the parent holding company issues capital instruments of one quality and downstream them as instruments of a higher quality.

While such asymmetrical down-streaming poses significant prudential concerns where the group is not subject to consolidated capital requirements, it can give rise to excessive leverage at the subsidiary level even in groups subject to a consolidated capital requirement and thus should be subject to significant supervisory monitoring. In the particular case of the holding company, assessment of group wide capital adequacy by supervisors will need to encompass the effect on the group of the capital structure. To achieve this, supervisors will need to be able to obtain information about the head company, so as to assess its ability to service all external debt.

Addressing the Risks in Consolidated Capital Measurement

Another objective of consolidated capital measurement has to do with addressing the risks being accepted by unregulated entities within the financial conglomerate that are carrying out activities similar to the activities of entities regulated for solvency purposes, e.g. leasing companies, factoring, reinsurance amongst others. With regards to the supervision of unregulated entity, supervisors have a number of analytical alternatives, including

- The substitution of a capital proxy for the relevant sector,
- The application of other ad hoc treatments that represent a prudent treatment of the risks being accepted, or
- The use of total deduction treatment is described later under sub-section 3.2.3.

For unregulated entities whose activities are similar to regulated entities (for example, leasing, factoring, reinsurance), a comparable or "notional" capital proxy (including any valuation

requirements for assets and liabilities) may be estimated by applying to the unregulated industry the capital requirements of the most analogous regulated industry. Normally, the capital proxy treatment is applied to a reinsurance company in a group. If the capital proxy treatment is not applied to reinsurance within the group, the supervisor of any insurance company in the group should consider whether it is prudent to give credit for reinsurance placed with the reinsurer in assessing the solo capital adequacy of the regulated group insurers.

Unregulated non-financial entities should normally be excluded from the assessment of the group. However, where it is clear that one or more regulated entities in the group have effectively provided explicit support, such unregulated entities should be brought into the group wide assessment, via capital proxy or through total deduction. More generally, where risk has been transferred from regulated companies in a group to unregulated companies in the group, supervisors of the regulated companies may need to look through to the overall quantum and quality of assets in the unregulated companies, especially where a notional capital proxy has not been used.

Note: The regulatory capital and risk weighted assets for regulated entities shall be as defined by the sectoral regulators and should be recognized in computation of group wide Capital Adequacy Reviews (CAR). Where a member of the group is an unregulated entity, a proxy capital requirement shall be applied. The qualifying capital for unregulated entities comprises only of Tier 1 Capital elements and is calculated as:

Required Capital = (Total Assets of unregulated entity + off-balance sheet activities) – (exposures to group entities)/100

To be considered adequate, the capital must:

- Support the volume and risk characteristics of all parent and subsidiary activities;
- Provide a sufficient buffer to absorb anticipated and unanticipated losses arising from holding company and subsidiary activities;
- Support the level and composition of corporate and subsidiary borrowing and
- Serve as a source of strength by providing an adequate base for the growth of risk assets

3.2.3. TECHNIQUES USED IN CAPITAL ADEQUACY MEASUREMENT

According to the Joint Forum (BIS, 1999), the three main techniques of capital measurement, that are capable of yielding comparable and consistent assessments of the capital adequacy of financial conglomerates, are:

- The Building-Block Prudential Approach (BBPA),
- The Risk-Based Aggregation Method (RBA) and;
- Risk-Based Deduction Method (RBDM)

In addition, the Total Deduction Technique (TDT) can also be of value, particularly in addressing problems of double/multiple gearing.

In applying the techniques outlined in this sub-section, supervisors have discretion to exclude entities, which are immaterial to the risk profile of the group or its capital adequacy. Furthermore, supervisors may have to exercise judgment in other areas, such as the definition of regulatory capital, the application of accounting and actuarial principles, the treatment of unregulated entities

and the treatment of minority and majority interests. Supervisors need to be aware that differences in the treatment of these elements may result in material differences in the overall assessment of the capital adequacy of the Financial Holding Company (FHC). If a FHC is considered not to have adequate capital, relevant supervisors should discuss and determine what appropriate measures need to be taken.

3.2.3.1. BUILDING BLOCK PRUDENTIAL APPROACH (BBPA)

This approach essentially compares the fully consolidated capital of the financial group to the sum of the regulatory capital requirements for each group member. The regulatory capital requirements are based on those required by each group member's supervisor or, in the case of unregulated entities, a comparable or notional capital proxy. Specifically, the "building block" prudential approach takes the fully consolidated accounts of the financial group as a single economic unit. By definition, all intra-group on- and off-balance sheet accounts or exposures have been eliminated. For prudential purposes, the consolidated balance sheet and off-balance sheet commitments are split into four different blocks (or sectors) according to the supervisory regime of the individual firms involved: banks, insurance companies, securities firms, and unregulated firms. Then, the regulatory capital requirements for each regulated entity or sector are calculated (these requirements could be different from those applicable on a solo basis because of the elimination of intra-group exposures). Each member's capital level is compared to its individual capital requirement to identify any capital deficits. Finally, the regulatory capital requirements of each regulated entity and the proxy for the unregulated entity is added together and the total is compared with the aggregate amount of capital across the group. Such an approach can be complemented by a review of the distribution of risks and capital within the economic unit, that is, whether the apparent risks within the unit are covered by an adequate type and quantity of capital.

Example 1: Calculating Capital using BBPA

BBPA identifies solo and group-wide capital surplus or deficit using consolidated financial statements:

Summary of Steps:

1. Consolidated balance sheet broken down into its major firms
2. Solo capital requirement/proxy is calculated for each firm or sector
3. Requirement/proxy is deducted from each dependant's actual capital to calculate surplus/deficit
4. Items deemed non-transferable are deducted
5. Solo capital requirements/proxies are aggregated and compared to actual group-wide capital to identify group-wide surplus or deficit

Table 3.3. Consolidated Statement Divided by Subsidiaries (No Intra-Group Account)

Banking (Parent Company)	Insurance	Securities (60% Owned)	Unregulated company

Full Consolidation

	Banking	Insurance	Securities (60% Owned)	Unregulated Company	*Aggregate Group-Wide*
Capital Required/Proxy	32	10	17	10	**60**
Actual Capital (Solo)	40	12	22	7	**81**
Surplus (Deficit)	8	2	5	-3	**12**

Aggregation →

Pro Rata Consolidation

	Banking	Insurance	Securities (60% Owned)	Unregulated Company	*Aggregate Group-Wide*
Capital Required/Proxy	32	10	10.2	10	**62.2**
Actual Capital (Solo)	40	12	13.2	7	**72.2**
Surplus (Deficit)	8	2	3.0	-3	**10.0**

Aggregation →

Modified Building Block Approach: Deduct from the capital of the parent company the capital requirement for its regulated dependants and notional capital proxy amounts for unregulated dependants in other financial sectors. This method is recommended when a dominant financial activity is undertaken by the parent company.

3.2.3.2. RISK-BASED AGGREGATION (RBA)

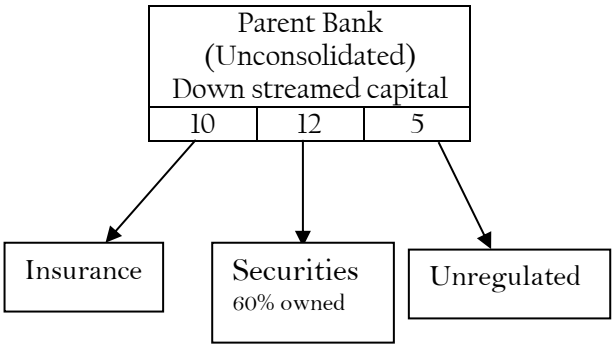
The risk-based aggregation approach is very similar to the building block approach. However, the difference between the two is that the RBA methodology is tailored to situations in which either fully consolidated financial statements are unavailable or intra-group exposures may not readily be netted out. This methodology is also helpful for situations in which the calculation of regulatory capital is more easily derived from unconsolidated statements and where the elimination of intra-group exposures may not be appropriate. Risk-based aggregation involves summing the solo capital requirements of the regulated group and capital norms or notional capital amounts of unregulated companies and comparing the result with group capital.

In calculating group capital (or own funds), adjustments should be made to avoid double counting capital by deducting the amount of funds down streamed or up streamed from one entity to another. Therefore, where dependants are held at cost in the accounts of the parent company, the group's capital should be calculated by summing the capital of the parent and its dependants and then deducting from that aggregate capital amount the book value of the parent's participation in the dependants.

Example 2: Steps in Calculating Capital using BBA

1. Sum solo capital requirements/proxy of parent and dependants
2. Sum actual capital held by parents and dependants
3. Deduct any up streamed or down streamed capital
4. Eliminate any non-transferable items
5. Compare aggregate requirement/proxy to aggregate group-wide capital to identify surplus or deficit

Table 3.4. Risk-Based Aggregation of Solo Capital



Full Consolidation

	Insurance	Securities (60% owned)	Unregulated	Unconsolidated Bank (Parent)	Elimination of downstream capital	Group-Wide Capital
Solo Capital Requirement/ Proxy	10	17	10	32		69
Actual Capital	12	22	7	67	-27	82
Surplus (Deficit)	2	5	-3	35	-27	12

Aggregation →

Pro Rata Consolidation

	Insurance	Securities (60% owned)	Unregulated	Unconsolidated Bank (Parent)	Elimination of downstream capital	Group-Wide Capital
Solo Capital Requirement/Proxy	10	10.2	10	32		62.2
Actual Capital	12	13.2	7	67	-27	72.2
Surplus (Deficit)	2	3.0	-3	35	-27	10.0

Aggregation →

Alternative Method to Deal with Double Leverage: If the amount of capital down streamed or up streamed within the group is unclear, a different technique that involves the identification of externally generated capital of the group can be used.

Externally Generated Capital:
An alternative technique for calculating the group's regulatory capital is to identify the externally generated capital of the group. This technique is particularly useful in the following situations:

- When dependants are not held at cost;
- When it is difficult to determine the amount of capital down streamed from the parent;
- When other intercompany transactions add complexity.

The externally generated capital of the group is found by adding the externally generated regulatory capital of the parent to that of its dependants. **Externally generated capital refers to regulatory capital not obtained elsewhere in the group including equity supplied by minorities, qualifying third party debt finance, retained profits arising from transactions with third parties, or other qualifying capital that is not reflected in the parent's own capital.** For externally generated capital to "belong" to the group it should be, in principle, payable to the group on the winding up or sale of the dependant. However, it may be judged that funds equivalent to such capital could readily be transferred to other parts of the group not withstanding any restrictions that might apply on the winding up or sale of the dependant.
A more prudent form of risk-based aggregation involves aggregating the greater of either the regulatory capital requirement/notional capital proxy or the investment of the group in each dependant. The aggregate figure of the dependants is then added to the regulatory capital requirement of the parent company itself to produce the overall group capital requirement. This requirement is then compared with the externally generated capital of the group (as described above).

3.2.3.3. RISK BASED DEDUCTION METHOD (RBDM)

The risk-based deduction method is very similar to the risk-based aggregation method but focuses on the amount and transferability of capital available to the parent or elsewhere in the group. Essentially, this approach takes the balance sheet of each company within the group and looks through to the net assets of each related company, making use of unconsolidated regulatory data. Under this method, the book value of each participation in a dependant company is replaced in the participating company's balance sheet by the difference between the relevant share of the dependant's capital surplus or deficit. Any holdings of the dependant company in other group companies are also treated in a similar manner. However, any reciprocal interest whether direct or indirect, of a dependant company in a participating company is assumed to have zero value and is therefore to be eliminated from the calculation.

Since the method focuses on the amount of surplus that is available for transfer to cover risks situated in other parts of the group, this approach is predicated on the use of pro rata consolidation of non-wholly-owned dependants. At the discretion of supervisors, further scrutiny of surplus transferability may be achieved by adjusting these surpluses to exclude any capital not attributable to the parent due to withholding or other tax payable on the transfer of resources and reserves or other items that would not be transferable as capital among group members.

Example 3: Calculating Consolidated Capital using RBD

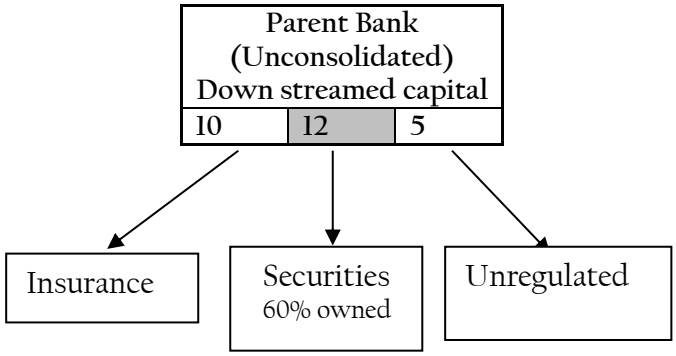
RBD is very similar to Risk-Based Aggregation, the differences include:

- The analysis is performed from perspective of parent company
- Focuses on capital surplus or deficit of each dependant
- Predicated on pro-rata integration

Summary of Steps:

1. Start with parent's capital accounts
2. Deduct investments in dependants from parent's capital
3. Add to adjusted capital, surplus or deficit values from each dependant
4. Take into account any limits on transferability of capital
5. Use pro rata consolidation method for non-wholly-owned dependants
6. Treat any holding of the dependant in other downstream group companies in a similar manner to this calculation
7. Eliminate any reciprocal holdings of a dependant in other upstream group companies
8. Subtract parent's solo capital requirement from adjusted capital
9. Resulting figure is surplus or deficit from a group-wide perspective

Table 3.5. Risk Based Deduction from Parent's Capital



Parent Capital	**67**
Deduct Capital Investments in Dependants	
Insurance Firm	-10
Securities Firm	-12
Unregulated Firm	-5
Substitute Dependants Surplus or Deficit	
Insurance Firm	2
Securities Firm (@60% Pro Rata)	3
Unregulated Firm	-3
Adjusted Parent Capital	**42**
Subtract Parent Solo Capital Requirement	32
Resulting Group-Wide Surplus	**10**
Reconciliation with Full Consolidation of other 2 Methods	
Add Back 40% of Securities Firm	2
Surplus with Full Consolidation	12

3.2.3.4. TOTAL DEDUCTION METHOD (TDM)

Each of the three techniques for evaluating group-wide capital adequacy of the financial group explicitly consider adverse effects of double gearing by examining capital adequacy of the parent and each of its dependants on a solo and group-wide basis. For supervisors that wish to quickly evaluate the extent to which double gearing may have compromised the capital adequacy of the parent company, there is a simple methodology that may be employed, this is referred to as the *Total Deduction Method (TDM)*.

The total deduction method is based on the full deduction of the book value of all investments made by the parent in dependants. Some supervisors may also wish to deduct any capital shortfalls in those dependants (as indicated by the capital standards of their solo supervisors) from the parent's own capital. In other words, under this technique the supervisor attributes a zero value, or in some cases a negative value, to the parent's investments. The parent's adjusted capital level is then compared with the parent's solo regulatory capital requirement, assuming that the parent is a regulated entity. The total deduction method implicitly assumes that no regulatory capital surpluses within dependants of the group would be available to support the parent's capital or debt service and that there is no regulatory capital deficit.

Note: This procedure is designed to evaluate the extent that double gearing might impair the capital adequacy of the parent organization and is not designed to evaluate the group-wide capital adequacy of the financial group.

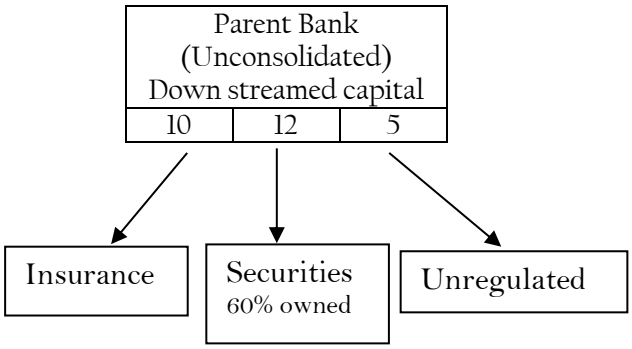
Example 4: Calculating Consolidated Capital using TDM

The total deduction method is a test for potential double gearing at parent level; however, it is not a substitute for the other three techniques. The TDM is almost identical to Risk-Based Deduction, but there is no credit given for any capital surpluses of dependants and no changes made for capital deficits.

Summary of Steps

1. Dependant's investments are fully deducted from parent capital
2. Any solo capital deficits may also be taken into account
3. Adjusted capital is compared to the parent's solo capital requirement

Table 3.6. Total Deduction from Parent Capital



	Insurance	Securities (60% owned)	Unregulated
Solo Capital Requirement/Proxy	10	17	10
Actual Capital	12	22	7
Surplus (Deficit)	2	5	-3

Parent Capital	**67**
Deduct Capital Investments in Dependants	
Insurance Firm	-10
Securities Firm	-12
Unregulated Firm	-5
Add Dependant's Deficit	
Unregulated Firm	-3
Adjusted Parent Capital	**37**
Subtract Parent Solo Cap. Requirement	32
Resulting Parent Surplus	

Table 3.7. Summary Balance Sheet of a Regulated Non-Operating Holding Company Under Different Capital Measurement Methods

Below is an abridged balance sheet of a non-operating Financial Holding Company (FHC), which is the parent company with two regulated 100% subsidiaries, and one unregulated 100% subsidiary. This example illustrates a situation of an undercapitalized group resulting from an undercapitalized parent holding company.

ABC Holding Company

Assets		**Liabilities**	
Book-Value participations in Bank A1	800	Capital	300
Insurance company A2	200	Other liabilities (long term loan)	800
Leasing company A3	100		
Total	1,100	Total	1,100

Bank A1 (Subsidiary)

Assets		Liabilities	
Loans	900	Capital	800
Other assets	400	Other liabilities	500
Total	1,300	Total	1,300

Insurance Company A2 (Subsidiary)

Assets		Liabilities	
Investments	7,000	Capital	200
		General reserves	100
		Technical provisions	6,700
Total	7,000	Total	7,000

Unregulated Leasing Company A3 (Subsidiary)

Assets		Liabilities	
Leases	2,000	Capital	100
		Other liabilities	1,900
Total	2,000	Total	2,000

Group (Consolidated)

Assets		Liabilities	
Bank loans	900	Capital	300
Other bank assets	400	General reserves	100
Insurance investments	7,000	Other bank liabilities	3,200
Leases	2,000	Technical provisions	6,700
Total	10,300	Total	10,300

Note: Other bank liabilities comprise of (Long term loan 800+ other liabilities 500+other liabilities from leasing company 1,900=3,200)

1) Assume the solo capital requirements/solvency margins of the regulated companies are as follows:

	Requirement	Actual Capital	Surplus/(Deficit)
Bank A1	100	800	700
Insurance Company A2	300	300	0
Notional Capital Proxy for the Leasing Company A3	150	100	(50)

2) Under the *building-block prudential approach*, the aggregated solo capital requirements and proxies (A1: 100; A2: 300; A3: Proxy of 150: Total: 550) are to be compared with the consolidated capital (300+100 =400). The group has a solvency deficit of 550-400=150.

3) Under the *risk-based aggregation method*, the solo capital requirements and proxies are again aggregated (550); the total requirements are compared to the sum of the capital held by the parent and its subsidiaries, deducted from the amount of the intra-group holding of capital [300 (parent) + 800 (A1) + 300 (A2) + 100 (A3) -1,100 (Participations)=400]. Again, the group has a solvency deficit of 150.

4) Under the *risk-based deduction method*, in the balance sheet of the parent the book value of each participation is replaced by its surplus or deficit value, i.e. total assets minus liabilities and minus capital requirement/proxy of the subsidiary. The book values of A1 (800), A2 (200) and A3 (100) are replaced by the solo surplus/deficit identified under (i): A1 (700), A2 (0), A3 (-50).

The revised balance sheet of the parent holding company is then as follows:

Assets		Liabilities	
Participations in:		Capital	-150
A1	700	Other liabilities	800
A2	0		
A3	-50		
Total	650	Total	650

The result again reveals a group solvency deficit of 150.

To sum-up, this example shows that although both regulated entities within the financial group meet their respective solo or sector solvency requirements, the financial conglomerate on a group-wide basis is undercapitalized. The reasons for this undercapitalization are twofold, first, there is excessive leverage in the group, as the parent has down streamed debt to its subsidiaries in the form of equity capital and secondly there is an undercapitalized unregulated entity in the group. The undercapitalization of the group is a potential risk for both regulated entities.

BOX 3.2. TECHNIQUES USED IN CONSOLIDATED CAPITAL MEASUREMENT: SUMMARY OF POINTS

Each technique results in similar capital assessments of the financial group, although different conclusions may result if in using one technique an analyst decides to use pro rata consolidation while in employing another technique, full consolidation is used.

1. Building Block Prudential Approach

- Uses consolidated financial statement
- Divides statement into individual sectors or blocks
- Adds together solo capital requirements/proxy of each member
- Compares aggregate capital requirement/proxy to consolidated capital

2. Risk-Based Aggregation

- Uses unconsolidated statements
- Adds together the capital of each entity in the group
- Subtracts intra-group holdings of regulatory capital to adjust for double gearing
- Adds together the solo capital requirements/proxies of each entity in the group to arrive at an aggregate capital requirement
- Subtracts aggregate capital requirement/proxy from adjusted group-wide capital to calculate surplus or deficit

3. Risk-Based Deduction Method

- Uses unconsolidated statements
- Analysis performed from parent company perspective
- Predicated on pro rata consolidation of dependants
- Parent capital reduced by amount of investments in dependants
- Parent capital increased/ (decreased) by solo capital surplus/ (deficits) of dependants
- Parent's solo capital requirement subtracted from adjusted parent capital to determine group-side surplus or deficit

3.2.4. ADDITIONAL CONSIDERATIONS IN CAPITAL ADEQUACY MEASUREMENT

3.2.4.1. MINORITY INTERESTS AND DOUBLE GEARING

The example below shows that where minority interests are present the choice between full Integration (consolidation) and pro-rata integration can have a material effect on the assessment of group capital adequacy. Under all methods described in this handbook, the supervisor has to make an explicit or implicit decision as to how to deal with minority interests in the various entities of the group. Specifically, the question is whether to include them by using full integration or exclude them by using a pro-rata approach. The example, using the risk-based aggregation method, demonstrates that full consolidation may yield a less conservative result than the pro-rata approach in cases where there are important surpluses and no deficits at solo level in the group and thus, may mislead supervisors about the situation of the group.

Consider a regulated parent and its 100% participation in a regulated subsidiary

Parent	
Capital	100
Capital requirements	-90
Participation 1 (historic cost)	40
SOLO SURPLUS	10
Subsidiary 1 (100%)	
Capital	40
Capital requirement	-25
SOLO SURPLUS	15
Group (Parent + Subsidiary 1)	
Capital	140
-Parent	100
-Subsidiary	40
Capital requirement	-115
-Parent	-90
-Subsidiary 1	-25
Participation (book value)	-40
GROUP DEFICIT	-15

Both institutions (parent and subsidiary 1) comply with their respective capital requirements at solo level. The assessment of capital adequacy at group level however reveals that there is an element of double gearing, which would call for regulatory action from the parent's regulator. Given that the parent has a 100% stake in the first subsidiary there is no difference between full and pro-rata integration).

Consider a situation where the parent also has a 60% participation in a second subsidiary with a considerable surplus at solo level.

Subsidiary 2 (60%)

Capital	100
- Parent	60
- Minority Interest	40
Capital Requirements	-25
SOLO SURPLUS	75

The group position would be as follows: Group (Parent + Subsidiary 1 + Subsidiary 2)

	Full Integration	Pro rata integration
Capital	240	200
-Parent	100	100
-Subsidiary 1	40	40
Subsidiary 2	100 (60 parent's share; 40 minority interests	60
Capital Requirement -Parent -Subsidiary 1 -Subsidiary 2	-140 -90 -25 -25	-130 -90 -25 -15
Participation 1 (book value)	-40	-40

Participation 2 (book value)	-60	-60
Group Deficit	0	-30

While pro-rata integration reveals a deficit at group level, full integration of the second subsidiary in the group calculation reveals no deficit because the second subsidiary's surplus compensates for the previous deficit at group level. This is because full integration regards capital elements attributable to minority shareholders as available to the group as a whole unless supervisors decide to limit the inclusion of the excess capital of this subsidiary. If the second subsidiary had a capital deficit at solo level, then full integration would reveal a larger deficit at group level than pro-rata integration because full integration has the effect of placing full responsibility for financing the deficit on the controlling shareholder (the parent).

3.2.4.2. INADEQUATE DISTRIBUTION OF CAPITAL

This example uses the risk-based aggregation method to show the application of a notional capital proxy to an undercapitalized unregulated entity whose business activities are similar to those of the regulated entities. The existence of solo requirements should normally prevent deficits at solo level in firms within the group. In situations where one entity of the group has a solo deficit, supervisors should consider whether excess capital in other firms of the group can cover such solo deficit. In the following example, this excess capital is needed to cover notional deficits in an unregulated entity.

Parent	
Capital	100
Capital requirement	75
Participation	25 (historic cost)
Subsidiary 1 (50% participation)	
Capital	60
Equity	50
Reserves	10
Capital requirement	10
SOLO SURPLUS	50

Group

	Pro rata aggregation	Full aggregation
Capital parent	100	100
Capital subsidiary	30 (50% of 60)	60
Capital requirement - Parent - Subsidiary	 -75 -5 (50% of 10)	 -75 -10
Participation	-25 (book value)	-25
GROUP SURPLUS	25	50

Notice that the surplus at group level stems from the partly owned subsidiary.

Subsidiary 2 (Undercapitalized Regulated Entity): This example deals with a situation where the parent holding company has a participation in an undercapitalized unregulated entity. The group's position will be as follows:

Unregulated Subsidiary 2 (100% Participation)

Capital	20
- Equity	10
- Reserves	10
Notional Capital Requirement	-50
Notional Solo Deficit	-30

Group

	Pro rata aggregation	Full aggregation
Capital	150	180
-Parent	100	100
-Subsidiary 1	30 (50% of 60)	60
-Subsidiary 2	20 (100% of 20)	20
Capital Requirements	-130	-135
-Parent	-75	-75
-Subsidiary 1	-5	-10
-Subsidiary 2	-50	-50
Participation 1	-25	-25
Participation 2	-10	-10
GROUP SURPLUS	-15	10

Notice that under the full integration approach, the surplus in subsidiary 1 is regarded as available to the group as a whole and it therefore more than compensates for the deficit in subsidiary 2. The pro-rata approach on the other hand, only takes account of that part of the surplus in subsidiary 1 which is attributable to the parent and, as shown this is not enough to offset the deficit in subsidiary 2 and the parent would either have to reduce its own risks, to increase its own capital or to leave the acquisition of the second firm.

3.2.4.3. QUALITY OF CAPITAL

Differences in the definition of capital between different legal entities that make up the financial group are one of the factors that complicate the assessment of capital adequacy at the group level. This is because it introduces a qualitative element to the process. This example below that uses the risk-based aggregation method, illustrates this element.

Parent

Capital	110
Capital requirement	90
Participation (historic cost)	20
SOLO SURPLUS	0
Subsidiary (100% participation)	
Capital	50
-Equity	20

-Subordinated debt	30
Capital requirement	20
SOLO SURPLUS	30

Assume that both the parent's and the subsidiary's regulator recognize subordinated debt as capital elements eligible for regulatory purposes.

Group

Capital	
-Parent	110
-Subsidiary	50
Capital Requirements	
-Parent	-90
-Subsidiary	-20
Book value of participation	-20
GROUP SURPLUS	30

The solvency surplus at the financial group level comes from the subsidiary's subordinated debt. The complication here stems from the fact that the subordinated debt is arguably only available to the subsidiary, in which case, the regulator of the parent holding company will need to guard against the possibility that this solvency surplus is used to cover risks at group level. The use of subordinated debt capital to cover losses is limited to the institution, which has issued it.

3.2.4.4. SUITABILITY OF CAPITAL STRUCTURE

Principle 19 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (cited BIS, 2012b) states that 'supervisors should require that assessment and measurement techniques evaluate any limitations on intra-group transfers of capital, taking into account potential impediments to executing such transfers that could constrain their suitability for inclusion in the assessment of group capital'.

A group-wide assessment of any participation needs to determine whether there are existing or potential impediments to the effective transfer of capital within the group. This may lead supervisors to judge that, although aggregate group-wide capital meets or exceeds capital requirements of the group, impediments or restrictions to intra-group transfers could result in capital shortfall at the group level. Such an assessment should consider restrictions (e.g. legal, tax, rights of other shareholders' and policyholders' interests, restrictions that may be imposed by solo regulation of dependants, foreign exchange, specific local requirements for branch operations) on the transferability of excess regulatory capital (whether by the transfer of assets or by other means) in such dependants.

Definitions of capital eligible for regulatory purposes differ considerably between regulatory regimes and regulators carrying out an analysis of capital adequacy at group level should duly consider these differences when assessing the suitability of capital elements to cover certain risks. The example below is an illustration of this principle. For instance, it could be possible at group

level, that the holding company's risks are covered by insurance capital (or vice versa), even when the holding company and the insurance firm that constitute the group each fulfil their solo capital requirements.

The Scenario:

- A parent holding company has own funds of 500, of which 200 is paid-up share capital (also recognized by insurance regulators);
- The remaining 300 comes from profits reserves appearing in the balance sheet, which forms part of the capital component recognized only by the holding company supervisors;
- The holding company has a 100% participation in an insurance subsidiary with a book value of 250. This amount complies with the capital requirement of the holding company.
- In addition to the 250 paid up share capital furnished by the holding company parent, the insurance subsidiary has hidden reserves and reserves for general insurance risk of 50 which-by definition-are not elements recognized as liable funds by the FHC's regulators. The insurance capital requirement is 300.

A purely quantitative, calculation, based on the risk-based aggregation method identifies a balanced capital position at group level with the sum of the capital elements equaling the capital requirements:

Capital of FHC's Parent		**Capital of the Insurance Subsidiary**	
Profit Reserves,	300	Paid-up Share Capital	250
Paid-Up Share Capital	200	Hidden Reserves	50
Less Book Value of Participation	250	Net Capital	300
Net Capital	250	Capital Requirement	300
Capital Requirement	250		

Capital Requirement	**FHC Risk**	**Insurance Risk**	**Excess/Deficit**
	250	300	
FHC Capital: 300	250		50
Insurance Capital: 50		50	0
Capital recognized by both supervisors: 200		200 50	
Excess/Deficit	0	-50	

The capital charge for the FHC's risk of 250 is more than covered by the 300 units of capital recognized only by the FHC's regulators; there is an excess of 50 units. The capital charge for insurance risk of 300 is covered by 50 units of capital recognized only by insurance regulators and by 200 units of capital recognized under both supervisory regimes; but the remaining charge of 50 is effectively covered by the FHC's capital- that is by capital components which the insurance regulators have deemed unsuitable for covering banking risks.

3.2.5. CAPITAL ADEQUACY ASSESSMENT: KEY SUPERVISORY ACTIONS

- Supervisors should require that all entities, whether regulated or unregulated, are included in the capital assessment of the group. Unregulated entities should be brought into the group-wide assessment via capital proxy or through deduction.
- Supervisors should, where appropriate and considering sectoral requirements, impose specific additional capital requirements, including for material risk exposures and investments in particular entities, when calculating capital requirements.
- Where risk has been transferred from regulated to unregulated entities in a group, supervisors of the regulated entities should look through to the overall quantum and quality of assets in the unregulated entity.
- Supervisors should require that situations of double or multiple use of capital (e.g. when a holding company provides regulatory capital to another group entity) are adequately addressed in the capital assessment of the group
- Supervisors should require participations that confer effective control to be consolidated in full.
- Supervisors should require that the capital adequacy assessments of the group and its components, as appropriate, exclude intra-group holdings of regulatory capital if not performed on a fully consolidated basis.
- Supervisors should be alert to ownership structures that pose prudential concerns (e.g. sister entities owning capital), and overly complex organizational structures that could obscure instances of double or multiple gearing within the financial conglomerate.
- Supervisors should be aware that problems, similar to those posed by intra-group double or multiple gearing, can also occur when different conglomerates hold cross participations in each other or in each other's dependants.
- Supervisors should require that the assessment of capital adequacy of a financial conglomerate incorporate the effect of the capital structure.
- Supervisors should assess the methods by which the down-streaming of proceeds from parents to subsidiaries occurs, and their potential to produce undetected excessive leverage.
- Capital adequacy measurement techniques should consider the potential for undue pressure to service a parent's debt (e.g. the obligation of a regulated subsidiary to pay dividends to its parent).
- In their group-wide assessment of participations, supervisors should determine whether there are existing or potential impediments to the effective transfer of capital within the group.
- Supervisors should require that funds treated as available and included in the group-wide capital assessment are legitimately movable within the group should the need arise.
- Supervisors should require that the regulatory capital in a dependant and the corresponding capital requirements is calculated according to the rules applicable to the financial sector and jurisdiction in question, except where the supervisor of the head company deems it necessary to use an alternative measure or proxy.
- Before recognizing any excess capital in a dependant on the balance sheet of the holding company, supervisors should ensure that the excess capital comprises adequate capital elements.
- Supervisors should assess the appropriateness of the distribution of capital resources within the group independent of the group's ability to transfer capital across entities within the group.

3.3. CREDIT CONCENTRATIONS, LARGE EXPOSURES AND INTRAGROUP TRANSACTIONS

Consolidated prudential reports enable supervisors to monitor and evaluate quantitative aspects of the financial conglomerate's condition. This section focuses on credit concentrations, large exposures, and intragroup transactions.

3.3.1. CREDIT CONCENTRATIONS

The accurate identification of a borrower's credit risk and the assignment of a risk rating that describes that risk are at the heart of an effective credit risk management process. But credit risk management does not conclude with the supervision of individual transactions. It also encompasses the management of concentrations, or pools of exposures, whose collective performance has the potential to affect a bank or financial conglomerate negatively even if each individual transaction within a pool is soundly underwritten.

Concentrations are probably the single most important cause of major credit problems. Credit concentrations are viewed as any exposure where the potential losses are large relative to the bank's capital, its total assets or, where adequate measures exist, the bank's overall risk level. In most jurisdictions, a "concentration" is defined to include direct, indirect or contingent obligations exceeding 25% of a bank's capital structure. Effectively, any exposure that exceeds 25% of capital is by definition a concentration. When exposures in a pool are sensitive to the same economic, financial, or business development, that sensitivity, if triggered, may cause the sum of the transactions to perform as if it were a single, large exposure. Examiners should note concentrations or pools of transactions that either poses a challenge to management or present unusual or significant risk to the group. Examiners should require management to take corrective action when concentration risk management is weak, or the quantity of concentration risk is too high.

Concentrations based on common or correlated risk factors reflect subtler or more situation-specific factors and often can only be uncovered through analysis. If the common characteristic becomes a common source of weakness, loans in the pool could pose considerable risk to earnings and capital. For instance, the 2007 global financial crisis that led to the crash of major financial markets via the fire sales of securities illustrate how close linkages among banks in terms of their collateral portfolios, under stress conditions and previously undetected correlations between market and credit risks, as well as between those risks and liquidity risk, can produce widespread losses.

3.3.1.1. CORRELATION OF POOLS

Transactions that may perform similarly because of a common characteristic or common sensitivity to economic, financial, or business developments may be formed into pools, some of which an institution may subsequently designate as concentrations because of their size or risk profile. Pools of transactions with similar characteristics include credit exposures that are:

- Extended to any one counterparty, borrower, or group of related counterparties or borrowers
- Dependent on the same source of repayment (including guarantors)
- Extended to independent borrowers who sell the same manufacturer's product
- Secured by a common debt or equity instrument

- Extended to other financial institutions including but not limited to due from accounts, investments, direct or indirect loans.
- Originated within a geographic area that might also be dominated by one or a few business enterprises
- Owed by a foreign government or related entities

The identification of correlated pools of exposure is an extremely important, but difficult, part of managing credit concentration risk. Two pools that do not exhibit strong performance correlation (i.e., similar credit performance metrics) in a benign economic environment may show very strong correlation in a crisis environment. For instance, many banks assumed that individual pools of residential mortgages, each representing a different geographic area, would not be highly correlated. While this could be a reliable assumption during a normal economic environment, the performance of these pools is likely to be highly correlated if there is a nationwide decline in house price. Therefore, experience and judgment play important roles in helping banks identify pools that might perform similarly in the future. A subsidiary bank within the financial conglomerate structure is expected to review all of its relatively larger and riskier pools—both those designated as concentrations and those not—to determine if there might be an additional level of performance correlation between two or more pools. While the list of all such combinations is potentially long, it is appropriate to focus on the relatively larger or riskier pools to determine if such a correlation exists.

Suppose, for example, that exposure in each of two industry pools, air transportation and hotels, was equal to 15% of capital. Although neither might be designated a concentration initially, if there were a downturn in the demand for passenger air service for any reason, the hotel business probably would suffer as well. Both pools would exhibit common performance characteristics and, at 30% of capital, may warrant scrutiny. Depending on the industry groups defined by an institution, there may also be a positive correlation between industries in the same supply chain. An institution may distinctly identify food and beverage industry and wheat and cocoa production within its industry structure. To the extent that borrowers within the wheat and cocoa industry sell to food and beverage manufacturers, a downturn in food and beverage sales would negatively affect the performance of both industries.

3.3.1.2. MANAGING CONCENTRATION RISK

There are many strategies for managing concentration risk at the banking subsidiary or intermediate holding company level. Some of these strategies have the effect of reducing risk over a relatively long horizon, while others have a more immediate impact. These strategies include:

- Modifying underwriting standards to increase exposure to higher quality transactions or to diminish exposure to weaker borrowers;
- At the same time, management can increase the level of credit supervision while executing exit strategies from lower-quality relationships (e.g., increasing pricing or tightening terms and conditions).
- Expanding the portfolio by booking transactions that are not likely to perform in a similar manner with the existing portfolio; for example, a decline in the price of oil and gas might affect borrowers in the oil and Gas production industry negatively but would have the opposite effect on borrowers in the Chemical Manufacturing industry. Similarly, an increase in the price of

wheat might boost the prospects of many companies in the Primary Wheat Production industry while pressuring those companies that use wheat as one of the raw materials in their production process (if the ability to pass through the price increase were constrained);
- Additionally, there are well-known linkages between industry performance and the stage of the economic cycle (e.g., the relatively strong performance of consumer staples in a weak economic environment);
- Altering exposure limits or credit risk benchmarks, such as adjusting limits on commitment or outstanding amounts, or tightening constraints on special mention, substandard, doubtful, or non-performing levels;
- Holding additional capital to compensate for the additional risk that may be associated with a concentration exposure;

3.3.1.3. CREDIT CONCENTRATION: KEY SUPERVISORY ACTIONS

In assessing a financial group's credit concentration, the supervisor should first determine the scope of the examination of the bank's credit concentration management process and identify examination activities necessary to meet the needs of the supervisory strategy for the bank. During the examination process, the examiners should obtain and review the following:
- Financial conglomerate's credit concentration management policies and procedures;
- Portfolio strategies and risk tolerance parameters;
- List of data elements captured by MIS for concentration reporting;
- Schedule of concentrations identified by the institution at both the group and subsidiary levels;
- Credit concentration limits and exposure and exception reports;
- Credit concentration reports submitted to senior management or the board of directors of the holding company;
- Group's capital planning and stress testing policies, procedures, and results.

In discussions with the management of the banking subsidiary or holding company, the supervisory should determine if there have been any significant changes in the following:
- Credit concentration management policies and procedures;
- Control systems, including MIS;
- Credit concentration levels;
- Portfolio strategies;
- Risk tolerance parameters, including changes in credit concentration limits and exception levels;
- The level of delinquencies, criticized or classified loans,
- Non-performing loans, or losses in any Credit Concentration;
- Capital Planning and Stress Testing Policies and Procedures amongst others

At the end, the supervisor should perform a *quantity of risk assessment* in order to assess the level of concentration risk associated with the bank's/conglomerate's credit portfolio and evaluate the amount of these risks that can be traced to any of the group's subsidiaries. The scope of a quantity of risk assessment typical covers the bank/conglomerate's credit policies, credit evaluation processes, personnel and control systems. In conducting a quantity of risk assessment, the supervisor should endeavour to:

- Evaluate the relevant policies to determine whether they provide appropriate guidance for identifying and managing the bank's credit concentrations. Consider whether the bank has:
    - Established a tolerance for risk. This may be shown as a percentage of capital or expressed in terms of risk, not simply size (e.g., risk of loss, or risk to earnings or capital);
    - Developed a firm and group-wide framework for identifying credit concentrations across business lines, including consideration of distinct groups of loans whose credit performance may be correlated;
    - Established a process for using stress testing to identify potential credit concentrations and to use stress testing to evaluate the potential impact of adverse scenarios on credit concentrations on the bank's capital and liquidity and for reporting those results to senior management and the board of directors;
    - Identified roles and responsibilities associated with identifying and managing credit concentrations, particularly those that may be extended to related parties;
    - Defined the process for setting credit concentration limits and for approving changes and exceptions thereto.
- Determine whether credit concentration limits are well defined and reasonable. Consider the way that limits are measured and the use of sub-limits for different types and tenors of exposure within a credit concentration (e.g., property types and geography).
- Verify that the bank's board of directors periodically reviews and approves the bank's credit concentration policies, including relevant limits or strategies on significant credit concentrations.
- Analyse the level of risk of the bank's credit concentrations. Consider in your analysis the size of the exposure and the concentration's credit quality indicators, including the amount and volatility of and trend in:
    - Delinquencies;
    - Criticized and classified loans;
    - Non-accrual or nonperforming loans;
    - Losses;
    - Other credit quality metrics used by the bank (e.g., weighted average risk grade or weighted-average probability of default).
    - Underwriting standards
    - Exceptions to policy
- Determine the risk implications of the following:
    - Significant growth in the size of a credit concentration's exposure, including whether such growth might be masking deterioration in credit quality indicators,
    - Material changes in policies, procedures, or underwriting standards. In carrying out this assessment, the supervisor should also ascertain whether there is an evidence of *abusive and self-serving lending* regarding related party and insider lending within the financial conglomerate (see sub-section 3.3.2).
- Review and discuss with management any internally prepared assessments of credit concentration risk (e.g. industry evaluations)
- Review the local, national, and global economic trends and outlook, and assess their impact on the bank's credit concentrations and overall leverage at the conglomerate level.

- Review the bank's business and strategic plans and evaluate how their implementation may affect the level of risk posed by any credit concentration to the overall health of the financial conglomerate.
- Review and discuss with management the results from applicable stress testing and capital planning assessments at both bank and conglomerate levels.
- Evaluate the impact of mitigation strategies on the quantity of risk (e.g. limits, loan sales, etc). Consider the objectives of these programs and management's experience with these tools.
- Give special attention to asset classes with more volatility in performance (e.g., commercial real estate construction, project finance, and margin lending). Based on these reviews and findings, assess whether the bank and the financial conglomerate have adequate capital to support the risk posed by its credit concentrations.
- In light of the scope and complexity of the bank's portfolio, evaluate the adequacy of the bank's process for analysing credit concentrations. Here the supervisor should consider the following:
    - Does the bank assess the level of risk associated with each concentration?
    - Do the bank's risk assessment processes aggregate exposures on a group-wide basis and across lines of business?
    - Are the results of the bank's risk assessments, including those from stress testing, appropriately incorporated into the conglomerate's overall capital planning process?
    - Do the bank's conclusions concerning credit concentrations appear reasonable in light of information available from other sources?
    - Is the bank's capital level adequate to support the level and types of credit concentration exposures?
    - Is a formal analysis of higher-risk credit concentrations conducted periodically, and does the bank have an effective system for monitoring developments in the interim?
    - Is the bank's analysis adequately documented and is its credit risk conclusions communicated in a way that provides decision makers with a reasonable basis for strategy development?
    - Are the resources devoted to the analysis of credit concentration, including the number and expertise of staff members, considered adequate?
- Assess the performance management and compensation programs for staff members managing credit concentrations. The supervisor should consider whether these programs measure and reward behaviour that supports the bank's and/or conglomerate's strategic objectives and risk tolerance limits.
- Determine whether management information systems provide timely, accurate, and useful information to evaluate risk levels and trends in the bank's credit concentrations. Consider the following:
    - Are all material credit risk exposures across all lines of business captured (e.g., loans, leases, overdrafts, counterparties, securities, or off-balance-sheet transactions)?
    - Is the breadth of the data elements collected adequate given the scope and complexity of the portfolio?
    - To whom are MIS reports distributed and how timely are these reports?
- Determine how compliance with credit concentration limits is monitored and reported to senior management and the board of directors;
- Assess the level of review for credit concentrations nearing their credit risk limits. Is there sufficient reporting to senior management and is oversight heightened?

- Evaluate the adequacy of the system for monitoring current conditions in higher-risk credit concentrations. Consider the types of internal and external resources used.

3.3.2. LARGE EXPOSURES AND INTRA-GROUP TRANSACTIONS

3.3.2.1. LARGE EXPOSURES

Monitoring and control of large individual exposures of the bank within the financial group is an important function of consolidated supervision. Financial conglomerates are subject to regulations, which limit their credit exposure to an individual counterparty, or group of related counterparties. The aim of limiting exposures is to prevent a licensee from incurring disproportionately large losses as a result of the failure of an individual client or a group of connected clients due to the occurrence of unforeseen events. In most financial jurisdictions, legislation are used to limit the amount of the exposures which a banking group may incur towards a single counterpart or related counter parties, normally as a percentage of the group's capital. A survey of international best practices of central banks reveals the following:

- An exposure in excess of **10%** of the regulatory capital base of the group constitutes a large exposure and must be reported on the *large exposures form* on a quarterly basis.
- Aggregate large exposure in any bank should not exceed eight times the shareholders' funds unimpaired by losses.
- In terms of connected lending, a director or a significant shareholder should not borrow more than **10%** of the bank's paid-up capital except with the prior approval of the Central Bank
- The maximum credit to all insiders should not exceed **60%** of a bank's paid up capital.

3.3.2.2. INTRA-GROUP EXPOSURES / INTERCOMPANY TRANSACTIONS

Intra-group exposures/transactions according to the Joint Forum (BIS, 2012b) can often take the form of a complex netting of direct and indirect claims which entities within financial groups typically hold on each other. The most transparent form of intra-group exposure is a credit or a line of credit, which either the parent grants to a subsidiary, or one subsidiary makes available to another subsidiary. Intra-group exposures can however originate in a variety of other ways, for example through:

- Intra-group cross shareholdings;
- Trading operations whereby one group entity deals with or on behalf of another group entity;
- Central management of short term liquidity within the group and
- Guarantees and commitments provided to or received from other companies in the group.

The analysis of intra-group or intercompany transactions between a parent company, its nonbank subsidiaries, and its bank subsidiaries is primarily intended to assess the nature of the relationships between these entities and the effect of the relationships on the subsidiary insured depository institutions (IDIs). Both the legal and financial ramifications of such transactions are often areas of concern to the Central Bank and other regulatory agencies because of the protection of the safety net. Several types of intercompany or intra-group transactions and the primary regulatory concerns of each are presented below:

i. *Dividends Paid by Subsidiaries to the Parent:*

Dividends are a highly visible cash outflow by subsidiaries. If the dividend payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the

subsidiary's capital ratios will deteriorate. These dividends may also have a negative effect on the subsidiary's liquidity position.

ii. *Transactions with Affiliates:*

Transactions between subsidiary IDI and its non-bank affiliates are another area of potential abuse of subsidiary banks. Regulatory concern centers on the quantitative limits and collateral restrictions on certain transactions by subsidiary banks with their affiliates. These restrictions are designed to protect subsidiary IDIs from losses resulting from transactions with affiliates. For example, in the United States, the following transactions are often "covered transactions" between a bank and its affiliates:

- Loans to the affiliate
- Purchase of assets from the affiliate
- Purchase of an affiliate's securities or investments in the affiliate
- Acceptance of the affiliate's securities as collateral
- Third-party guarantees issued on behalf of the affiliate
- Securities lending or borrowing transactions;
- Repo and reverse repo transactions

iii. *Fees Paid by Subsidiaries:*

Management or service fees are another cash outflow of bank subsidiaries. These fees may be paid to the parent, the nonbank subsidiaries, or, in some cases, to the other bank subsidiaries. Regulatory concern focuses on whether such fees are reasonable in relation to the services rendered and on the financial impact of the fees on the bank subsidiaries.

iv. *Tax Allocation:*

How a Financial holding company organization determines to allocate taxes among its component companies involves questions of both the magnitude and timing of the cash-flow effects. Unreasonable or untimely tax payments or refunds to the bank can have an adverse effect on the financial condition of the banking subsidiaries.

v. *Purchases or Swaps of Assets:*

Asset purchases or swaps between a bank and its affiliates can create the potential for abuse of subsidiary banks. Regulatory concern focuses on the fairness of such asset transactions and their financial impact and timing. Fairness and financial considerations include the quality and collectability and fair values of such assets and their liquidity effects. IDIs generally are prohibited from purchasing low-quality assets from affiliates. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with non-earning assets. Improper timing or certain structuring of asset transactions also can cause them to be regarded as extensions of credit to affiliates. As such, these types of transactions could potentially violate applicable regulations and statutes.

vi. *Compensating Balances:*

A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The

subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

vii. *Other Expense Allocations:*

In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. Furthermore, a subsidiary bank should not pay for expenses for which it does not receive a benefit.

3.3.2.3. INSIDER LENDING AND RELATED INTEREST TRANSACTIONS

Business transactions between a parent Financial Holding Company (FHC) or its nonbank subsidiary and a holding company official or an official's related interests require close supervisory review. "*Financial holding company official*" is defined as any director, executive officer, or principal shareholder of the parent company or any of its subsidiaries, excluding the subsidiary financial holding company's nonbank subsidiaries. In a sense, most of these transactions are usually well structured and have a legitimate business purpose that result in equitable treatment for all parties. However, examiners should pay close attention to all extensions of credit by a FHC or its nonbank subsidiary to a FHC official or related interest to ensure that the terms of the credit, particularly interest-rate and collateral terms, are not preferential and that the credit does not involve more than a normal risk of repayment.

Abusive and Self-Serving Lending:

An extension of credit by an FHC or nonbank subsidiary may be considered abusive or self-serving if its terms are unfavourable to the lender, or if the credit would not have been extended on the same terms if there was no official relationship; that is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist.

Supervisory Guidance:

When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained. A Related Party-Lending is considered non-abusive if it meets the following criteria amongst others:

- Is extended in the ordinary course of the company's consumer credit business,
- Is a kind of credit generally made available to the public, and
- Is made on market terms or on terms that are no more favourable than those offered to the general public.

Other transactions involving FHC officials, their related interests, and the FHC and nonbank subsidiary that should be reviewed by the examiners include the —

- Purchase of assets or services from the FHC or nonbank subsidiary, particularly if at a discount or on preferential terms;
- Sale of assets or services to the FHC or nonbank subsidiary, particularly if at a premium;
- Lease of property to or from the FHC or nonbank subsidiary; and
- Use of FHC or nonbank subsidiary property or personnel by a FHC official or related interest

Inspection Procedures

- Review the balance sheets and other records of the parent-only and nonbank subsidiaries to determine if there are any loans or other extensions of credit to FHC officials
- Review the income statements and supporting records of the parent-only and nonbank subsidiaries to determine if any interest income, other income, or expense is associated with a transaction with a FHC official or a related interest.
- Ask management to identify all such transactions and to provide supporting documentations
- Review management's familiarity with relevant regulation as it concerns related party transactions and the steps they have taken to establish policies for the internal administration of their subsidiary banks' extensions of credit to FHC officials or other connected parties.
- Review any information prepared by management that presents a listing of all FHC officials and their related interests.

3.3.2.4. QUANTITATIVE AND QUALITATIVE LIMITS TO INTRAGROUP TRANSACTIONS

Holding Company regulators in many international financial jurisdictions apply a number of quantitative and qualitative guidelines for FHCs with respect to intercompany and related party transactions:

Quantitative Limits

- Covered transactions or exposures between an IDI and any one non-bank affiliate should not exceed 10% of the bank's shareholder's funds (i.e. paid-up capital plus surplus)
- Covered transactions or exposures between an IDI and all affiliates together should not exceed 20% of the bank's shareholder's funds
- On a consolidated basis, the aggregate of all large exposures should not exceed eight times (8x) the shareholders' funds unimpaired by losses.
- The holding company regulator should require that any extension of credit to, or guarantee issued on behalf of, an affiliate, or the acceptance of an affiliate's letter of credit, be collateralized from 100% to 130% of the value of the transaction, depending on the nature of the collateral – Debt obligations of an affiliate are prohibited as collateral for a covered transaction

Qualitative Limits:

- IDI transactions with affiliates should be conducted at 'arms-length' or on 'fair-market' terms. Thus, the holding company regulator requires that all such transactions be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the FHC or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies; OR in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies or the general public
- The regulator requires that any covered transaction be on terms and conditions that are consistent with safe and sound banking practices
- Exposures on a consolidated group basis shall consist of the total of the parent bank's exposure and/or exposures of individual companies in the banking group to an individual customer or related persons

- The bank may not purchase any "low quality" asset from an affiliate the bank may not accept a "low quality" asset as collateral for an extension of credit to guarantee on behalf of, or acceptance of a letter or credit from, an affiliate. Low quality" assets include:
    - Substandard, doubtful, or loss assets
    - Assets currently on nonaccrual
    - Assets that are 30 or more days past due
- The holding company regulator generally prohibits:
    - A bank, in its fiduciary capacity, purchasing securities issued by an affiliate
    - A bank purchasing securities during the existence of an underwriting or selling syndicate, if an affiliate is the principal underwriter
    - A bank advertising or entering into an agreement implying or suggesting that the bank will be responsible for the obligations of the affiliate

3.4. LIQUIDITY RISK MANAGEMENT AND SUPERVISION IN FINANCIAL CONGLOMERATES

In earlier sections, we mentioned that financial conglomerates are required to be a source of financial strength to their subsidiaries. This underscores the importance of the supervision of liquidity risk management in FHCs as an important aspect of quantitative consolidated supervision. Principle 20 of the Joint Forums' *Principles for the Supervision of Financial Conglomerates* (cited in BIS, 2012b) states clearly that 'supervisors should require that the head of the financial conglomerate adequately and consistently identify, measure, monitor, and manage its liquidity risks and the liquidity risks of the financial conglomerate. Supervisors should require that liquidity be sufficient across the financial conglomerate to meet funding needs in normal times and periods of stress.'

Where a financial conglomerate is part a wider group, supervisors should have timely access to information concerning the wider group's liquidity position and risks to that liquidity position, to enable the evaluation of the adequacy of the liquidity position of the financial conglomerate in the context of its relationship to the wider group. Conglomerates should develop and maintain liquidity management processes and funding programs that are consistent with their complexity, risk profile, and scope of operations. Appropriate liquidity risk management is especially important since liquidity difficulties can easily spread to subsidiaries, particularly in cases of similarly named companies where customers may not always understand the legal distinctions between constituent entities. Generally, financial conglomerates that are active in key financial markets or operate specific funding programs should: (a) maintain sufficient liquidity, cash flow, and capital strength to service debt obligations and cover fixed charges; (b) assess the potential that funding strategies could undermine public confidence in the liquidity or stability of constituent entities; and (c) ensure the adequacy of policies and practices addressing the stability of funding and integrity of the institution's liquidity risk profile as evidenced by funding mismatches and the degree of dependence on potentially volatile sources of short-term funding.

The rest of this section summarises the key observations of a review of funding liquidity risk management practices[8] in selected financial conglomerates engaged in banking, securities, and

[8] Funding liquidity risk is the risk that the firm will not be able to efficiently meet both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the firm.

insurance activities. The review was conducted by the Joint Forum's[9] Working Group on Risk Assessment and Capital and was published by the Bank for International Settlements (BIS, 2006). The review focused on 40 large, complex financial groups with operations spanning national borders, financial sectors, and currencies. The majority of the financial institutions represented in the review were involved in at least two of the banking, securities, or insurance sectors[10]. All observations are based on information and opinions provided by the firms through written responses to a survey, interviews, and presentations to the Working Group.

3.4.1. SOURCES OF LIQUIDITY STRAIN IN FINANCIAL CONGLOMERATES

Liquidity risk arises from many sources, including a financial firm's business decision to provide liquidity to the markets, potential damage to a firm's reputation, specific products and activities, and potential changes in the macroeconomic environment.

3.4.1.1. EVENT-DRIVEN SOURCES

Ratings downgrades or other negative news leading to a loss of market confidence in a firm were cited as the most significant firm-specific sources of liquidity risk across the sectors. For securities firms, a downgrade or other loss of market confidence would impact the firms' ability to refinance current unsecured debt obligations, which are their primary sources of funding for activities that cannot be self-financed. For insurers, such a triggering event would typically cause many policyholders to consider surrendering their policies provided that the contractual and economic conditions are fulfilled. In addition, many reinsurance contracts include a ratings-downgrade trigger under which collateral is required when the rating of the counterparty falls below investment grade. For banking organizations, a downgrade can result in reduced market access to unsecured borrowings (e.g. commercial paper) from institutional investors, a reduction or cancellation of inter-bank credit lines, or a reduction of deposits. Downgrades or other material, negative, firm-specific news or rumours can also increase liquidity demands through margin calls, requirements to post additional collateral, the need to provide credit enhancements or backup lines for securitizations, and the need to fund assets no longer capable of being sold or transferred via securitization.

Funding liquidity risk also arises from *systemic events*, such as Long-Term Capital Management's near-collapse following the 1998 Russian bond default, or external events and catastrophes resulting in large claims on insurers. Financial groups find that preparing for systemic events presents challenges because scenario analysis requires in-depth and detailed determinations of appropriate assumptions regarding different sources of systemic risk, the speed and timing of the event, its impact across the various firms within the group, and the behavior of counterparties – information that is not easily derived from historical data.

It differs from the market liquidity risk, which is the risk that a firm cannot easily offset or eliminate a position without significantly affecting the market price because of inadequate market depth or market disruption. However, in many cases, the same factors may trigger both types of liquidity risk.

[9] i.e. Basel Committee on Banking Supervision, International Organization of Securities Commissions, and International Association of Insurance Supervisors

[10] When categorized by their most prominent sector, groups include 23 firms primarily in banking, five primarily in securities, and 12 primarily in insurance. Fourteen of them have significant activity in all three sectors.

3.4.1.2. TRANSACTION- AND PRODUCT-DRIVEN SOURCES

The survey indicated that the primary transaction- and product-driven sources of liquidity risk involve derivatives, other off-balance sheet instruments, and on-balance sheet insurance contracts with embedded optionality. The most significant sources of transaction-driven liquidity risk at securities firms, and among the more significant sources at banking firms, are over-the-counter (OTC) derivative transactions and stock-borrowing transactions, where sharp and unanticipated market movements or events, such as an unanticipated bankruptcy, default, or ratings downgrade, could cause demand for additional collateral from counterparties[11]. Similar pressures on firms' (especially banks' and securities firms') liquidity positions can arise from collateral calls from exchanges in connection with foreign exchange and securities transactions, margin and collateral agreements in the OTC derivative market or repo market, liability mismatches arising from settlement systems requiring effective hedging or increased collateralization, and short positions in financial options with cash delivery. Firms reported that the liquidity risks from these sources have been increasing over recent years. Margin requirements for collateralized transactions are becoming more common because the rating agencies require high collateralization levels and ratings-downgrade triggers to support their highest credit ratings. Higher trading volumes, information-efficient markets, and ratings linked behaviors of market participants have contributed to funding liquidity pressures for some firms.

Off-balance sheet exposures also contribute to liquidity risk at banking firms during times of stress. Key off-balance sheet products that can give rise to sudden material demands for liquidity at banking firms include committed lending facilities to customers, committed backstop facilities to commercial paper conduits, and committed back-up lines to special purpose vehicles. Insurance contracts offering policyholders the right, at regular intervals, to surrender a contract on guaranteed terms give rise to liquidity risk. Another commonly mentioned product was linked funds, where investors are entitled to demand redemptions; funds holding illiquid assets such as real estate are especially problematic. Other products mentioned by a few firms include swaps, futures, and put options sold by the firm that might need collateralization, and reinsurance or other contracts containing rating triggers.

3.4.1.3. MARKET TRENDS

In addition to specific products and activities, firms noted certain market trends that may increase liquidity risk. Banking firms noted that a movement to more volatile funding sources, such as wholesale funds, brokered certificates of deposit, and internet banking, and depositors' ability to switch funds among accounts by electronic means, have complicated liquidity risk management. Insurance firms noted that they are selling a larger volume of savings-based products as opposed to protection products and there is also greater awareness by customers of the options available to them in various insurance products. Growth in insurers' institutional business has increased the proportion of the customer base that is operating with large volumes of assets that can be switched to new firms or products with relative ease.

[11] In a stock borrow transaction, the firm borrows securities and provides cash as collateral in an amount equal to the value of the securities borrowed. If the market value of the securities increases, the firm will be called upon to provide additional cash collateral or return some of the borrowed securities.

3.4.2. LIQUIDITY RISK MANAGEMENT IN FINANCIAL CONGLOMERATES

3.4.2.1. METRICS USED FOR LIQUIDITY MANAGEMENT

Most financial firms use a variety of metrics to monitor the level of liquidity risk to which they are exposed. The basic approaches may be categorised into three types: (1) the liquid assets approach, (2) the cash flow approach, and (3) a mixture of the two.

- Under the *liquid assets approach*, the firm maintains liquid instruments on its balance sheet that can be drawn upon when needed. As a variation on this approach, the firm may maintain a pool of unencumbered assets (usually government securities) that can be used to obtain secured funding through repurchase agreements and other secured facilities. (The relevant metrics in this approach are ratios.)
- Under the *cash flow matching* approach, the firm attempts to match cash outflows against contractual cash inflows across a variety of near-term maturity buckets.
- The *mixed approach* combines elements of the cash flow matching approach and the liquid assets approach. The firm attempts to match cash outflows in each time bucket against a combination of contractual cash inflows plus inflows that can be generated through the sale of assets, repurchase agreement or other secured borrowing. Assets that are most liquid are typically counted in the earliest time buckets, while less liquid assets are counted in later time buckets.

Because, as stated above, most firms use several metrics, there will be some overlap in the approaches taken by firms in the three sectors. Nonetheless, the Working Group's survey revealed notable sectoral leanings. The liquid assets approach is the most commonly used approach in the securities sector for both normal and stress environments. It is used to a lesser extent in the banking and insurance sectors. These two sectors place more emphasis on the cash flow matching approach. When gaps in maturity buckets are unfavourable, banks and insurance companies would utilise the mixed approach to help ensure that they will be able to meet their obligations to provide cash to counterparties.

3.4.2.2. LIQUIDITY RISK MANAGEMENT PRACTICES

The Working Group reviewed the extent to which financial groups integrate liquidity risk management across sectors. Firms in each of the three sectors (banking, securities and insurance) monitor and manage liquidity risk primarily through:

(1) The use of risk limits,
(2) Monitoring systems, and
(3) Scenario analyses that are incorporated into contingency funding plans (CFPs).

However, given differences in business lines[12] and funding mix, liquidity risk management is mostly separated in financial groups that contain firms operating in multiple sectors. With few exceptions, liquidity risk management is not well integrated in groups conducting an insurance

[12] The term "business line" refers to the traditional business activities and balance sheets in each sector. Banking institutions fund long-term, illiquid instruments (e.g. loans) with short-term non-contractual funding sources (e.g. deposits). Securities firms' balance sheets are made up primarily of highly liquid securities (trading assets) that are funded through secured transactions such as repurchase agreements and stock loans. Insurance companies, especially life insurance companies, take on long-term liabilities that are invested in assets with an emphasis on matched funding.

business as well as banking and/or securities businesses. Conglomerates generally have integrated to some extent liquidity risk management across the banking and securities business lines, although the degree of integration varies considerably among firms.

The Working Group also studied differences in liquidity risk management practices within individual sectors. Factors that appear to have a significant influence on a firm's approach to liquidity risk management include:

- Scope of international operations,
- Level of complexity of activities undertaken in different jurisdictions in which the group is present,
- Types of foreign currency exposure,
- Supervisory requirements,
- Legal environment and restrictions,
- Commercial market environment, and
- National markets.

The Working Group found a greater range of practice within the banking sector than within the securities and insurance sectors in areas such as liquidity risk measures and limits, types of scenarios, time considerations, and underlying assumptions. Some of the surveyed firms indicate that regulations may have an impact on the design of their structures for managing liquidity risk. Some regulatory restrictions impede the movement of liquidity across jurisdictions; for example, regulatory restrictions may give rise to the need to maintain liquid assets in separate jurisdictions and currencies, rather than in a single pool. Products and activities that give rise to liquidity risk include (1) derivatives, (2) other off-balance sheet instruments, and (3) on-balance sheet contracts with embedded optionality. Additionally, certain market trends serve to increase the amount of liquidity risk to which firms are exposed. These include changes in funding sources and greater customer awareness of product options.

Firms' assumptions regarding available sources of liquidity in a stress situation are reflected in their CFPs. Most importantly, where allowed, firms nearly universally expect to raise funds through secured borrowing during times of stress. Firms take into account the possibility that they will face operational risk in the short-term secured funding market or in clearing and other market mechanisms during a liquidity stress event. However, an implicit, and in some cases explicit, assumption that the official sector would address any operational risk that causes widespread disruption across multiple markets is embedded in certain firms' scenario analyses.

In the area of stress testing, the Working Group reviewed the extent to which tests incorporate both *firm-specific* and *market-wide shocks* and the level and depth of stress tests. Most firms test liquidity using firm-specific shocks, generally the impact of a rating agency downgrade. Scenarios that combine a firm-specific stress event with a time of general market stress are utilised by all of the surveyed securities and insurance firms. In the banking sector, about one-third of surveyed banks test the impact of a firm-specific event within an unsettled market environment, while approximately two-thirds simulate firm-specific and market events separately. The outcomes of stress tests across firms should be interpreted carefully in light of differences in the nature of stress

tests across and within the three sectors. With a few exceptions, liquidity stress testing is also conducted at the subsidiary level when it is conducted at the group level.

3.4.2.3. LIQUIDITY RISK MANAGEMENT: KEY SUPERVISORY ACTIONS

In line with the guidance provided by the Joint Forum (BIS, 2012b), supervisors should pay attention to the following in supervising the management of liquidity in financial conglomerates:

- Supervisors should require that the financial holding company develops and maintains liquidity management processes and funding programs that are consistent with the complexity, risk profile, and scope of operations of the financial conglomerate.
- Supervisors should require that liquidity risk management processes and funding programs take into full account lending, investment, and other activities, and ensure that adequate liquidity is maintained at the head and each constituent entity within the financial conglomerate. Processes and programs should fully incorporate real and potential constraints, including legal and regulatory restrictions, on the transfer of funds among these entities and between these entities and the head.
- Supervisors should require that liquidity risks are managed with: 1) effective governance and management oversight as appropriate; 2) adequate policies, procedures, and limits on risk taking; and 3) strong management information systems for measuring, monitoring, reporting, and controlling liquidity risks.
- Supervisors should require that risks undertaken should be managed with:
    - Effective governance and management oversight as appropriate;
    - Adequate policies, procedures, and limits on risk taking; and
    - Strong management information systems for measuring, monitoring, reporting, and controlling liquidity risks.
- Supervisors should have adequate access to the information necessary to maintain an understanding and assessment of these functions.

CHAPTER 4: RATING SYSTEM FOR EVALUATING FINANCIAL CONGLOMERATES

Supervisors can use the information obtained from both quantitative and qualitative supervision to develop a risk assessment of a financial group in conformance with international best practice principles. The rating system discussed in this chapter is essentially drawn from the rating model used by the Federal Reserve System for Bank Holding Companies (BHCs) and Financial Holding Companies (FHCs) – see Federal Reserve System (2013a). For the purpose of this chapter, we refer to FHCs as representing either banking groups or financial conglomerates.

Each FHC is assigned a composite rating "C" based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The main components of the rating system represent *Risk management* (R); *Financial condition* (F); and *potential Impact* (I) of the parent company and non-depository subsidiaries (collectively non-depository entities) on the subsidiary depository institution(s). While all FHCs are required to act as sources of strength to their subsidiary depository institutions, the impact rating (I) focuses on downside risk— that is, on the likelihood of significant negative Impact on the subsidiary depository institutions. A fourth component rating, *Depository institution* (D), will generally mirror the primary regulator's assessment of the subsidiary depository institution(s). Thus, the primary component and composite ratings are displayed:

RFI/C (D)

To provide a consistent framework for assessing risk management, the R component is supported by four subcomponents that reflect the effectiveness of the banking organization's risk management and controls. The subcomponents are (1) board and senior management oversight; (2) policies, procedures, and limits; (3) risk monitoring and MIS; and (4) internal controls. The F component is similarly supported by four subcomponents reflecting an assessment of the quality of the consolidated financial organization's (1) capital, (2) asset quality, (3) earnings, and (4) liquidity.

The FHC rating system requires analysis and support for FHCs of all sizes. As such, the level of analysis and support will vary based upon whether a FHC has been determined to be "complex" (e.g. large multiple financial services conglomerate) or "non-complex" (e.g. one or more small or mid-sized banking groups or financial services firms). In addition, the resources dedicated to the inspection of each FHC will continue to be determined by the risk posed by the subsidiary depository institution(s) to the government's safety net and the risk posed by the FHC to the subsidiary depository institution(s). A simplified version of the rating system that requires only the assignment of the risk-management component rating and composite rating could be applied to noncomplex FHCs with assets below $1 billion[13].

Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A 1 indicates the highest rating, strongest performance and practices, and least degree of supervisory concern; a 5 indicates the lowest rating, weakest performance, and highest degree of supervisory

[13] This benchmark is for the US and will be different across financial jurisdictions.

concern. All of the FHC numeric ratings, including the composite, component, and subcomponent ratings, should be presented in the report of inspection, in accordance with the regulatory institution's supervisory practices. The management of each FHC under inspection should be made aware of the fact that this rating is furnished solely for its confidential use and under no circumstances should the FHC or any of its directors, officers, or employees disclose or make public any of the ratings.

The following two sections contain detailed descriptions of the composite, component, and subcomponent ratings; and definitions of the ratings.

4.1. DESCRIPTION OF THE FHC RATING SYSTEM ELEMENTS

(1) The Composite (C) Rating

"C" is the overall composite assessment of the FHC as reflected by consolidated risk management, consolidated financial strength, and the potential impact of the non-depository entities on the subsidiary depository institutions. The composite rating encompasses both a forward looking and static assessment of the consolidated organization, as well as an assessment of the relationship between the depository and non-depository entities. Consistent with current international best practice, the C rating is not derived as a simple numeric average of the R, F, and I components; rather, it reflects examiner judgment with respect to the relative importance of each component to the safe and sound operation of the FHC.

(2) The Risk-Management (R) Component

"R" represents an evaluation of the ability of the FHC's board of directors and senior management, as appropriate for their respective positions, to identify, measure, monitor, and control risk. The R rating underscores the importance of the control environment, taking into consideration the complexity of the organization and the risk inherent in its activities.

The R rating is supported by four subcomponents that are each assigned a separate rating. The four subcomponents are as follows: (1) board and senior management oversight; (2) policies, procedures, and limits; (3) risk monitoring and MIS; and (4) internal controls. The subcomponents are evaluated in the context of the risks undertaken by and inherent in a banking organization and the overall level of complexity of the firm's operations. They provide the regulator with a consistent framework for evaluating risk management and the control environment.

Board and Senior Management Oversight

This subcomponent evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the FHC's activities, as well as the general capabilities of management. It also includes consideration of management's ability to identify, understand, and control the risks undertaken by the institution, to hire competent staff, and to respond to changes in the institution's risk profile or innovations in the banking sector.

Policies, Procedures, and Limits

This subcomponent evaluates the adequacy of a FHC's policies, procedures, and limits given the risks inherent in the activities of the consolidated FHC and the organization's stated goals and

objectives. This analysis will include consideration of the adequacy of the institution's accounting and risk-disclosure policies and procedures.

Risk Monitoring and Management Information Systems
This subcomponent assesses the adequacy of a FHC's risk measurement and monitoring, and the adequacy of its management reports and information systems. This analysis will include a review of the assumptions, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the organization's activities.

Internal Controls
This subcomponent evaluates the adequacy of a FHC's internal controls and internal audit procedures, including the accuracy of financial reporting and disclosure and the strength and influence of the internal audit team within the organization. This analysis will also include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the organization.

(3) The Financial-Condition (F) Component
"F" represents an evaluation of the consolidated organization's financial strength. The F rating focuses on the ability of the FHC's resources to support the level of risk associated with its activities. The F rating is supported by four subcomponents: capital (C), asset quality (A), earnings (E), and liquidity (L). The CAEL sub-components can be evaluated along individual business lines, product lines, or on a legal-entity basis, depending on what is most appropriate given the structure of the organization. The assessment of the CAEL components should use benchmarks and metrics appropriate to the business activity being evaluated. Consistent with current supervisory practices, examination staff should continue to review relevant market indicators, such as external debt ratings, credit spreads, debt and equity prices, and qualitative rating-agency assessments as a source of information complementary to examination findings.

Capital Adequacy
"C" reflects the adequacy of an organization's consolidated capital position, from a regulatory capital perspective and an economic capital perspective, as appropriate to the FHC. The evaluation of capital adequacy should consider the risk inherent in an organization's activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the level and composition of the parent company and subsidiaries' debt.

Asset Quality
"A" reflects the quality of an organization's consolidated assets. The evaluation should include, as appropriate, both on-balance-sheet and off-balance-sheet exposures and the level of criticized and nonperforming assets. Forward-looking indicators of asset quality, such as the adequacy of underwriting standards, the level of concentration risk, the adequacy of credit administration policies and procedures, and the adequacy of MIS for credit risk, may also form the regulator's view of asset quality.

Earnings

"E" reflects the quality of consolidated earnings. The evaluation considers the level, trend, and sources of earnings, as well as the ability of earnings to augment capital as necessary to provide ongoing support for a FHC's activities.

Liquidity
"L" reflects the consolidated organization's ability to attract and maintain the sources of funds necessary to support its operations and meet its obligations. The funding conditions for each of the material legal entities in the holding company structure should be evaluated to determine if any weaknesses exist that could affect the funding profile of the consolidated organization.

(4) The Impact (I) Component
Like the other components and subcomponents, the 'I' component is rated on a five-point numerical scale. However, the descriptive definitions of the numerical ratings for I are different than those of the other components and subcomponents. The I ratings are defined as follows:
1—low likelihood of significant negative impact
2 —limited likelihood of significant negative impact
3 —moderate likelihood of significant negative impact
4—considerable likelihood of significant negative impact
5—high likelihood of significant negative impact

The I component is an assessment of the potential impact of the non-depository entities (e.g. insurance and securities) on the subsidiary depository institution(s). The 'I' assessment will evaluate both the risk management practices and financial condition of the non-depository entities—an analysis that will borrow heavily from the analysis conducted for the R and F components. Consistent with current practices, non-depository entities will be evaluated using benchmarks and analysis appropriate for those businesses. In addition, for functionally regulated non-depository subsidiaries, examination staff will continue to rely, to the extent possible, on the work of those functional regulators to assess the risk management practices and financial condition of those entities. In rating the 'I' component, examination staff is required to evaluate the degree to which current or potential issues within the non-depository entities present a threat to the safety and soundness of the subsidiary depository institution(s).

In this regard, the 'I' component will give a clearer indication of the degree of risk posed by the non-depository entities to the federal safety net than does the current rating system. The 'I' component focuses on the aggregate impact of the non-depository entities on the subsidiary depository institution(s). In this regard, the 'I' rating does not include individual subcomponent ratings for the parent company and non-depository subsidiaries. An 'I' rating is assigned always for each FHC; however, as is currently the case, nonmaterial non-depository subsidiaries may be excluded from the 'I' analysis at the examiner's discretion. Any risk-management and financial issues at the non-depository entities that potentially impact the safety and soundness of the subsidiary depository institution(s) should be identified in the written comments under the 'I' rating. This approach is consistent with the central bank's objective not to extend bank like supervision to non-depository entities.

The analysis of the parent company for the purpose of assigning an 'I' rating should emphasize weaknesses that could directly impact the risk-management or financial condition of the subsidiary depository institution(s). Similarly, the analysis of the non-depository subsidiaries for the purpose of assigning an 'I' rating should emphasize weaknesses that could negatively impact the parent company's relationship with its subsidiary depository institution(s) and weaknesses that could have a direct impact on the risk-management practices or financial condition of the subsidiary depository institution(s).

The analysis under the I component should consider existing as well as potential issues and risks that may impact the subsidiary depository institution(s) now or in the future. Particular attention should be paid to the following risk management and financial factors in assigning the I rating:

Risk-Management Factors

- *Strategic considerations.* The potential risks posed to the subsidiary depository institution(s) by the non-depository entities' strategic plans for growth in existing activities and expansion into new products and services.
- *Operational considerations*. The spillover impact on the subsidiary depository institution(s) from actual losses, a poor control environment, or an operational loss history in the non-depository entities.
- *Legal and reputational considerations.* The spillover effect on the subsidiary depository institution(s) of complaints and litigation that name one or more of the non-depository entities as defendants, or involve violations of laws or regulations, especially pertaining to intercompany transactions where the subsidiary depository institution(s) is involved.
- *Concentration considerations.* The potential risks posed to the subsidiary depository institution(s) by concentrations within the non-depository entities in business lines, geographic areas, industries, customers, or other factors.

Financial Factors

- *Capital distribution.* The distribution and transferability of capital across the legal entities.
- *Intra-group exposures*. The extent to which intra-group exposures, including servicing agreements, have the potential to undermine the condition of subsidiary depository institution(s).
- *Parent company cash flow and leverage.* The extent to which the parent company is dependent on dividend payments, from both the non-depository subsidiaries and the subsidiary depository institution(s), to service debt and cover fixed charges. Also, the effect that these upstreamed cash flows have had, or can be expected to have, on the financial condition of the FHC's non-depository subsidiaries and subsidiary depository institution(s).

(5) The Depository Institutions (D) Component

The (D) component will reflect generally the composite CAMELS rating assigned by the subsidiary depository institution's primary supervisor. In a multi-bank FHC, the (D) rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institutions, weighted by both asset size and the relative importance of each depository institution within the holding company structure. In this regard, the CAMELS composite rating for a subsidiary depository institution that dominates the corporate culture may figure more

prominently in the assignment of the (D) rating than would be dictated by asset size, particularly when problems exist within that depository institution.

The (D) component conveys important supervisory information, reflecting the primary supervisor's assessment of the legal entity. The (D) component stands outside of the composite rating, although significant risk-management and financial-condition considerations at the depository institution level are incorporated in the consolidated R and F ratings, which are then factored into the C rating.

Consistent with current practice, if, in the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Central Bank and the depository institution's primary regulator, then the (D) rating should reflect the Central Bank's evaluation.

To highlight the presence of one or more problem depository institution(s) in a multibank FHC whose depository institution component, based on weighted averages, might not otherwise reveal their presence (i.e., depository institution ratings of 1, 2, or 3), a problem modifier, P, would be attached to the depository institution rating (e.g., 1P, 2P, or 3P). Thus, 2P would indicate that, while on balance the depository subsidiaries are rated Satisfactory, there exists a problem depository institution (composite 4 or 5) among the subsidiary depository institutions. The problem identifier is unnecessary when the depository institution component is rated 4 or 5.

4.2. RATING DEFINITIONS FOR THE RFI/C (D) RATING SYSTEM

As noted earlier, all component and subcomponent ratings are rated on a five-point numeric scale. With the exception of the 'I' component, ratings will be assigned in ascending order of supervisory concern as follows:

1—Strong
2—Satisfactory
3—Fair
4—Marginal
5—Unsatisfactory

As is current practice in the US, the component ratings are not derived as a simple numeric average of the subcomponent ratings; rather, weight afforded to each subcomponent in the overall component rating will depend on the severity of the condition of that subcomponent and the relative importance of that subcomponent to the consolidated organization. Similarly, some components may be given more weight than others in determining the composite rating, depending on the situation of the FHC. Assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the FHC, although generally the composite rating bears a close relationship to the component ratings assigned.

Composite Rating

Rating 1 (Strong). FHCs in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Risk-management practices and financial condition provide resistance to external economic and financial disturbances. Cash flow is more than adequate to service debt and other fixed obligations, and the non-depository entities pose little risk to the subsidiary depository institution(s).

Rating 2 (Satisfactory). FHCs in this group are fundamentally sound but may have modest weaknesses in risk-management practices or financial condition. The weaknesses could develop into conditions of greater concern but are believed correctable in the normal course of business. As such, the supervisory response is limited. Cash flow is adequate to service obligations, and the non-depository entities are unlikely to have a significant negative impact on the subsidiary depository institution(s).

Rating 3 (Fair). FHCs in this group exhibit a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe. These companies are less resistant to the onset of adverse business conditions and would likely deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, these companies are vulnerable and require more-than normal supervisory attention and financial surveillance. However, the risk-management and financial capacity of the company, including the potential negative impact of the non-depository entities on the subsidiary depository institution(s), pose only a remote threat to its continued viability.

Rating 4 (Marginal). FHCs in this group have significant risk-management and financial weaknesses, which may pose a heightened risk of significant negative impact on the subsidiary depository institution(s). The holding company's cash-flow needs is being met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, the organization's future viability could be impaired. These companies require close supervisory attention and substantially increased financial surveillance.

Rating 5 (Unsatisfactory). The magnitude and character of the risk-management and financial weaknesses of FHCs in this category, and concerns about the non-depository entities negatively impacting the subsidiary depository institution(s), could lead to insolvency without urgent aid from shareholders or other sources. The imminent inability to prevent liquidity and/or capital depletion places the FHC's continued viability in serious doubt. These companies require immediate corrective action and constant supervisory attention.

Risk-Management Component

Rating 1 (Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the FHC's activities. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward-looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and are understood, reviewed, and approved by the board. Policies and limits are supported by risk monitoring procedures, reports, and MIS that provide management and the board with the information and analysis that is necessary to make timely and appropriate decisions in response to changing conditions. Risk-management practices and the organization's

infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient experience, expertise, and depth to manage the risks assumed by the institution.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with the standards of safety and soundness, and in accordance with internal and supervisory policies and practices. Risk-management processes are fully effective in identifying, monitoring, and controlling the risks to the institution.

Rating 2 (Satisfactory). A rating of 2 indicates that the institution's management of risk is largely effective but lacking in some modest degree. Management demonstrates a responsiveness and ability to cope successfully with existing and foreseeable risks that may arise in carrying out the institution's business plan. Although the institution may have some minor risk management weaknesses, these problems have been recognized and are in the process of being resolved. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and MIS are considered satisfactory and effective in maintaining a safe and sound institution. Risks are controlled in a manner that does not require more-than-normal supervisory attention.

The FHC's risk-management practices and infrastructure are satisfactory and generally are adjusted appropriately in response to changing industry practices and current regulatory guidance. Staff experience, expertise, and depth are generally appropriate to manage the risks assumed by the institution. Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). A rating of 3 signifies that risk-management practices are lacking in some important ways and, therefore, are a cause for more-than-normal supervisory attention. One or more of the four elements of sound risk management (active board and senior management oversight; adequate policies, procedures, and limits; adequate risk-management monitoring and MIS; comprehensive internal controls) are considered less than acceptable and has precluded the institution from fully addressing one or more significant risks to its operations. Certain risk-management practices need improvement to ensure that management and the board are able to identify, monitor, and control all significant risks to the institution.

Also, the risk-management structure may need to be improved in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. In addition, management's response to changing industry practices and regulatory guidance may need to improve. The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by a failure to adhere to written policies and procedures. The risk-management weaknesses could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). A rating of 4 represents deficient risk-management practices that fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are deficient and requires immediate and concerted corrective action by the board and management. The institution may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in internal control or accounting procedures, or improved adherence to supervisory standards or requirements. The risk-management deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). A rating of 5 indicates a critical absence of effective risk management practices with respect to the identification, monitoring, or control over significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient, and management and the board have not demonstrated the capability to address these deficiencies.

Internal controls are critically weak and, as such, could seriously jeopardize the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and the potential for losses if corrective measures are not taken immediately. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

Financial-Condition Component

Rating 1 (Strong). A rating of 1 indicates that the consolidated FHC is financially sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. The capital adequacy, asset quality, earnings, and liquidity of the consolidated FHC are more than adequate to protect the company from reasonably foreseeable external economic and financial disturbances. The company generates more-than-sufficient cash flow to service its debt and fixed obligations with no harm to subsidiaries of the organization.

Rating 2 (Satisfactory). A rating of 2 indicates that the consolidated FHC is fundamentally financially sound but may have modest weaknesses correctable in the normal course of business. The capital adequacy, asset quality, earnings, and liquidity of the consolidated FHC are adequate to protect the company from external economic and financial disturbances. The company also generates sufficient cash flow to service its obligations; however, areas of weakness could develop into areas of greater concern. To the extent minor adjustments are handled in the normal course of business, the supervisory response is limited.

Rating 3 (Fair). A rating of 3 indicates that the consolidated FHC exhibits a combination of weaknesses ranging from fair to moderately severe. The company has less-than-adequate financial strength stemming from one or more of the following: modest capital deficiencies, substandard asset quality, weak earnings, or liquidity problems. As a result, the FHC and its subsidiaries are less resistant to adverse business conditions. The financial condition of the FHC will likely deteriorate if concerted action is not taken to correct areas of weakness. The company's cash flow is sufficient to meet immediate obligations but may not remain adequate if action is not taken to

correct weaknesses. Consequently, the FHC is vulnerable and requires more-than-normal supervision. Overall financial strength and capacity are still such as to pose only a remote threat to the viability of the company.

Rating 4 (Marginal). A rating of 4 indicates that the consolidated FHC has either inadequate capital, an immoderate volume of problem assets, very weak earnings, serious liquidity issues, or a combination of factors that are less than satisfactory. An additional weakness may be that the FHC's cash flow needs are met only by upstreaming imprudent dividends and/or fees from subsidiaries. Unless prompt action is taken to correct these conditions, they could impair future viability. FHCs in this category require close supervisory attention and increased financial surveillance.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the volume and character of financial weaknesses of the FHC are so critical as to require urgent aid from shareholders or other sources to prevent insolvency. The imminent inability of such a company to service its fixed obligations and/or prevent capital depletion due to severe operating losses places its viability in serious doubt. Such companies require immediate corrective action and constant supervisory attention

Impact Component
The 'I' component rating reflects the aggregate potential impact of the non-depository entities on the subsidiary depository institution(s). It is rated on a five-point numerical scale. Ratings will be assigned in ascending order of supervisory concern as follows:

1 —low likelihood of significant negative impact
2—limited likelihood of significant negative impact
3—moderate likelihood of significant negative impact
4—considerable likelihood of significant negative impact
5—high likelihood of significant negative impact

Rating 1 (low likelihood of significant negative impact). A rating of 1 indicates that the non-depository entities of the FHC are highly unlikely to have a significant negative impact on the subsidiary depository institution(s) due to the sound financial condition of the non-depository entities, the strong risk-management practices within the non-depository entities, or the corporate structure of the FHC. The FHC maintains an appropriate capital allocation across the organization commensurate with associated risks.

Intra-group exposures, including servicing agreements, are very unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is sufficient and not dependent on excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within or facing the non-depository entities are minor in nature and can be addressed in the normal course of business.

Rating 2 (limited likelihood of significant negative impact). A rating of 2 indicates a limited likelihood that the non-depository entities of the FHC will have a significant negative impact on the subsidiary

depository institution(s) due to the adequate financial condition of the non-depository entities, the satisfactory risk management practices within the parent non-depository entities, or the corporate structure of the FHC. The FHC maintains adequate capital allocation across the organization commensurate with associated risks. Intra-group exposures, including servicing agreements, are unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is satisfactory and generally does not require excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within the non-depository entities are modest and can be addressed in the normal course of business.

Rating 3 (moderate likelihood of significant negative impact). A rating of 3 indicates a moderate likelihood that the aggregate impact of the non-depository entities of the FHC on the subsidiary depository institution(s) will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk-management practices of the non-depository entities. The FHC may have only marginally sufficient allocation of capital across the organization to support risks. Intra-group exposures, including servicing agreements, may have the potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may at times require excessive dividend payments from subsidiaries. Strategic-growth plans, weaknesses in the control environment, risk concentrations, or legal or reputational issues within the non-depository entities may pose significant risks to the subsidiary depository institution(s). A FHC assigned a 3-impact rating requires more-than-normal supervisory attention, as there could be adverse effects on the safety and soundness of the subsidiary depository institution(s) if corrective action is not taken by management.

Rating 4 (considerable likelihood of significant negative impact). A rating of 4 indicates that there is a considerable likelihood that the non-depository entities of the FHC will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk-management practices of the non-depository entities. A 4-rated FHC may have insufficient capital within the non-depository entities to support their risks and activities. Intra-group exposures, including servicing agreements, may also have the immediate potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may be dependent on excessive dividend payments from subsidiaries. Strategic-growth plans, weaknesses in the control environment, risk concentrations, or legal or reputational issues within the non-depository entities may pose considerable risks to the subsidiary depository institution(s). A FHC assigned a 4-impact rating requires immediate remedial action and close supervisory attention because the non-depository entities could seriously affect the safety and soundness of the subsidiary depository institution(s).

Rating 5 (high likelihood of significant negative impact). A rating of 5 indicates a high likelihood that the aggregate impact of the non-depository entities of the FHC on the subsidiary depository institution(s) is or will become significantly negative due to substantial weaknesses in the financial condition and/or risk management practices of the non-depository entities. Strategic-growth plans, a deficient control environment, risk concentrations, or legal or reputational issues within the non-depository entities may pose critical risks to the subsidiary depository institution(s). The parent company also may be unable to meet its obligations without excessive support from the subsidiary

depository institution(s). The FHC requires immediate and close supervisory attention, as the non-depository entities seriously jeopardize the continued viability of the subsidiary depository institution(s).

Depository Institutions Component

The (D) component identifies the overall condition of the subsidiary depository institution(s) of the FHC. For FHCs with only one subsidiary depository institution, the (D) component rating generally will mirror the CAMELS composite rating for that depository institution. To arrive at a (D) component rating for FHCs with multiple subsidiary depository institutions, the CAMELS composite ratings for each of the depository institutions should be weighted, considering asset size and the relative importance of each depository institution within the overall structure of the organization. In general, it is expected that the resulting (D) component rating will reflect the lead depository institution's CAMELS composite rating.

If, in the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Central Bank and the depository institution's primary regulator, then the (D) rating should reflect the Central Bank's evaluation.

CHAPTER 5: CHALLENGES TO THE IMPLEMENTATION OF CONSOLIDATED SUPERVISION

As already revealed in this handbook, financial conglomerates are involved in a mix of several economic activities, including regulated and unregulated entities (such as special purpose entities and unregulated holding companies) across sectoral and international platforms. As a result, financial conglomerates present enormous supervisory challenges to regulators. This chapter attempts to review the numerous challenges facing the effective implementation of consolidated supervision and the efforts being made by the international community to address these problems. These problems range from legal and regulatory issues to transparency in financial groups, information sharing and cooperation, resources to implement consolidated supervision as well as the cross-border supervision of financial conglomerates.

5.1. LEGAL AND REGULATORY ISSUES

There could be legal and regulatory gaps on the right of the supervisor to impose corrective measures or sanctions on financial groups, including their international operations. It is important that supervisors have the power to address the sources of risk to a banking group or financial conglomerate from any regulated or unregulated entities within the group or the wider group. In order to effectively implement consolidated supervision, the following legal and regulatory challenges would have to be addressed:

5.1.1. SUPERVISORY POWERS

Lack of supervisory powers is a major challenge in the supervision of FHCs. For example, after the global financial crisis, the European Commission found the Financial Conglomerates Directive ineffective for some groups due to legal structures. Supervisors lacked appropriate tools, forced to choose between banking, insurance, or supplementary supervision, as definitions across directives were mutually exclusive, limiting oversight of complex financial conglomerates (Peleckiene et al., 2011). In order to implement an adequate consolidated supervision process, *sufficient and clear supervisory powers and authority* should be established in order to ensure that supervisors can conduct effective group-wide supervision of financial conglomerates, addressing all entities which may affect the overall risk profile and/or financial position of the financial conglomerate and/or the individual entities within the group. Supervisory powers may also include the ability of the supervisor to order changes in the structure of the financial conglomerate, including the suspension of domestic or international operations, the temporary or final closing of offices or subsidiaries where it has been established that these are potential sources of risk to the entire conglomerate or the financial system. Supervisors often encounter difficulties in accessing relevant information on the activities and business of a financial group or conglomerate (e.g. its nonbank activities, international and/or offshore activities and businesses). Thus, it is also important that there be clear powers and authority to enable cooperation, coordination and information sharing among relevant supervisors.

5.1.2. DESIGNATING A GROUP-LEVEL SUPERVISOR FOR COMPREHENSIVE GROUP-WIDE SUPERVISION

In order to ensure comprehensive group-wide supervision, there should be a single group-level supervisor, who is responsible for effective group-level supervision of the financial conglomerate,

and for facilitating coordination between sectoral and other relevant supervisors to enable effective group-wide supervision. Principle 1 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (cited in BIS, 2012b) states that 'the legal framework for the supervision of financial conglomerates should grant supervisors (including the group-level supervisor) the necessary powers and authority to enable comprehensive group-wide supervision'

The determination of a group-level supervisor should consider the powers and authorities available to the relevant supervisors and in many cases the group-level supervisor would likely be the supervisor that has responsibility for supervision of the holding company, carries out consolidated supervision or which is responsible for the largest part of the conglomerate. The determination of separate responsibilities for a group-level supervisor should not create the perception that other supervisors' responsibilities have shifted to the group-level supervisor. That is, group-level supervisory responsibility does not replace sectoral supervisory responsibility. Instead, effective group-level supervision of the financial conglomerate is required, in conjunction with and supplemental to, effective sectoral supervision, to enable effective group-wide supervision of the financial conglomerate.

To assess the risk profile of the financial conglomerate the legal framework should provide clear legal authority to collect information in respect of the holding company and the constituent entities of the financial conglomerate including records, prudential reports and statistical returns. It should also provide the authority to collect information that is necessary to assess the level of risk and support from the wider group. Assessing support could include an assessment of risks, intra-group transactions, risk concentrations, corporate governance and enterprise risk management (ERM). According to the BIS (2012b) document, the legal framework should grant the necessary power and authority to supervisors (including the group-level supervisor) to:

- Identify, or set the parameters for the identification of a financial conglomerate and the entities within the scope of supervision, particularly those entities that could pose risks to regulated entities or the broader financial system;
- Require appropriate standards for significant owners of financial conglomerates;
- Require that financial conglomerates have a sufficiently transparent group structure so as to not impede effective supervision, recovery or resolution;
- Enable, in relation to the wider group, an assessment of the risks and support provided by the wider group to the financial conglomerate;
- Access the board and senior management of the head of the financial conglomerate and of the other material and relevant entities related to the financial conglomerate, to assess the risks and support available to the financial conglomerate;
- Enable a comprehensive range of supervisory tools to be used to ensure timely corrective actions including but not limited to, actions necessary to address deficiencies in corporate governance or risk management, capital and liquidity shortfalls, large exposure concentration limits, and inappropriate group transactions;
- Deal with a crisis situation including to address concerns or issues related to resolution and recovery.

5.1.3. ESTABLISHMENT OF PRUDENTIAL STANDARDS AND COVERAGE

Effective supervision of financial conglomerates requires a strong framework of minimum prudential standards against which supervisors are able to appropriately assess the financial conglomerates. Principle 7 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (cited in BIS, 2012b) states that 'supervisors should establish, implement and maintain a comprehensive framework of risk-based minimum prudential standards for financial conglomerates'. The fundamental components of a prudential framework include requirements in relation to governance, capital requirements, liquidity requirements, accounting standards and risk management, and these components are equally relevant for financial conglomerates. Risks that are heightened for financial conglomerates have been examined already in earlier sections and include (but are not limited to) double gearing, contagion risk, concentration risk, conflicts of interest and intra-group transactions and exposures. These risks need to be adequately addressed in the prudential framework for financial conglomerates. According to ASBA (2007), firewalls can be established among financial conglomerates with a common ownership in order to reduce risks, including contagion risk. These firewalls can include: (a) prudential limits on permissible activities, (b) ownership of other companies, (c) connected lending/investments and (d) prohibitions on shared infrastructure and client bases. However, establishing firewalls could limit group-wide operational synergies and cause inefficiencies in financial conglomerate operations (e.g. cost increase on the group).

In order to aid consolidated supervision of (and compliance by) financial conglomerates, the prudential guidelines should be clear as to which elements apply to the holding company and which apply to other entities within the conglomerate. The framework and standards should supplement existing core principles and prudential requirements of sectoral supervisors that are applied in respect of entities within the financial conglomerate. As financial instruments and markets evolve and develop over time, it is also important that the prudential framework be regularly reviewed to ensure that it remains effective and relevant. This review should also address the development and expansion of financial conglomerates across jurisdictions over time.

5.1.4. SUPERVISORY TOOLS AND ENFORCEMENT POWERS

Enforcement is the key element of any effective supervisory methodology, including consolidated supervision. Principle 9 of Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should, when appropriate, utilize supervisory tools to compel timely corrective actions and/or enforce compliance of financial conglomerates with the prudential framework'. Supervisors should, when appropriate, impose sanctions on or require corrective actions to be taken by the financial conglomerate or its constituent entities, subject to appropriate due process. Sanctions and corrective actions may be qualitative or quantitative. They should be used to address sources of risk or issues of non-compliance and may include, but are not limited to: (1) provisioning for specific risks, (2) imposing fines for engaging or undertaking substantial investment in specific risky activities, (3) restricting current or future activities, (4) changing the organization's structure (e.g. closing or relocating operations, removal of management, and so on), (5) suspending dividends to shareholders of relevant entities within the financial conglomerate and (6) other measures to prevent capital from falling below the required levels. The exercise of sanctions or imposition of corrective actions should be subject to appropriate due process, including mechanisms for appeal where necessary. According to ASBA

(2007), enforcement actions are effective where the legislation or regulations establishing the process of appeals by supervised institutions regarding supervisor's decisions does not constitute grounds for suspension of the supervisor's corrective measures. Adequate legal protection may be given to supervisors in instances where it may be lacking and representing an obstacle to the effective implementation of corrective actions and sanctions against problem institutions.

5.1.5. REGULATORY CAPITAL REQUIREMENTS

Difficulty in applying capital rules and requirements to a financial group also represents one of the major challenges affecting the application of consolidated supervision. For example, Basel II or III capital rules are specifically designed for banks and bank holding companies and cannot be easily applied to non-banking financial firms such as insurance companies. Even if bank regulators would wish to apply uniform capital standards on financial conglomerates with substantial non-financial components, it is not clear how such standards would affect the diverse, individual businesses.

5.1.6. CONSOLIDATION OF SUPERVISORY AGENCIES

Regulators of different types of firms, operating under different statutory mandates might also make supervisory integration more challenging. There is therefore the need to substantially consolidate the supervision of most financial intermediation firms under a single regulatory agency. For example, in UK, the Financial Services Act (2012) creates a new regulatory framework for financial services and abolishes the Financial Services Authority (FSA). Specifically, it gives the Bank of England the responsibility for financial stability, bringing together macro and micro prudential regulation. The Act now creates a new regulatory structure consisting of the Bank of England's Financial Policy Committee, the Prudential Regulation Agency (PRA) and the Financial Conduct Authority (FCA). The PRA is now responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms, while the FCA regulates financial firms providing services to consumers and maintains the integrity of the UK's financial markets. In total, the PRA regulates around 1,700 financial firms. Some of the underlying reasons for consolidation include administrative efficiencies and political considerations.

5.2. TRANSPARENCY OF FINANCIAL CONGLOMERATES

As noted in chapter 1 of this handbook, one of the major problems of consolidated supervision relates to the difficulties in understanding the increasingly complex ownership/managerial structure of financial conglomerates, especially the material parts of the organization. The task of determining the ownership of companies or groups of companies can be complicated by various factors, including: (1) insufficiently detailed regulatory reporting, (2) information on cross border ownership and financial condition not readily available to host regulators, (3) limited transparency in accounting consolidation, (4) ownership control exercised by minority interests either through common management or other controlling arrangements. In addition, because of the blurry nature of the ownership and managerial structures in many financial conglomerates, it is difficult to identify related borrowers. Identification of related borrowers is important to verify compliance with established credit limits, prevent excessive risk exposure to and abuse by related borrowers. Some of the difficulties in identifying related borrowers have arisen as a result of the lack of legal and regulatory framework for identification of individuals or groups related to owners or managers of a financial conglomerate. There is also a lack of a uniform effort by all regulatory/supervisory

agencies including international regulators in terms of human, material and technological resources to comprehensively identify all parties related to financial conglomerates.

Moreover, there are significant differences with respect to the reporting of consolidated financial statements and the scope of consolidation. Consolidation rules may be different from country to country (e.g. GAAP, IFRS, IAS for consolidations). Also, the scope of consolidation may or may not be defined in some jurisdictions. In some financial jurisdictions, the scope of consolidation covers only those related entities that carry on activities of financial services, while risks inherent in non-financial services companies are usually assessed qualitatively.

5.2.1. GROUP-WIDE DISCLOSURES

Transparency through adequate disclosure of information in relation to the financial condition, governance and risk management of a financial conglomerate is important to support market discipline. In order for a supervisor to be able to carry out consolidated supervision effectively, increased transparency is required in the following areas:

- Overall structure of the financial group
- Ownership and governance structure
- Legal and managerial structure, clearly stating reporting lines
- Material activities of a group's domestic and cross-border operations
- Risk exposures and risk management strategies
- Corporate governance policies and processes
- Consolidated financial condition and performance

Such disclosure reports should be submitted accurately and in a timely manner. They should also be easily accessible and comprehensible.

5.2.2. REGULATORY REPORTING, ACCOUNTING CONSOLIDATION & CONVERGENCE

In an effort to reduce 'regulatory arbitrage' risk, there is need for cross-jurisdictional consistency in regulatory reporting and accounting rules used by financial groups. Accounting rules have a direct bearing on one of the most important aspects of supervision – financial reporting- and this impact can be substantial. For example, it might be beneficial for financial regulators overseeing financial groups operating within a particular region to harmonize specific accounting and regulatory standards across the region, including regulatory reporting requirements, definitions of 'capital'. The objectives of this plan are (1) to encourage consistency in the application of standards for comparability across institutions and jurisdictions, and (2) to reduce regulatory arbitrage.

5.2.3. ADOPTION OF A SINGLE AUDITING FIRM

Adopting a single auditing firm for an entire financial conglomerate could be another solution to the transparency of financial conglomerates (ASBA, 2007). A single audit standard – international, domestic, or otherwise predetermined – may be an advantage especially if a conglomerate operates predominantly in a single business sphere. The objective is to obtain internationally uniform and comparable findings, reporting and disclosures. However, conglomerates that offer or even promote substantial autonomy to their different business groups, especially internationally, may be better served by using different audit firms that report to individually accountable boards of the domestic legal entities.

5.3. INFORMATION SHARING, COORDINATION AND COOPERATION

Another major challenge in implementing consolidated supervision has to do with information sharing, coordination and cooperation among regulators and supervisors both on cross-sectoral and cross-jurisdictional basis (Brown, 2011). Principle 6 of Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors should establish a process to confirm the roles and responsibilities of each supervisor in supervising the financial conglomerate, and to ensure efficient and effective information sharing, cooperation and coordination in the supervision of the financial conglomerate'. Clear distinction in the responsibilities of supervisors, adequate information sharing and effective coordination and cooperation among functional and cross-border supervisory agencies are necessary to minimize supervisory gaps and overlaps. The G-7 Finance Ministers in May 1998 also issued ten key principles on information sharing which were published in a report of the Ministers entitled *Financial Stability - Supervision of Global Financial Institutions.* (See FSB 1998). We can summarize the provisions of these principles under the following headings:

5.3.1. AUTHORIZATION TO SHARE AND GATHER INFORMATION

Lack of sufficient authority to share and gather information can impede consolidated supervision. Each Supervisor[14] should have general statutory authority to share its own supervisory information with foreign supervisors, in response to requests, or when the supervisor itself believes it would be beneficial to do so. The decision about whether to exchange information should be taken by the Provider[15], who should not have to seek permission from anyone else. A provider should also possess adequate powers (with appropriate safeguards) to gather information sought by a Requestor[16]

5.3.2. CROSS BORDER INFORMATION SHARING

Information sharing among international supervisors is essential to ensure that a financial group's global activities are supervised on a consolidated basis. In order to facilitate cross-border information sharing, some countries have established MoUs for establishing bilateral relationships between the home and host supervisors. MoUs specify, among other things, cooperation during the licensing process, supervision of ongoing activities and in the handling of problem institutions. Information sharing is generally subject to certain statutory requirements including confidentiality and disclosure clauses.

5.3.3. CROSS SECTOR INFORMATION SHARING

In order to supervise and analyze the health of a financial group or conglomerate, supervisory agencies must gather information of all the economic units that are part of this group. Thus, banking supervisors may need to gather information from a variety of sources including from other functional regulators (e.g. securities, insurance and pension regulators) and other sources, to assess the group's risk profile, risk management and capital adequacy. Supervisors from different sectors of financial services should also be able to share supervisory related information with each other

[14] "Supervisor" means the entity or entities with statutory, supervisory or regulatory powers over financial firms and/markets within their jurisdiction.
[15] "Provider" means the Supervisor to which a request for information has been made.
[16] "Requestor" means the Supervisor that has asked for information.

both internationally (e.g., a securities supervisor in one jurisdiction and a banking supervisor in another) and domestically.

5.3.4. REGULAR CONTACT WITH CO-SUPERVISORS

Supervisors should endeavor to have arrangements with other relevant supervisors, both domestic and cross border to receive information on the financial condition and adequacy of risk management and controls of the different entities of the financial conglomerates for which they have supervisory responsibility. Supervisors should promote proactive communication and responses to material risk aggregations (particularly cross-sectoral), emerging issues and concerns in a timely manner. Well-established and regular communication should alleviate issues such as the potential for differing views across supervisors as to what constitutes a material event or piece of information and for information to be understood in context. Well-established and regular communication should also enable each supervisor to discharge its duties to effectively supervise the financial conglomerate or the regulated entities within the financial conglomerate for which they have responsibility.

5.3.5. CREATION OF SUPERVISORY COLLEGES AND COMMITTEES

Supervisory colleges, committees and crisis management groups provide an effective mechanism for supervisory cooperation and coordination. In order to achieve a better communication and understanding among supervisors of each financial market, a committee can be formed to discuss the main problems and barriers that obstruct consolidated supervision and to strengthen cooperation liaisons among them. Committees can also be created on a cross-border basis. Among other activities, the Committee can:

- Exchange experiences
- Discuss and measure the impact of new legislation
- Jointly inspect financial groups
- Exchange technical skills
- Set working groups to investigate topics of common interest (e.g. harmonization of rules, monitoring and minimizing regulatory arbitrage or other distortions)
- Consultation and exchange of information/views between regulators in 'fit and proper' assessments concerning new licensee applications or change of ownership situation
- Develop 'what if' contagion scenarios involving the collapse of a financial conglomerate for assessing policy implications, setting priorities and deriving appropriate and well coordinated contingency plans

5.4. RESOURCES FOR IMPLEMENTATION OF CONSOLIDATED SUPERVISION

Given the size and complexity of financial conglomerates, effective supervision is resource intensive. The increasing numbers and complexity of financial conglomerates may have challenged existing human, technical and financial resources in many jurisdictions. Assessing the sufficiency of resources requires consideration of a number of factors including whether staffing numbers and skills are commensurate with the number, size and complexity of institutions supervised and whether the budget allows for sufficient resources to conduct supervision and to equip its staff with the tools needed to adequately supervise financial conglomerates. In this regard, many regulatory authorities face numerous challenges, including but not limited to:

- Difficulty in hiring and retaining technical staff with specialized skills in consolidated supervision
- Protracted and bureaucratic hiring process and low salary levels
- Resource costs and budgetary constraints involved in providing ongoing specialized training for existing employees
- Lack of budgetary autonomy and over-reliance on government funding

Principle 4 of the Joint Forum's *Principles for the Supervision of Financial Conglomerates* (as cited in BIS, 2012b) states that 'supervisors of financial conglomerates should be adequately resourced in a manner that does not undermine their independence' or their ability to carry out their duties. Effective and comprehensive oversight of financial conglomerates requires sufficient resources for supervisors to carry out group-wide risk assessments and monitoring that may include more than one sector and may involve coordination and communication with other supervisors of the group. Supervisory agencies should consider augmenting their human, technical, and financial resources dedicated to consolidated supervision responsibilities. They should determine ways to better utilize existing resources (for example, through enhanced coordination among functional supervisors and among home and host supervisor). Establishing clear and distinct responsibilities among supervisory agencies may also reduce resource demands for hiring new personnel by eliminating any redundancies. Supervisory agencies should work on achieving budgetary autonomy and endeavor to implement '*pay for performance*' schemes and to increase salaries to attract and retained skilled staff.

5.5. CROSS-BORDER SUPERVISION OF FINANCIAL CONGLOMERATES

In many financial jurisdictions, there are difficulties in imposing consolidated supervision over an internationally active financial conglomerate, owing to a number of reasons, including differences in business model for global operations of a financial conglomerate. For example, some international companies transplant all or as many as possible of their domestic operations to their foreign offices (e.g. banking, brokerage, insurance, etc), whereas other international groups only operate a single arm of their activities in some host countries while partnering with a domestic firm in those countries. There are also differences in statutory and regulatory regimes, which make exercising consolidated supervision prerogatives difficult. The scope of supervising cross-border financial institutions covers two aspects of cross-border relationships: (1) subsidiaries/associates or branches of domestic financial institutions having overseas operations, and (2) any foreign financial institution operating in domestic financial sector, including representative offices.

The supervision of cross-border financial conglomerates should be considered in accordance with the Minimum Standards established by the BCBS as follows:

- The regulator shall adopt consolidated approach in the supervision of all domestic financial institutions with foreign branches and/or subsidiaries as well as foreign financial institutions operating in domestic economy.
- All domestic financial institutions operating outside the shores of the country shall receive the prior consent of the home and the host country regulatory authorities.
- The home country regulator shall possess the right to gather information from foreign financial institutions.

- If the relevant regulators determine that any foreign financial institution, including representative offices wishing to operate in a particular jurisdiction, does not meet any of the above standards, it could impose restrictive measures or prohibit the establishment of offices of such a financial institution.

The home country regulator should ensure that its powers to obtain the information needed to carry out consolidated supervision are unimpeded. These are evaluated by ensuring that the:

- Supervised financial institution has its own process for collecting and validating information from all its foreign affiliates.
- Supervised financial institution has its own process for identifying, measuring, monitoring and controlling its risks on a global basis.
- Home country regulator receives regular financial information relating to both the whole of the group, and to entities in the group individually.
- Home country regulator is able to verify that the information (i.e. through inspection, internal and external auditors' reports or information received from the host authority) is adequate for achieving the objectives of consolidated supervision.
- Existence of access to information on all intra-group transactions and other related companies.
- Home country regulator has the power to prohibit corporate structures that impede consolidated supervision

The effectiveness of the procedures put in place by the home country regulator to perform cross-border supervision of financial conglomerates would be determined by the following:

- Authorization of entry and changes in ownership structure.
- Prudential standards for capital, credit concentrations, asset quality (i.e. provisioning or classification requirements), liquidity, market risk, governance, etc.
- Off-site capabilities (including systems for statistical reporting of risks on a consolidated basis and the ability to have the reports verified).
- Capability to inspect or examine entities in foreign locations.

Home-Host Relationships

As noted earlier, collaboration between home and host countries supervisors is very essential in cross-border supervision of financial conglomerates. Supervisors should also have the authority to exchange prudential information. Consequently, there should be a clear channel of information as follows:

- From the holding company to the home supervisor.
- From the foreign subsidiary or branch to the host supervisor; and
- From the host supervisor to the home supervisor and vice versa

There should be a documented MOU on information sharing on the entities in the Group. Due consideration should be given to secrecy requirements that guarantee customers' confidentiality, except in criminal situations. The MOU between home and host regulators should address the following issues, among others:

- Access to information often inhibited by financial institutions' secrecy legislations.
- Right to supervisory cross-border inspection.
- Sanctions for non-compliance with the terms and conditions of the MOU.

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ANNEX I: CONSOLIDATED SUPERVISION QUESTIONNAIRE

Name of Banking/Financial Group:	
Address:	
Telephone No:	
Date Completed:	
Fax No.	
Person(s) responsible for completion:	
E-mail address:	
Approved by Chief Executive Officer: (Name and Signature)	

INTRODUCTION

The Central Bank of.....[Insert country] has designed this questionnaire in order to evaluate, analyze and understand the groups to which banks and financial institutions belong. The responses to the questionnaire will provide the Central Bank with background information on the functioning of your group including the organizational and management structure and internal controls, and the unique risks facing the subsidiaries that are part of the group. In addition this will help identify conditions or issues that might require supervisory attention.

Responses to the questionnaire will be considered in conjunction with a quantitative assessment of:

- The overall importance of the various entities to the group;
- Overall capital levels in the group, and capital adequacy of individual institutions within the group; and
- Large exposures and related party transactions on a group and individual entity basis

The qualitative and quantitative assessments will provide an indication of the overall level of risk and quality of risk management within the group, which will be used in determining the supervisory strategy for the group. The questionnaire covers: Organizational Structure, Corporate Governance, Risk Management and Management Oversight. **Please provide us with copies of the relevant documents to support your responses, where appropriate.**

A. Historical Background and General Information

Provide a brief history of the group, detailing incorporation dates, earlier names, mergers, and major events (e.g. listing of on stock exchanges).

B. Shareholding

1) Shareholding structure for the group as at.....(date)			
	No. of shareholders	Number of shares held	Percentage of shares
Private Companies	Foreign:		
	Local:		
Individuals	Foreign:		

	Local:		
Sub-total private sector shareholders			
Public sector enterprises and government	Foreign:		
	Local:		
Total shareholding			

2) Please provide a list of all your shareholders and their % holdings, indicating the ultimate beneficiaries

C. Organizational Structure, Corporate Governance and Management Oversight

1. Provide the group's organizational chart, showing the holding company's associates and subsidiaries (identifying % shareholding)
2. Provide the group's management structure
3. Provide the group's business activities structure
4. Which legal entities are regulated and by whom? Which entities are unregulated? Who is responsible for coordinating regulatory relationships in the group and in each legal entity? Information on regulators of subsidiary institutions may be presented as follows:

Legal Entities	Regulator	Coordinator within each entity
(i)		
(ii)		
(iii)		
(iv)		
(v)		

4. What roles and responsibilities does the group's board of directors have? Outline the composition of the board indicating whether they are executive, non-executive or independent. Information on directors may be presented as follows:

Directors of the Group			
Name	Designation (Executive, Non Executive, Independent) Qualifications and Experience	Area(s) of responsibility and/or Board Committee membership(s)	Contact details (email, phone, fax)
(i)			
(ii)			
Directors for Subsidiary A			
Name	Designation Qualifications and Experience	Area(s) of responsibility and/or Board Committee membership(s)	Contact details (email, phone, fax)
(i)			
(ii)			
Directors for Subsidiary B			
Name	Designation Qualifications and Experience	Area(s) of responsibility and/or Board Committee membership(s)	Contact details (email, phone, fax)
(i)			

(ii)			

5. Provide a list of all senior management staff and their responsibilities for the group and all the subsidiaries. This information may be presented as follows:

Senior Management of the Group			
Name	**Designation**	**Area(s) of responsibility**	**Contact details (email, phone, fax)**
(i)			
(ii)			
(iii)			
(iv)			
Senior Management of Subsidiary A			
Name	**Designation**	**Area(s) of responsibility**	**Contact details (email, phone, fax)**
(i)			
(ii)			
(iii)			
(iv)			
Senior Management of Subsidiary B			
Name	**Designation**	**Area(s) of responsibility**	**Contact details (email, phone, fax)**
(i)			
(ii)			
(iii)			
(iv)			

6. How is the group managed and controlled – on a global basis, on a regional, country or business line basis, or some combination of these? Provide details
7. Which functions are undertaken centrally at group level?
8. What responsibilities do different types of managers (e.g. legal entity, corporate, business line, etc) have within the holding company and how do these managers interact? Provide details relating to their reporting lines
9. Provide an organizational chart(s) of the banking subsidiaries (both local and foreign) in the group showing all departments and divisions. Provide a list of all branches of your subsidiaries. Provide the geographic spread and size in terms of assets of subsidiaries

D. Capital Resources

1. What is the group's capital?
2. What is the group's capital allocation strategy?
3. Where is capital held within the group (group level or subsidiary level)?
2. What factors influence the allocation of capital across the group (e.g. regulatory factors, risk factors, etc)?
3. Indicate who is responsible for capitalizing the subsidiaries and associates
4. Describe and/or provide the capital retention, capital growth and dividend policies of the group
5. What management of information reports are produced on capital-related issues?
6. What are the restrictions on the movements of capital among your subsidiaries between domestic and/or international establishments?

E. Intra-group and Related Entity Transactions and Financial Exposures

1. What is the nature of intra-group related entity transactions or other arrangements used within the group (e.g. servicing agreements, back-to-back transactions, etc)?
2. What is the volume of intra-group/related entity transactions?
3. What is the group's overall strategy with respect to intra-group transactions and exposures? How are intra-group and related entity exposures and transactions monitored?
4. What is the group's policy on intra-group exposures? What is the group's overall strategy with respect to intra-group transactions and exposures? How are intra-group and related entity exposures and transactions monitored?
5. What types of management information reports are produced on intra-group and related entity transactions and exposures? How frequently are these reports produced?

F. Risk Management Profile

1. Provide the bank/group's risk management policy
2. What are the group's principal risks?
3. How does the group identify, measure, monitor and control each type of risk (if applicable, indicate types of models, etc)?
4. Which risk management reports are available to senior management and the board of directors? How frequently are these reports produced (e.g. global reports, business line reports)?
5. Are there elements of risk management that are implemented on a centralised or decentralised basis (e.g. centralisation of information capture, decentralization of limit setting process)? Which risks are managed centrally by one legal entity? Indicate the entities concerned. What role do regional or geographic managers play in risk management?
6. What risk control mechanisms does the group have in place? Who monitors the limits or other mechanisms?
7. What are the management's plans with respect to stress testing, contingency planning and back testing?

G. Liquidity Management

1. Provide the group's liquidity policy
2. Who is responsible for liquidity management at group and subsidiary level? Which elements of liquidity management are centralised (at head office) and which elements are conducted at the local or legal entity level?
3. Who is responsible for crisis and contingency funding planning?
4. Which reports are produced on liquidity risk and how frequently are these reports produced?

H. Accounting Systems and Management Information

1. Provide the group's accounting policy
2. What area(s) of the group is/are responsible for accounting issues?
3. What are the responsibilities and reporting lines of this area?
4. How are the results of using the accounting policies of different jurisdictions reconciled at group level?
5. What types of management information reports are produced by the financial control function? What is the frequency of these reports?
6. How is the financial control function managed (centrally, along geographic lines, business lines)?
7. What are mechanisms are in place to identify and correct internal control breaches, violations, and other issues of non-compliance?
8. What is the financial-year end of your institution and/or group?
9. Provide audited financial statements for the past three years, together with copies of the auditor's management letters for your group
10. Provide audited financial statements for the previous year for your organization/group

I. Internal Audit

1. Provide the group's internal audit policy.
2. What types of information, summaries and other reports (e.g. board reports, senior management reports) are available on internal audits (e.g. performance reports, unresolved issues, etc)?
3. How is the internal audit function structured (centralize or decentralized)? What roles and responsibilities belong to the centralised element of the audit function, if there is one? What roles belong to decentralised units of the internal audit function, if any?
4. To whom does the internal audit function report?
5. Are there any aspects of the internal audit function that are outsourced? If so, from who are they outsourced?
6. Please attach the latest internal audit reports for the group and its subsidiaries

J. External Audit

1. Who are the external auditors for the whole group? Also indicate the external auditors of subsidiaries if different. Who is responsible for selecting the external auditor? What is the group's selection criterion and how does the group ensure external auditor's independence?
2. What is the role of non-executive board members with respect to external audit?
3. What are the responsibilities of the external auditors? Information on the external auditors may be presented as outlined in the table below:

Institutions: Group/Subsidiaries	*External Auditor(s)*	*Senior Partner*	*Contact Details (postal address, email, phone, fax)*
(i)			
(ii)			
(iii)			

K. Information Systems

1. Provide ICT architecture currently supporting business operations showing, in schematic view, the application systems deployed and their interfaces. Give details of the current versions of all major systems
2. Provide the details of internal controls and security management systems in place to secure both hardware and software systems
3. Does the group have board/management committees overseeing ICT issues? Attach the relevant committee's terms of reference
4. Provide the group's policies for General ICT Management, Information Security and Business Continuity Management
5. Does the group/or any of its subsidiaries carry out formalised ICT risk assessments? Attach the latest ICT risk assessment report
6. Provide the group's procedures for systems development, acquisitions and deployment and change management
7. Provide details of all major system vendors as well as contracts and service level agreements between the group/subsidiary and the vendor
8. Does the group's internal audit cover ICT activities? Attach the latest audit report
9. Provide the latest external audit report.

ANNEX II: SUMMARY OF KEY POINTS IN EXAMINATION OF LARGE COMPLEX FHCs: CORE PROGRAMME

The FHC examiner should use this CORE Holding Company Program[17] to examine higher risk or complex holding company enterprises. To ensure maximum effectiveness, this programme should be followed in addition to the consolidated supervision questionnaire.

C - CAPITAL
O - ORGANIZATION STRUCTURE
R - RISK MANAGEMENT
E - EARNINGS & LIQUIDITY

C – CAPITAL
Examination Objectives:
- Determine the holding company enterprise's financial resources relative to its risk profile.
- Evaluate the holding company enterprise's capital structure and level of debt.
- Assess capital allocation and planning processes, including oversight and capital management.

Examination Procedures:
1. Assess the holding company's ability to service its outstanding debt and the degree it relies on the bank or other subsidiaries to upstream funds to service the debt. Determine whether double leveraging is occurring, and to what extent.
- Determine if the level of consolidated debt is increasing and if interest expense is a significant portion of recurring income.
- Calculate the ratio of ***consolidated holding company debt to consolidated tangible capital***. (For holding companies with significant nonbank operations, particularly in industries with large investments in fixed assets, calculate the ***debt-to-total asset*** ratio)
- Calculate the holding company's ***leverage*** ratio.
- Compute the ***debt-to-equity*** ratio on a market value and book value basis to assess the market perception of the company.
- Consider if the holding company is investing in leveraged instruments such as futures and options that can require volatile cash needs.
- Consider whether the holding company is committed to investments with material cash needs or capital-intensive business activities.

2. Assess the holding company's consolidated capital structure. Consider the quantity and composition of capital. Does the holding company enterprise have enough capital to meet its subsidiaries' regulatory requirements as well as protect the enterprise from risky activities or adverse events? Does capital provide a cushion to absorb unanticipated losses and to support the level and composition of borrowing?

3. Consider the overall risk profile you identify in the Organizational Structure review and assess all risk factors, including credit, market, operational, and legal risks in your analysis of capital adequacy.
- Determine if the holding company enterprise's capital position has deteriorated since the last examination. If so, cite the reasons.
- Analyze whether the holding company has significantly restructured its as-set/liability portfolio or made significant acquisitions or divestitures.

[17] See Office of Thrift Supervision (2009a & b) for more details on the CORE programme.

- Review the composition of consolidated capital. How would capital adequacy change if you applied bank capital conventions, FHC capital conventions, or the capital conventions of other functional or foreign regulators?
- Consider the extent to which the holding company uses debt-like instruments such as trust preferred stock for financing. Determine if management developed a sound plan for investing the proceeds of any such financing activities. Determine how interest or dividend obligations are financed; specifically, if the holding company relies on the bank or another subsidiary, in whole or in part, to service such obligations?
- Review the holding company's capital plans. Consider the effect of future transactions and major acquisitions on capital. Assess the holding company's access to capital markets.

4. In cases where capital is inadequate, discuss with management any plans to access the capital markets or otherwise augment capital.

5. Does the holding company enterprise have sufficient capital to support its business plans and strategies, and/or the ability to enter capital markets to raise additional capital as necessary?

6. Consider the effect of the holding company's dividend practices on its capital condition.
- Identify situations where the holding company or subsidiary bank must borrow funds or sell assets to maintain dividend payments.
- Calculate the holding company's ***dividend payout to earnings*** ratio and determine if it is consistent with the business plan.
- Compare the dividend payout ratios, net income, and asset size of significant affiliates to assess relative contributions.

7. Evaluate the holding company's capital allocation and planning process in the context of its complexity. Determine whether capital management and oversight practices relate capital to risk, anticipate capital needs, and outline strategies to maintain sufficient capitalization.

8. For affiliates that are regulated by another regulator, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (such as capital contributions) to that entity. If such an agreement exists, determine the extent to which it could ultimately have an adverse impact on the enterprise, including the subsidiary bank.

O – ORGANIZATIONAL STRUCTURE

Examination Objectives:
- Analyze ownership and control.
- Determine if there is evidence that the holding company structure is designed to circumvent regulatory policies.
- Identify activities of the holding company and its noninsured subsidiaries to determine permissibility.
- Identify and assess the inherent risks in the holding company enterprise's activities

Examination Procedures:

1. Analyze changes in the holding company enterprise since acquisition or the previous examination.

2. Compare the current organization chart with one at the time of acquisition or the previous examination.
- Identify all tiers of the holding company. Ensure that the holding company database accurately reflects the current structure.
- Determine if the holding company has acquired, formed, divested, or transferred any subsidiaries or significant portion of its consolidated assets.

3. Determine whether any individual or entity – directly, indirectly, or by acting in concert – has acquired control (as defined in chapter 2 of this handbook)

- Review a list of all significant shareholders to determine the number of shares owned and percentage of outstanding stock held. (Significant shareholders include any person or entity that owns ten percent or more of shares either individually or acting in concert.)
- Determine whether any changes in ownership (10 percent or more of voting shares) have occurred since acquisition or previous examination.
- Determine whether the holding company repurchased a significant amount of its stock or if any new issuances of capital stock, capital notes, or subordinated debentures occurred.

4. Identify and evaluate the inherent risks in the holding company enterprise and determine whether the company engages in any impermissible activities.

- Evaluate the risk that the activities of the holding company or other affiliates pose to the bank or the entire enterprise.
- Ensure that the holding company is not engaged in any acts or acquisitions prohibited by regulation regarding ownership interests in nonaffiliated companies.

5. Determine the extent to which the holding company integrates the operations of the subsidiary bank or other affiliates within the holding company enterprise. Assess the risks posed by integrated systems, common risk management practices, central decision-making, joint marketing and delivery systems, and linked market reputation. Evaluate whether the subsidiary bank can insulate itself from adverse events within the holding company structure and operate on a stand-alone basis.

- Assess the risk posed by integrated systems, common risk management practices, central decision-making, joint marketing and delivery systems, linked market reputation, and common controls.
- Assess the reputation risk posed by the linking the public identity of the holding company with affiliates, including the subsidiary bank. In particular, review the management representation letter, or an attached attorney's letter, to the external auditor detailing pending or threatened litigation that could harm the holding company, and pose reputational risks for the bank or other affiliates.
- Evaluate whether the bank can insulate itself from adverse events within the holding company structure and operate on a stand-alone basis. Ensure that it maintains a separate corporate identity.

6. Identify and analyze material asset, liability, and off-balance sheet concentrations. Include a summary of material concentrations in the report of examination.

7. Identify and analyze any tax-sharing agreements and policies, tax payments paid by the subsidiary bank to the holding company, and the income tax accounting and settlement practices where the bank does not file a separate tax return.

- Determine whether the agreement conforms to the regulatory policy, particularly with regard to timing, amount, refunds, and treatment of deferred taxes.
- Determine whether the agreement governs the current practices of the consolidated group.
- Determine that taxes the parent company collects from the bank are not in excess of the amount that the bank would pay if it filed a separate return.
- Determine that the bank's tax payments do not significantly precede the time that a consolidated estimated tax liability would be due and payable by the holding company to the taxing authorities.
- Determine that the amount and timing of payment of taxes and receipt of refunds by the bank is no less favorable to the bank than if it had filed separate returns or made separate estimated payments to the taxing authority.

- Determine that the bank maintains deferred tax accounts on its own books and does not transfer them to the books of the holding company
- Determine if the Federal Internal Revenue Service (FIRS) or other taxing authorities have assessed any additional tax payments on the consolidated group.
- Determine that the holding company has allocated any such additional assessments in accordance with the tax-sharing agreement.
- Check if there is a conflict between the tax sharing policies of the FHC regulator and the policies of another regulatory agency and resolve any differences.
- Analyze the income tax accounting and settlement practices where the bank does not file a separate tax return.
- Review consolidating schedules supporting financial reporting and determine the reasonableness of income tax expense (benefit) to the bank compared with other members of the group. Timing differences between book income and taxable income may affect the analysis.
- Determine if any FIRS examinations are ongoing and whether there may be any material additional tax obligations as a result.
- Determine if there are outstanding refunds from amended or net operating loss carrybacks that should be allocated to the bank, or filings of questionable recoverability (from the holding company) that could result in chargebacks to the bank.

8. Identify and assess significant intra-group transactions. Assess the direct and indirect impact on the subsidiary bank and any other material subsidiaries of any significant transactions including asset purchases/sales, contracts for services, loans, or guarantees. If the transactions involve the bank, ensure that it properly identifies them in its books and records. For bank transactions, ensure they comply with the appropriate affiliate transaction regulations.

R – RISK MANAGEMENT

Examination Objective(s)

- Assess whether the board of directors and management identifies, understands, and controls the risks within the holding company enterprise.

Examination Procedures

1. Assess the influence of the holding company's board of directors and management. Consider the independence of the boards of directors of the bank, holding company, and other affiliates. Do any relationships create the appearance of a conflict of interest or usurpation of corporate opportunity?

- Determine the effect of accounting changes to the financial recordkeeping and reporting processes. Identify any material restatements and determine if they are the result of improper controls.
- Review the audit committee minutes and any correspondence between the holding company and the independent auditor to identify financial recordkeeping deficiencies disclosed to the directors.
- Identify any recommendations, criticisms, or comments related to financial recordkeeping and reporting in the most recent independent audit report and prior examination reports of FHC regulator and any other regulatory agency.

2. Assess the adequacy of the board and management's written policies, procedures, and limits. Evaluate changes and determine how they affect the risk-profile and financial condition of the holding company.

- Verify that the policies and procedures are sufficient to manage the enterprise's level of risk and sufficiently address each of the material risk areas you identify in your review of Organizational Structure.

- Ensure that the enterprise has sufficient policies and procedures for identifying, managing, and reporting risk concentrations.
- Determine if the board's risk limits are reasonable and match the risk appetite of the enterprise. Also verify that the enterprise complies with the risk limits

3. Determine if the holding company has adequate and accurate risk measurement and monitoring reports and systems.

4. Assess the adequacy of internal controls, books, records, and systems to ensure that the holding company enterprise adequately manages risk.

- Determine whether the financial statements, reports, and systems are complete, consistent, and accurate. Resolve any discrepancies.
  Functionally or Foreign Regulated - Determine if any discrepancies are due to different forms of regulatory accounting practices.
- Identify who performs the external audit of the holding company, whether there has been a change in auditing firms, and the reason for such change.
- Identify who performs the internal audit work for the holding company and determine whether the internal audit function is adequate and meets independence requirements.
- Determine the effect of accounting changes to the financial recordkeeping and reporting processes. Identify any material restatements and determine if they are the result of improper controls.
- Review the audit committee minutes and any correspondence between the holding company and the independent auditor to identify financial recordkeeping deficiencies disclosed to the directors.
- Identify any recommendations, criticisms, or comments related to financial recordkeeping and reporting in the most recent independent audit report and prior examination reports of FHC regulator and any other regulatory agency.

5. Verify compliance with statutory and regulatory requirements.

- Ensure that the holding company enterprise tracks and resolves outstanding examination and audit concerns. In particular, identify any corrective actions or formal enforcement actions and ensure their satisfactory resolution.
- Review the findings of functional and foreign regulators for material entities within the enterprise. Identify any patterns of violations that are material to the enterprise.

E – EARNINGS AND LIQUIDITY

Examination Objectives
- Assess the holding company enterprise's overall financial performance, including earnings, profitability, liquidity and sources of funds.
- Determine if the holding company's earnings and cash flow trends may lead it to require the bank or other subsidiaries to provide funds through dividends or other means.

Examination Procedures
1. Review the holding company's financial statements, consolidated audit, management representation letter, and Securities and Exchange Commission filings. Identify financial trends, discussions of significant accounting practices, and any identified material weaknesses in the most recent independent audit report and the prior examination reports of the FHC regulator or other regulators. Determine the relative strength of subsidiaries to holding company profitability and balance sheet strength.

- Calculate the following ratios to identify financial trends: cash position, current ratio, operating cash flow, debt ratio, and return on equity.
- Using trend and peer analysis, evaluate the earnings of the company's nonbank operations/subsidiaries over the prior three years and determine the causes for weak or deteriorating performance.
- Evaluate the quality of earnings. Determine whether the sources of earnings of pre-tax income are recurring.
- Assess whether the holding company is in a highly cyclical business.

2. Evaluate the holding company enterprise's overall financial performance, quantity and quality of earnings.

3. Evaluate the holding company enterprise's liquidity levels and funds management practices.

4. Use external information to evaluate the holding company's financial condition.

- Identify any changes to the bond ratings of the holding company or significant affiliates. Assess the causes for any changes.
- Determine stock price. Compute the ***market value to book value ratio*** and ***price/earnings ratio***. Compare results to the company's peers.

EXAMINER'S SUMMARY, RECOMMENDATIONS AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

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