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Regulatory Bulletin

**RB 35**



**Handbook: Holding Companies**

**Subject: Large and Complex Enterprises (Conglomerates)**

**Section: 940**

**Holding Companies Handbook Update**

**Summary:** This bulletin provides a brief summary of Section 940, Large and Complex Enterprises (Conglomerates), a new section to the Holding Companies Handbook.

**For Further Information Contact:** Your Office of Thrift Supervision (OTS) Regional Office or the Holding Company and Affiliate Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: [www.ots.treas.gov](http://www.ots.treas.gov).

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This is a new handbook section that addresses the supervision of large and complex enterprises, referred to as conglomerates. The section will be applied to a limited, select number of thrift holding companies and is designed to familiarize OTS examiners and holding company personnel with the OTS's approach to supervising these entities. Experience shows that large and complex enterprises are often highly integrated and managed differently than a more traditional holding company – with greater focus on, for instance, product lines or geographic areas. The guidance directs OTS examiners and holding company personnel to broadly evaluate the enterprise across business lines to specifically consider intra-group transactions and exposures, risk concentrations, capital adequacy, and risk management systems.

Attachment

—Scott M. Albinson

**Managing Director, Supervision**

**INTRODUCTION**

A conglomerate is generally defined as a corporate enterprise made up of a number of different companies, or legal entities, that operate in diversified fields. Some of our large and complex holding company enterprises (Category II) fall in this category. Often, conglomerates are highly integrated and managed differently than a more traditional holding company – with less regard for separate corporate existence and more focus on, for instance, product lines or geographic areas. Such functional management allows enterprises to take advantage of the synergies among their components, to deliver better products to the market, and to provide higher returns to stockholders.

This shift from managing along legal entity lines to functional lines means that the information and conclusions drawn during the examinations of individual entities within the conglomerate may be incomplete unless understood in the context of the examination findings of other related legal entities or centralized functions. In short, we must think along functional or centralized lines in order for the examination process to match the business practice. Therefore, it is appropriate to consider a broad scope of intra-group transactions, as well as risk concentrations across company lines. Furthermore, while the thrift and other regulated financial activities may have capital adequacy guidelines, as emphasized in Section 300, the capital adequacy of the consolidated holding company enterprise must also be evaluated.

This Section will provide you with a better understanding of the additional areas to consider within each CORE component when you examine a conglomerate. You should consider this guidance in connection with your examination and ongoing supervision of large and complex holding company enterprises that engage in multiple lines of business. This would typically include diversified holding companies, or holding companies that control numerous different legal entities engaged in lines of business that cross traditional sectors. A joint decision will be made by senior management in DC and the region as to whether a holding company enterprise is: 1) a conglomerate subject to the

guidance contained in this Section; and 2) a conglomerate subject to a directive issued by the European Parliament and the Council of the European Union (see Appendix A).

**ONGOING SUPERVISION AND USE OF SUPERVISORY PLANS**

The complexity of the conglomerate will mean that we need to approach supervision differently. The rapidly changing environment of a conglomerate means that we will need to increase planning and offsite monitoring. Ongoing supervision allows for timely adjustments to our supervisory strategy as conditions change within the organization or the economy. To be effective, our supervisory efforts must be flexible and responsible. The supervisory process needs to be dynamic and forward looking in order to respond to technological advances, product innovation, new risk management systems and techniques, changes in markets, and the financial condition and operating performance of entities within the conglomerate.

We will use a more formalized annual supervisory planning process in supervising conglomerates. This process will be documented in a customized Supervisory Plan. The Supervisory Plan will serve to focus our efforts on major areas of risk, particularly those that may not be subject to full review by other regulatory authorities. In addition, the Supervisory Plan will outline our expectations with respect to reporting requirements, especially as they relate to risk concentrations, intra-group transactions, and capital adequacy. The goals and expectations outlined in the Supervisory Plan must be communicated to management to ensure that they understand the regulatory scheme in place for their organization and that OTS has their full cooperation.

In all likelihood there will be other regulators that have a supervisory role with respect to entities in the conglomerate. If there are other regulators, we will need to work closely with them to ensure that our combined supervisory efforts are seamless,

regulatory burden is reduced, and duplication is avoided. In this regard, you should get input from supervisors responsible for significant regulated entities when formulating the Supervisory Plan.

The Administration section outlines the functional regulation procedures. In addition to coordinating with fellow U.S. financial regulators, in many conglomerates you may also need to communicate with financial regulators or nonfinancial regulators in other countries.

The first step is to identify and establish communication with other interested regulators. Once you have done so, you should establish acceptable procedures for sharing information, as well as a general understanding of what types of information you will exchange. Depending on the regulator, a formal information sharing agreement may exist. To most effectively supervise the conglomerate, you should ask the other regulators for their supervisory assessment of the entity(ies) that they are primarily responsible for, as well as the nature of any major sanctions or supervisory measures they have deemed necessary.

As the group-wide regulator of the conglomerate, we should share the following:

- An organizational chart or similar summary of the major entities in the conglomerate that also identifies other regulators and their point of contact. This step will facilitate communication between interested regulators, as well as give other regulators the opportunity to verify the accuracy of your assessment of the major entities in the conglomerate.
- A list of major shareholders and managers that exercise significant influence in the conglomerate.
- The strategic policies of the conglomerate. This will allow each interested regulator to assess the impact of the conglomerate's policies on their relevant regulated entity.
- Your conclusions about the financial condition and capital adequacy of the conglomerate.

- Any significant risk concentrations or intra-group transactions that may raise supervisory concern.
- Assessment of the capability and effectiveness of management.
- Your assessment of the adequacy of risk management and internal control systems of the conglomerate.
- Any developments with major entities in the conglomerate (including the thrift) that may adversely impact other entities in the enterprise.
- Much of this information will be contained in the holding company examination report. You may share your supervisory findings with other supervisors. These conclusions should be presented to the other regulators using the Conglomerate Supervisory Review format. You will draw much of the information needed to complete the Review from the holding company examination report. Examination conclusions should be summarized in the review.

The guidance in this Section will help you assess the risks that are unique to a conglomerate. The following discussion outlines elements that you should consider in each CORE component of the holding company examination.

## **CAPITAL**

One of our most important functions is to ensure that a conglomerate maintains adequate capital to support its risk profile and that it meets the minimum regulatory capital standards of any regulated financial sector (banking, insurance, or securities). Your review on a group-wide basis does not diminish the need for functional regulators to maintain and monitor regulated entities' compliance with the sector's requirements. The reason for conducting a capital analysis at the conglomerate level is to identify, and, if necessary, address concerns of large intra-group holdings of capital that cause difficulties in one entity to be transmitted to other entities within the group.

Your main goal is to assess capital adequacy on a group-wide basis and identify instances of double or multiple gearing that can overstate group-wide capital. You must also identify minority interests and quality of capital issues that will impact your capital analysis. A group-wide analysis will require you to consider the entire conglomerate, including both regulated and unregulated entities. While the capital requirements for regulated entities such as banks, insurance companies, and securities firms, are explicit, you will need to develop a notional capital proxy for unregulated entities based on the most analogous capital rules for a regulated entity. For instance, the regulatory capital standards for a banking company could be used to develop a notional capital proxy for a leasing company. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

Definitions of regulatory capital also vary from sector to sector. For instance, what may constitute regulatory capital in one industry, may not be includable as regulatory capital in another industry. In those instances where surplus capital in one sector offsets capital deficits in other sectors, you will need to make a qualitative assessment as to whether that surplus capital would be includable as regulatory capital in the capital deficient sector and is transferable to that sector.

In addition, conglomerates need to have board approved capital adequacy policies in place to provide capital management guidelines to senior managers. Capital adequacy policies should address the fundamentals of capital management such as identifying appropriate levels of capital throughout the organization, how the conglomerate will raise capital when needed, dividend and share repurchase policies, and overall capital and capital allocation strategies.

A conglomerate's capital adequacy is based on the five principles discussed below. While your capital adequacy analysis will need to be based on these principles, also consider the discussion of

leveraging, earnings, and cash flow analysis described in the other sections of this Handbook.

**1. Identify instances of double or multiple gearing, for example where the same capital is used simultaneously as a buffer against risk in two or more legal entities.**

Double gearing involves two entities within a conglomerate that both include the same capital in their capital bases. Typically, this involves a parent company obtaining capital that is downstreamed to a subsidiary and counted as capital a second time. Multiple gearing is another iteration of this process whereby the same capital is counted by a third company as capital. Also be aware that double and multiple gearing can occur in different forms when capital is raised by a subsidiary and then upstreamed, or a sister affiliate raises capital that is transferred to a related company through a purchase of stock or other equity instrument. Capital gearing is likely to overstate the external capital of a conglomerate, as it is double-counted through the organization. As such, intra-group holdings of capital should be excluded.

As an example, assume that a parent insurance company has available capital<sup>1</sup> of \$1,500 with \$500 invested as common stock in a wholly owned regulated bank. Also assume that the second-tier bank, with available capital of \$900, invests \$250 of its capital into a wholly owned regulated securities company (third-tier organization) in the form of common stock. The securities company has available capital of \$500. Further, assume that the capital required levels are \$800 for the top-tier parent, \$800 for the second-tier bank, and \$400 for

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<sup>1</sup> Throughout this Section, the term "available capital" includes the various definitions of regulatory capital in each industry worldwide and as a description of any substitute for "regulatory capital" in unregulated industries where you need to develop a notional capital proxy. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

## SECTION: Large and Complex Enterprises (Conglomerates)

## Section 940

the third-tier securities company for a total of \$2,000.

	Parent Insurance Company	100% Owned 2 <sup>nd</sup> Tier Banking Company	100% Owned 3 <sup>rd</sup> Tier Securities Company	Group-Wide Totals
Available Capital <sup>2</sup>	\$1,500	\$900	\$500	<b>\$2,900</b>
Capital Required	-800	-800	-400	<b>-2,000</b>
Capital Surplus / - Deficit Before Adj. For Gearing	700	100	100	<b>900</b>
Adj. for Multiple Gearing	-500	-250	0	<b>-750</b>
Capital Surplus / - Deficit After Adj. For Gearing	200	-150	100	<b>150</b>

By simply aggregating the available capital of the three entities (\$1,500 + \$900 + \$500 = \$2,900), it would appear that on a combined basis the group-wide available capital easily exceeds the capital required of \$2,000. However, as \$500 of the parent's available capital was downstreamed into the second-tier bank and counted by the bank as available capital, that capital is double-gearred. Further, the bank's investment of \$250 of its available capital in its securities company represents an instance of multiple gearing because the same funds are now being counted by three different entities as

<sup>2</sup> It is assumed for this example that available capital at the insurance company, the bank, and the securities company includes \$500, \$400, and \$250 of general reserves, respectively. The composition of available capital may differ depending upon the regulations for each industry and in each country.

available capital. Removing the double and triple counting of capital by deducting the insurance company's \$500 investment in the bank, and the bank's \$250 investment in the securities company, \$750 in total, the entire conglomerate maintains a group-wide capital surplus of only \$150. Also note that the parent's capital surplus is reduced from \$700 to \$200 and the bank's capital surplus of \$100 becomes a capital deficit of \$150. As the example shows, the capital adequacy of conglomerates may appear significantly better before double and multiple-gearing is recognized and removed from group-wide capital.

### 2. Identify instances where a parent issues debt and downstreams the proceeds in the form of equity, which can result in excessive leverage.

The use of borrowings at one level of a conglomerate that is then infused to other entities as capital raises concerns about excessive leverage. Excessive leveraging can ultimately lead to concerns with meeting debt service requirements if the company's earnings and/or cash flow were to deteriorate. This is particularly an issue when the borrowing company must rely on dividends from subsidiaries or capital injections from a parent or an affiliate to service the debt. As other regulated entities generally must meet minimum regulatory capital requirements and/or where regulators have the authority to preclude dividend payments to protect the equity of the regulated entity, a source of income and cash flow for the borrowing company may become unavailable.

In addition, loan arrangements often contain covenants and restrictions that can impact a company's ability to provide cash flow support to service the debt through dividends or capital injections from other entities within the organizational structure.

**3. Identify the effects of double, multiple, or excessive gearing through unregulated intermediate holding companies which have participations in dependents or affiliates engaged in financial activities.**

Your evaluation of capital adequacy for the conglomerate must also identify instances where intermediate unregulated holding companies provide capital to subsidiaries or affiliates. You will need to effectively eliminate the capital contribution of all of the intermediate holding companies in the organizational structure to deduct the impact of capital gearing.

**4. Identify the risks being accepted by unregulated entities.**

As unregulated entities are not required to meet regulatory capital standards, they pose a separate and distinct problem when assessing capital. The solution is to develop a notional capital proxy for regulatory capital thresholds. For unregulated entities that have activities similar to regulated entities, for example leasing, you should apply the capital requirements of the most analogous regulated industry, such as banking, to construct a notional capital proxy. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

Consider an example of an unregulated parent holding company with two wholly owned regulated subsidiaries (a bank and an insurance company) and one wholly owned unregulated subsidiary (leasing company). The relevant financial information and required capital levels are:

<b>Unregulated Parent Holding Company</b>	
Investment in Bank Subsidiary	\$700
Investment in Insurance Subsidiary	200
Investment in Leasing Subsidiary	100
Equity Capital	300
Capital Required	0

<b>100% Owned Bank Subsidiary</b>	
Equity Capital	\$700
General Reserves	100
Available Capital <sup>3</sup>	800
Capital Required	-100
Capital Surplus / - Deficit	700

<b>100% Owned Insurance Subsidiary</b>	
Equity Capital	\$200
General Reserves	100
Available Capital	300
Capital Required	-300
Capital Surplus / - Deficit	0

<b>100% Owned Unregulated Leasing Co.</b>	
Equity Capital	\$100
Notional Capital Proxy	-150
Capital Surplus / -Deficit	-50

The example demonstrates that while the regulated entities have available capital to meet their own required capital levels, the overall group is insufficiently capitalized because the parent has downstreamed capital to its subsidiaries and there is an undercapitalized unregulated leasing company within the structure of the organization. The result of eliminating the double-gearing of the capital through consolidation and identifying a notional capital proxy for the unregulated leasing company results in the group-wide capital deficit.

<sup>3</sup> Note that the definition of regulatory capital will vary between industries and countries. In this example, the \$100 of general reserves at the insurance company and the bank are included in available capital.

<b>Group-Wide Totals</b>	
Equity Capital Consolidated	\$300
General Reserves	200
Available Capital	500
Aggregate Capital Required	-550
<b>Group-Wide Capital Surplus / - Deficit</b>	<b>-50</b>

In this example, the parent holding company is unregulated and considered a shell company with its only significant assets being investments in subsidiaries; therefore, a notional capital proxy is not required. However, if this parent holding company had substantial operations, then you would also have to develop a notional capital proxy for the parent company and factor the additional capital needed into your analysis. The capital analysis method used in this example is referred to as the Accounting Consolidation method and relies on consolidation to remove double-gearing of capital through elimination of intercompany account balances and transactions. This method is explained in further detail in Appendix B.

**5. Identify investments in regulated and unregulated subsidiaries to ensure that the treatment of minority and majority interests is prudent.**

In those instances where parent companies control less than 100 percent of one or more subsidiaries, you will need to carefully assess each interest. You will need to determine if your assessment of capital adequacy is more representative of the associated risks by fully aggregating the interests or excluding them by pro rating the interests. In situations where the conglomerate maintains a majority ownership interest, in excess of 50 percent but less than 100 percent, full consolidation is typically required. However, full consolidation is likely to overstate capital adequacy when capital surpluses exist. If you fully aggregate the surplus capital of subsidiaries where the parent holds less than a 100 percent interest, you may overstate capital adequacy, as compared to pro rating the

capital surplus based on the parent's ownership interest. Pro rating the capital surplus recognizes the minority interest holders' right to their proportionate share of the surplus capital. It is expected that you would generally pro rate surplus capital if the conglomerate's interest in an entity is less than 100 percent. Additional discussion of the prudent treatment of majority and minority interests is detailed in Appendix C.

After pro rating the capital surplus, your assessment will also need to take into account any types of restrictions on the transferability of the surplus capital in the lower tier entities. If you decide that restrictions are present that prohibit the transfer of the surplus capital, then you will need to exclude any nontransferable surplus capital from available capital. The following page discusses transferability of capital.

In those cases where the parent holds less than a 100 percent interest in a subsidiary that is capital deficient, pro rata attribution of that capital deficiency may understate the parent's obligation to provide capital. The parent may have an obligation to fund a capital deficiency in excess of its pro rata ownership interest. For instance, in the event of a capital deficit at a regulated entity in which the parent owns 60 percent of the common equity with proportionate voting control, the conglomerate's liability to fund the capital deficit may exceed 60 percent of the deficit because it is the control owner. In this instance, the parent's obligation to fund the capital call may exceed its pro rata interest in the subsidiary. It is expected that the entire capital deficit of a sector or an entity will be factored into the group-wide capital analysis, if the parent holds a majority interest.

When the conglomerate holds a minority interest in an entity, you will need to carefully analyze whether the conglomerate's interest is a controlling interest based on percentage ownership, voting rights, and any other factors. Other factors to consider would be board membership, participation in operations or policy making, and significant intercompany relationships or transactions. Normally, you should expect that only the pro rata portion of the surplus capital of the subsidiary would be

available to the parent that holds a minority interest. If the parent's minority interest in a subsidiary is such that the parent can exert significant influence and has significant exposure to risk, you should treat the interest like a majority interest. The test of significant influence and exposure to risk can generally be expected to apply to interests of 20 percent or more, but under 50 percent.

### **CAPITAL MEASUREMENT METHODS**

There are three capital measurement methods to assess capital adequacy – the Accounting Consolidation method, the Deduction and Aggregation method, and the Book Value / Requirement Deduction method. You may also combine each of the methods to best capture the conglomerate's capital adequacy requirements. Examples of each of the methods are presented in Appendix B.

You must first understand the ownership interests of each company throughout the conglomerate before you begin your capital assessment. Understanding the structure of the conglomerate is essential to identify unregulated entities, capital gearing, use of debt downstreamed or upstreamed as capital, and partial ownership interests. The availability of information, consolidated or unconsolidated, may dictate which capital measurement method is appropriate. Your choice of method will depend on which is best suited for that particular conglomerate. You have the flexibility to determine if one method, or a combination of the methods, most appropriately captures the risk and capital structure of the conglomerate. Examples of each of the methods are contained in Appendix B.

When applying any of these methods, you need to take into account any of the conglomerate's proportional share of any less than wholly owned entities. Proportional share means the proportion of the subscribed capital which is held directly, or indirectly by that entity. When a regulated lower tier entity has a capital deficit, or an unregulated entity has a notional capital deficit, you will need to determine how to best reflect that deficit in your analysis. If a conglomerate holds a majority interest, and in some instances a minority interest, you would typically include the entire capital deficit in

your analysis. However, if you determine that the parent holding company is only responsible for its share of that entity's capital deficit, you may account for that capital deficit on a proportional basis.

Regardless of the method chosen, you must ensure that: 1) any capital gearing or intra-group capital is eliminated; 2) that the capital requirements for each different financial sector shall be met by available capital as calculated according to the corresponding rules of that sector; 3) if the parent has a capital deficit only cross-sector capital that complies with the parent's capital rules is allowable; 4) where sectoral rules limit the eligibility of cross-sector capital, these limits would apply in principle when calculating capital at the level of the conglomerate; 5) when calculating available capital at the conglomerate level, you must consider the effectiveness of transferability of capital across different legal entities; and 6) in the case of a nonregulated entity, a notional solvency requirement must be calculated, or the parent's investment in the nonregulated entity (as determined under the equity method of accounting) must be deducted from the group's capital.

If there are capital surpluses within the conglomerate, you will need to determine if those surpluses can be employed in other parts of the organization. For instance, you will need to determine if the capital surplus of an insurance entity or sector can be transferred to the parent or another entity within the group. In making that determination, there may be legal, tax, shareholder rights, policyholder rights, restrictions imposed by primary regulators, and other considerations that will need to be weighed in assessing if the surplus capital is transferable. You will also need to consider the capital rules for the relevant sectors and whether the surplus capital is of a form that would meet the capital eligibility rules of the other sectors. If not, then the surplus capital should not be considered transferable and available to other parts of the conglomerate.

The Accounting Consolidation method compares the fully consolidated capital of the conglomerate to the sum of the capital required for each sector or

entity. Available capital includes only those elements that qualify for regulatory capital in accordance with the relevant rules for each sector. The regulator for each entity or sector determines the regulatory capital required. This method requires the elimination of all intra-group balance sheet transactions, which is usually accomplished by consolidating the entities. The capital surplus or deficit positions for each subsidiary is then identified and used to assess the availability of capital group-wide to resolve any capital deficits. You will also need to develop a notional capital proxy for any unregulated entities, or deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital when a proxy is not available, and then add together the total capital required amounts and compare to the available capital group-wide.

The Deduction and Aggregation method involves summing the available capital of each regulated and nonregulated sector or entity in accordance with the appropriate sectoral rules and comparing this to the sum of the individual capital required of the regulated sectors and the notional capital proxies for the unregulated sectors, plus the book value of the investments in those entities or sectors. The book value of the investments are included as they represent geared capital that is not eliminated because this approach is conducted using the conglomerate's unconsolidated accounts. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

The third method is the Book Value / Required Deduction method. This method takes the balance sheet of each company within the group and looks through to the net assets of each related company using unconsolidated balance sheet data. The conglomerate's capital surplus / deficit is calculated as the difference between parent's available capital and the sum of the parent's required capital and the higher of the book value of the parent's investment in each entity or sector and the capital required for each entity or sector.

When evaluating capital adequacy, regardless of the method, you should consider the following points:

- What is the conglomerate's capital and capital allocation strategy?
- Does the conglomerate have an effective capital adequacy policy? Does it describe their capital and capital allocation strategy? Does it identify minimum capital thresholds?
- Where is capital held within the conglomerate and why is it held there?
- What factors affect the allocation of capital across the conglomerate (for example, regulatory or risk factors)?
- How are decisions made on capital allocation?
- How are capital decisions affected by the legal entity and business line structures?
- Do management and the board periodically review overall capital adequacy as well as the capital adequacy of the individual subsidiaries?
- Are there any plans to issue new capital instruments or additional equity? Are there any stock repurchase plans in place or contemplated?
- To what extent, if any, are legal entities able to raise capital on more favorable terms than others?
- Is the parent and/or any of the individual entities rated by the rating agencies? If so, what are the ratings? Have any of the rating agencies indicated that their ratings are under review for an upgrade or a downgrade? If so, what are the implications for the organization?
- Is there surplus capital available in the corporate structure that can be transferred to other entities within the conglomerate? If so, are there impediments to flows of capital among legal entities?

- What restrictions are placed on the instruments available to the conglomerate for raising capital and what is the nature of the restrictions? Consider the affect of debt covenants.
- Are there unregulated entities within the corporate structure? If so, what are their lines of business? Do any of the regulated entities have significant interests in on- or off-balance-sheet assets or liabilities with these entities, such as debt guarantees?
- Are partial ownership interests present in the structure of any of the subsidiaries? If so, what are their ownership and voting rights? Are there other factors that could influence a determination as to their obligations?
- Have you evaluated quality of capital issues, such as the use of subordinated debt or other equity-like instruments that may not be considered to be acceptable regulatory capital for all of the regulated entities across the conglomerate?
- Have all of the intercompany transactions been identified that could impact your capital assessment? Such intercompany transactions could be on- or off-balance sheet or include less obvious items such as significant tax liabilities.
- Does the conglomerate or any of its individual entities securitize any of its products? If so, how are the securitizations managed and structured? Are the securitizations properly accounted for and monitored on a regular basis? Are these activities properly capitalized?
- Are there significant derivatives outstanding? What is the impact of the derivative positions on capital adequacy?
- If derivatives are present, are they used to hedge certain risks, to speculate on market movements, or are any of the entities actively engaged in derivatives as a line of business?

Prior to undertaking your capital analysis, you will need to understand the conglomerate's organizational structure. Only by understanding the legal

structure of each significant entity, can you begin to consider the capital implications.

### **ORGANIZATIONAL STRUCTURE**

As with all holding company enterprises, you must determine the organizational structure and reporting hierarchy. It is not unusual for a conglomerate to have a large number of separately chartered legal entities. Some of the entities within the conglomerate may be regulated, whereas others may not.

In assessing the organizational structure of the conglomerate, you should consider:

- What factors influence the overall approach to the corporate legal structure?
- How closely is the conglomerate's business line structure aligned with its corporate legal structure? If not closely aligned, what factors influenced the "divergent" structure?
- What is the conglomerate's strategy with respect to corporate legal structure?
- Does management feel this is an ideal structure? If not, what changes would make it optimal and what impediments exist that prevent management from implementing those changes?
- What legal entities are regulated, and by whom? How does management view the regulatory structure within which it must operate?

In addition to wholly or majority owned subsidiaries, the conglomerate may have a variety of significant investments where they are not the majority owner. Despite the fact that these investments represent only a minority ownership interest, they may, nonetheless, be important to the ongoing operation and financial condition of the conglomerate. They may also add increased or additional types of risk to the structure. You should also identify minority investments and evaluate their risk.

Understanding the organizational structure, and the factors that influence its design will better position you to evaluate the risks within the conglomerate. By combining business lines, conglomerates offer the potential for broad diversifications. However, new risk concentrations may arise at the group level. More specifically, different entities within the conglomerate could be exposed to the same or similar risk factors, or to apparently unrelated risk factors that may interact under unusually stressful circumstances.

A risk concentration refers to exposures or loss potential that is borne by entities within the conglomerate that are large enough to threaten the capital adequacy, or the financial position in general, of the entities in the conglomerate. Risk concentrations can arise in a conglomerate's assets, liabilities or off-balance sheet items. Risk concentrations can take many forms, including exposures to:

- Individual counterparties;
- Groups of individual counterparties or related entities;
- Counterparties in specific geographical locations;
- Industry sectors;
- Specific products;
- Service providers (for example, back office services); and
- Natural disasters or catastrophes.

Conglomerates must have comprehensive systems to measure, monitor, and manage risk concentrations. Systems should be able to aggregate exposures across legal entities and business lines. To assess whether the conglomerate has adequate risk management processes in place to manage group-wide risk concentrations, you should consider:

- What are the conglomerate's principal risks? For each risk:

- How does the conglomerate measure the risk?
- What kinds of risk reports are available and how frequently are they produced? Who reviews and is responsible to respond to the reports?
- Is the risk managed centrally or by individual legal entities?
- What are the major risk-taking legal entities within the conglomerate?
- What risk control mechanism does the conglomerate have in place (for example, limits, vacation policy, job rotation)? If limits exist, are they established by legal entity, business line, or conglomerate? Who establishes and monitors them? Who has authority to override limits?
  - Does management perform stress testing, contingency planning and back testing? If so, evaluate the results.

Most conglomerates will have some degree of country risk. Country risk is an exposure, credit, price, capital markets, foreign exchange, settlement, or other type of risk, that can be directly impacted by the social, political, economic, or legal climate of other countries. These risks can arise from direct lending to foreign borrowers, underwriting insurance to foreign entities, entering into capital market contracts with foreign counterparties, or operating offices or subsidiary companies in other countries. These risks are present with both foreign and domestic entities or other entities, and sovereign nations themselves. You will need to determine if the conglomerate has significant direct or indirect country risk. A conglomerate has direct country risk when it is a party to financial transactions with entities based in other countries as compared to indirect foreign risk wherein the conglomerate is a party to financial transactions with entities based in the same country and that entity has direct foreign risk. An example of indirect foreign risk would be an American based conglomerate lending to an American manufacturing company that has foreign operations or other significant foreign exposures. The manufacturing

company could be impacted by adverse results of its international operations caused by political changes that directly affect the company's repayment abilities. If the conglomerate does have significant country risk, you will need to consider:

- If board approved policies, procedures, and authorizations have been established?
- If country limits have been established and if the actual exposures versus the limits are monitored on a regular basis at a senior level?
- If country risk exists to emerging market countries that may be more volatile, or is the country risk limited to developed countries?
- If country risk is monitored and controlled on a centralized or decentralized basis?
- If an effective country risk rating system that risk ranks foreign exposures, including credit and capital market exposures, has been established?

A specific type of country risk is foreign exchange risk, i.e., the conglomerate undertakes transactions in foreign currencies that are subject to price and settlement risk. If the conglomerate is exposed periodically or continuously to significant foreign exchange risk, then you will need to consider:

- How the conglomerate manages its foreign exchange risk?
- What type of foreign exchange risk is the conglomerate exposed to, such as direct lending in other currencies, capital market transactions in other currencies, or overseas operations that are funded in other currencies?
- How large is the conglomerate's foreign exchange risk relative to earnings and capital?
- Do the conglomerate's policies and procedures directly address authorizations for conducting such transactions and exposure limits by types of transactions and by country?

- Does the conglomerate maintain specific foreign exchange counterparty and settlement limits by entity? Are the limits monitored on a regular basis with exceptions identified?
- Does the conglomerate hedge its foreign exchange risk? If so, what policies, procedures, controls, and reporting have been established?

As you draw conclusions about risk concentrations, keep in mind that all risk concentrations are not inherently bad if well managed. A certain degree of concentration is an acceptable result of a well-articulated business strategy – for instance, product specialization or targeting a particular customer base.

## **RELATIONSHIP**

The integrated nature and size of a typical conglomerate makes it a challenge to assess the effectiveness of management and the relationship between the various entities in the group. In our role of supervising the conglomerate, we must look beyond how decision makers, and the relationship in general, impact the thrift to also assess how management oversees the conglomerate as a whole. You should begin by considering:

- What is the overall management structure of the conglomerate?
- How closely does the management structure align with the business lines or corporate legal entities and what is the strategy for alignment?
- How is the conglomerate managed and controlled – on a regional basis, on a global basis, business line basis, or some combination of these?
- How does the conglomerate manage businesses that cut across geographic and legal boundaries?
- What responsibilities do different types of managers (for example, legal entity, corporate, or business line) have within the conglomerate and how do these managers interact?

- What roles and responsibilities does the conglomerate's board of directors have? What is the composition of the board? For example, what percentage is outside directors? Are outside directors independent of management? How do the roles and responsibilities of the conglomerate's board compare to those of the legal entities? What degree of overlap exists?

In its oversight role, the board must ensure that the conglomerate's risk management program is adequate to identify, monitor, and control any significant risk to the conglomerate. Conglomerates with good risk management programs will rely on a reporting and control system that clearly identifies emerging and established risks posed by excessive concentrations, changing markets, economies, and interest rate environments, substantial or inappropriate intra-group transactions, significant off-balance sheet activities, and compliance with the conglomerate's policies and procedures.

Given that a conglomerate is generally going to be a complex organization, it follows that its internal controls should be sophisticated. An integral part of a good risk management program incorporates a system of internal controls that are sufficient to identify areas of weakness, particularly in financial reporting and accounting systems and records, and with regard to regulatory compliance. Good internal controls will ensure that management and financial accounting reports are accurate and properly portray the risk profile of the conglomerate. Conglomerates with strong risk management programs will ensure that internal controls are well integrated throughout the organization, from the board to line employees, through policies and procedures that clearly delineate authorities, responsibilities, permissible activities, and limits. You will need to evaluate how the conglomerate ensures the integrity of its internal control structure, including controls over information technology (IT). You should begin your assessment by asking the following questions:

- Does the conglomerate maintain an effective risk management program? Is the board and senior management actively engaged in risk management? Does the board approve risk management and other significant policies?
- Do policies and procedures clearly delineate limits, activities, responsibilities, and authorities? Are policies and procedures updated on a timely basis for changes? Are policy and procedural changes communicated to employees?
- Are management reports sufficient to identify and monitor significant risks to the conglomerate? Are these reports accurate and timely? Who reviews these reports and how often?
- Does the conglomerate model its significant risks? If so, do they properly document the methodology, data, and assumptions employed? Do they back-test the results? Who reviews modeling results and how often?
- Is the system of internal controls appropriate to the type and level of risks posed by the nature and scope of the conglomerate's activities? Are controls managed centrally, along geographic or business lines?
- Does the board and management support strong internal controls by properly addressing policy exceptions, excessive risks, regulatory compliance, and employee misconduct?
- Are strong internal controls evident in the conglomerate's IT infrastructure? Is the IT infrastructure subject to outside reviews periodically?
- Are there contingency plans in place for major operational concerns such as IT failures, disasters, liquidity needs, etc...? Are the contingency plans tested and up to-date?
- Does the organizational structure establish clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits?
- Does the conglomerate ensure adequate separation of duties where appropriate throughout the organization?

- Are internal controls and information systems adequately tested and reviewed with coverage, procedures, findings, and responses properly documented and material weaknesses reviewed at an appropriate level? Are exceptions corrected effectively and on a timely basis?
- What mechanisms are in place to identify and correct internal control breaches, violations, and other issues of noncompliance?
- What information is available to monitor and ensure compliance with relevant laws and regulations?
- How is the internal audit function structured? What roles and responsibilities belong to the centralized element of the audit function (if there is one)? What roles belong to centralized units of the internal audit function, if any?
- What types of information, summaries and reports are available on the results of internal audits? To whom is this information available? What is the process for following up or acting on issues requiring action identified by the internal auditor?
- How does the conglomerate ensure sufficient independence of the internal audit function? To whom does the internal audit function report? Are there any aspects of the audit function that are outsourced? If yes, to whom and how is the decision to outsource made?
- How does the conglomerate ensure the independence of the external audit process? What is the role of nonexecutive board members? How does the external audit firm interact with the internal audit function? How does the conglomerate select its external auditor?
- What information is available on external audit issues? Who is this information made available to? Who is responsible for, and what follow-up is conducted, with respect to deficiencies or other issues identified by the external audit?
- What are the major incentives provided to management to meet the conglomerate's goals

and objectives? What impedes meeting these goals and objectives?

- How are strategic business and individual goals developed, communicated, and monitored?

Intra-group transactions and exposures are an important element of corporate governance and internal control. Given the size, complexity and number of legal entities within a large conglomerate, control over capital, funding, and other risk and income-transferring mechanisms is critical. Furthermore, different approaches to capital regulation and accounting requirements in different financial sectors may increase the opportunities for regulatory arbitrage.

Intra-group transactions and exposures can facilitate synergies between the different legal entities in the conglomerate. Such synergies can lead to healthy cost efficiencies and profit maximization, and more effective control of capital and funding. However, significant intra-group transactions and exposures can also expose one part of a conglomerate to problems or ailments in another part of the conglomerate. Where regulated entities are predominant in the conglomerate, and business lines and other activities follow legal entity lines, there may be few supervisory concerns.

However, if there are significant unregulated entities in the conglomerate, or the way in which the operations are managed differ from the legal entity structure, then sound management of intra-group transactions is even more important.

It is management's, and ultimately the board of directors', responsibility to achieve the appropriate balance between the benefits and risks of intra-group transactions and exposures. Sound risk management of intra-group transactions and exposures begins with policies and procedures approved by the board or other appropriate body and active oversight by both the board and management. The conglomerate's policies and procedures should set transaction and exposure limits.

Intra-group transactions and exposures can take many forms. You are probably most familiar with the transactions that are covered by the affiliate regulations involving a thrift. In a conglomerate, new types of intra-group transactions and exposures arise. Intra-group transactions and exposures can arise through:

- Cross shareholdings;
- Trading operations whereby one company within the group deals with, or on behalf of, another company in the group;
- Centralized management of short-term liquidity within the conglomerate;
- Guarantees, loans and commitments provided to, or received from, other entities in the group;
- Providing management or other service arrangements (for example back office services);
- Exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees);
- Exposures arising from placing client assets with another legal entity in the group;
- Purchases or sales of assets between entities in the group;
- Transfer of risk through reinsurance; and
- Transactions that shift third party risk exposure between entities within the conglomerate.

Your assessment of intra-group transactions and exposures can begin by considering:

- What information is available on the range of intra-group and related entity transactions and exposures? What types of management information reports are produced and how frequently?
- What is the conglomerate's overall strategy with respect to intra-group transactions and exposures? What types of intra-group/related

entity transactions or other arrangements are used (for example, servicing agreements, loans)?

- How are intra-group and related entity exposures and transactions monitored?
- What is the volume of intra-group/related entity transactions and level of finance exposures? Does the conglomerate have internal limits or thresholds on such transactions or exposures? Are there internal or external limits or thresholds on such transactions or exposures (such as regulatory, borrowing, or board set limits)?
- What is the level of financial exposure to entities that are not wholly owned? Are there limits or thresholds for transactions and exposures to such entities?

The following transactions with any regulated entity in the conglomerate would raise supervisory concern:

- Transactions that result in capital or income being inappropriately transferred from a regulated entity.
- Transactions that are on terms or under circumstances that are not at arm's length or not under terms and circumstances that a third-party would accept.
- Transactions that can adversely affect the capital, liquidity or profitability of entities within the group.
- Transactions that are used as a means of supervisory arbitrage to evade capital or other regulatory requirements.

Public disclosure of intra-group transactions and exposures can promote market discipline by providing insight into the relationships among the various entities in the conglomerate. Insightful public disclosure allows for more effective market discipline because stakeholders in the conglomerate will be better able to understand the dynamics of

the conglomerate's financial statements and risk management activities.

Intra-group relationships and transactions, on- and off-balance sheet, will often times significantly impact how a company within the group operates, raises its funding, implements its risk management program, and manages other facets of its business. Understanding these relationships between entities within a conglomerate is an important and necessary initial step to analyzing its capital adequacy and financial performance.

### **EARNINGS**

A conglomerate, by definition, will be a large complex business, likely encompassing a number of different lines of business, with each line of business offering a variety of different products. As a result, your earnings assessment will need to include an analysis of each of these different business segments to understand how they contribute to the financial performance of the conglomerate as a whole. You will, therefore, first need to understand the organizational structure of the conglomerate to determine the primary lines of business, the most significant entities within the group and their roles, as well as their geographic reach. Only after achieving a solid understanding of the organizational structure, and the interrelationships among the entities, can you begin to analyze earnings.

Your assessment will include an analysis of earnings, cash flow, and liquidity, conducted on both a consolidated and an unconsolidated basis. You will have to identify those entities that contribute significant earnings, cash flow, and liquidity to the parent company or affiliates. The analysis of inter-company support via earnings, cash flow, and liquidity is as important as understanding the contribution of the individual entities to the consolidated conglomerate's results. While inter-company transactions can be managed in a prudent manner and to the benefit of the conglomerate, such transactions can also transmit financial problems to other entities within the group and jeopardize the reputation, and possibly, the financial stability of the conglomerate. You need to

identify those situations where inter-company transactions pose concerns and potential risk to the conglomerate.

Your analysis may be complicated when any significant entities within the group are unregulated. If a significant company within the group is unregulated, then regulatory reports will not be available to provide insight into the financial performance of that company or line of business. Available information may be limited to only the public domain and what the conglomerate provides. In addition, inter-company transactions between unregulated entities can pose a greater risk, as they are not subject to regulatory restrictions or review. Only by understanding the individual entities, regulated and unregulated, and group-wide earnings and cash flows, can you properly assess the conglomerate's financial stability, ability to service debt and pay dividends, and generate new capital to support growth and losses.

Begin your analysis with a review of the conglomerate's corporate structure and identify the major entities, the predominant lines of business, regulated versus unregulated entities, the primary business products, and their geographic reach. You will need to review the analyses performed as part of the Organization and Relationship sections of this Handbook module. After completing this review, you will need to consider:

- If any regulatory reports describe concerns with the financial or risk profile of a company or line of business, or with any inter-company transactions?
- Are there any inter-company transactions that are indicative of a particular business segment or significant company that is overly reliant on other parts of the conglomerate for financial support? Your review should include analyzing consolidating balance sheets and income statements for on-balance sheet items, and other reports for off-balance sheet inter-company relationships, such as financial derivatives.

- Are there any lines of business or significant entities within the conglomerate that are experiencing earnings, cash flow, or liquidity problems? If so, has management identified the situation and developed a remedial plan?
- How is the financial control function organized with respect to legal entities and business lines? What part of the conglomerate is responsible for accounting and financial reporting issues?
- Does the conglomerate obtain annual independent audits? If so, are audits prepared for the conglomerate on a group-wide basis or are there individual audit reports for separate entities within the corporate structure? Is the audit opinion qualified in any manner? Are there any significant audit adjustments?
- What accounting rules are used by the conglomerate? How are these rules applied across the conglomerate? How do they vary across geographic lines and business segments? How is accounting reconciled across different financial sectors or countries?
- Are there any new accounting pronouncements that will significantly impact any of the individual entities?

The ability of the conglomerate to generate consistently strong earnings provides the ability to grow, pursue opportunities, access capital markets at reduced costs, and absorb losses. The earnings strength of the conglomerate will be dependent on the earnings of the major business segments. Each business segment may have significantly different factors driving its earnings from stock market activity for a securities broker/dealer, to the interest rate and credit risk environment for a bank, to catastrophic weather events for a property and casualty insurance underwriter. As a result, the conglomerate's earnings may have components that are cyclical or volatile in nature, or susceptible to particular events, all of which you will need to consider. In addition, your analysis should focus on the most significant, and if present, the most problematic entities within the conglomerate.

When conducting your analysis, you will need to consider:

- How profitable are the major business segments and the significant entities within the conglomerate? What are the short and long term profitability trends?
- Are earnings stable and generated by core operations, or are there volatile or cyclical earnings components?
- Are significant nonrecurring gains present, such as a large gain from the sale of assets that are benefiting net income?
- Are there unprofitable or under-performing business segments or significant entities within the conglomerate? If so, how is management addressing these problems?
- How strong are the conglomerate's basic financial measures, such as return on equity, cost of equity, return on assets, and turnover?
- Does management and the board periodically review earnings performance of the individual entities and on a group-wide basis?
- Does the conglomerate have a budget and financial projections? Are they produced at the individual company level and on a group-wide basis?
- Are any of the individual entities or lines of businesses significantly under-reserved for potential losses?
- Does the strategic plan identify any major actions such as stock repurchase plans, new products, or lines of business that will have a significant financial or risk impact on any of the entities or lines of business?
- How do the individual entities and the conglomerate as a whole, manage their income taxes? Are there significant income tax liabilities due? Are there any new changes to income tax regulations or laws that will significantly alter future tax liabilities?

Your assessment of the financial stability of the conglomerate will also need to identify potential problems with cash flow or liquidity within the conglomerate. To identify potential cash flow or liquidity issues, you will need to analyze the cash flow and liquidity needs and resources for each major company and/or line of business. In addition, you may need to evaluate the balance sheet of the underlying entities to identify significant concentrations of assets that are not liquid or do not generate cash, such as goodwill or deferred policy acquisition costs.

Of prime concern is the conglomerate's ability to meet its financial obligations on a timely basis. If one company within the group defaults, or loses the confidence of market participants, the reputation and financial wherewithal of the entire organization can be jeopardized, which can translate to problems for an entire sector and other conglomerates if there are significant cross-holdings. Your analysis needs to identify any concerns with a conglomerate being able to meet its financial obligations on a timely basis including repaying debt, honoring financial derivatives, debt guarantees and other types of commitments, and meeting all underlying debt and other types of covenants. You will need to identify concerns with deterioration in a company's debt service abilities and/or liquidity position, and seek remedial action where appropriate. Your analysis will need to consider:

- Is there publicly available information from rating agencies on the conglomerate or its significant subsidiaries? Is the conglomerate well rated and considered financially sound? Has any rating agency announced its intent to conduct a credit review of the conglomerate with an outlook towards changing the rating?
- Do regulatory reports of individual entities or lines of business indicate any concerns with cash flow management, the liquidity position, or the ability of an entity to meet its financial obligations?
- Is access to the capital markets performed only at the parent level or through a specialized entity, or do the individual entities maintain access to the capital markets?
- Are there any legal, tax, or regulatory restrictions that could impact the conglomerate's ability to manage its cash flows and service its debt?
- Are there inter-company guarantees provided on debt or other types of contracts that could pose a significant funding issue?
- Are there other types of inter-company transactions, particularly with unregulated entities within the group that could impact the financial strength of a company within the group?
- How is cash flow and liquidity managed for the conglomerate as a group and on an individual company basis? Are these functions centralized or decentralized?
- Does the conglomerate and the individual entities maintain liquidity and borrowing policies and limits consistent with prudential standards? How are these policies and limits applied group-wide?
- How are liquidity and cash flow demands measured on an everyday basis? Is senior management regularly involved in monitoring the liquidity needs of the conglomerate? What information is available on liquidity? How frequently is it produced?
- Do the individual entities generate sufficient cash flow to service their own debt or are they reliant on subsidiaries or outside resources to meet debt service and other obligations?
- Is there any significant credit drawn or available to any of the entities? If so, are there any significant restrictions or covenants associated with any credit agreements that could prevent the payment of dividends or other transfers of capital, the use of liquidity, ability to borrow, or otherwise significantly impact the conglomerate's or any of the individual company's operations or ability to service its debt?

- Are there any significant unfunded obligations, such as under-funded pension plans, that could significantly impact the conglomerate's liquidity or earnings?
- Are there significant off-balance sheet items such as commitments, securitizations, financial derivatives, or lease commitments that could require significant liquidity commitments at the conglomerate level or at any of the significant subsidiaries?
- What plans have been made for crisis or contingency funding? To what extent have such plans been elaborated?

As you conduct your financial analysis, refer as needed to Section 600 of this Handbook for additional guidance. You have the flexibility in choosing those areas of the Handbook that will be useful in completing your assessment.

Your conclusions about the financial wherewithal of the conglomerate will need to carefully weigh all of the above factors, as well as consider management's approach in conducting the conglomerate's business and the organizational structure. Your final assessment should be from the perspective of the conglomerate as a whole, highlighting its financial strengths and weaknesses. You should also address any significant concerns with the financial stability of any of the major underlying entities, regulated or unregulated.

### **SUMMARY**

Your assessment of a conglomerate will require you to carefully weigh all of the CORE components and their interrelationships. You will need to conduct your comprehensive assessment from the perspective of the consolidated regulator at the parent, top-tier, organization within the conglomerate. Particular emphasis, however, should be placed upon a parallel assessment of the top-tier financial company. While the primary emphasis will be to analyze the conglomerate's capital adequacy and risk profile, such an analysis cannot be conducted without first considering the Organization and Relationship components. In order to

understand the dynamics of the conglomerate, you will need to:

- Understand the organization – how it is structured, managed, and controlled. You will need to identify the conglomerate's most significant entities and understand how they conduct their business.
- Identify and understand all significant intra-group relationships and transactions to assess their impact on the organization's earnings, risk profile, and capital adequacy.
- Coordinate closely with other regulators and consider their examination and inspection reports, publicly available information, and information provided by management.
- Assess the conglomerate's major risk exposures and how these risks are impacted, both domestically and internationally, by economic changes, legal and tax considerations, how the conglomerate conducts its business, and the stability of the financial markets in which they operate.
- Determine the conglomerate's group-wide capital adequacy. This includes assessing capital adequacy relative to the needs of each major business sector and the parent's own capital adequacy.

As the consolidated regulator of the conglomerate, we need to ensure that we coordinate closely with all interested regulators worldwide. This involves sharing information with other regulators so that all parties understand the conglomerate's overall dynamics. This also involves being prepared to act accordingly in the event of a crisis by obtaining information from the conglomerate on the consequences of such an event, their contingency plans and options to minimize the impact of a crisis, and exchanging information with all interested regulators to assist in coordinating and executing any necessary supervisory actions.

Worldwide, the regulation of conglomerates is evolving. Banking, insurance, and securities regulators have recognized that the risks of the combined enterprise must be evaluated. The Joint Forum<sup>1</sup>, a group established by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors, has outlined principles related to the supervision of conglomerates.

It is widely recognized that a form of supplementary supervision is needed and that a central regulatory contact point is essential. As the word “supplementary” implies, the supervision of the enterprise is in addition to the role of the primary regulator(s) for each financial sector. Since the OTS has numerous holding companies with operations throughout the world, this guidance is designed to ensure that our regulatory approach to conglomerates is considered equivalent to the standards and principles set by other governing bodies. This approach ensures that our holding companies are on a level playing field, and not subject to unnecessary or duplicative regulatory burden by having to comply with differing regulatory schemes.

The substance of the guidance provided throughout this Section relies heavily on documents produced by the Joint Forum. In particular, in July 2001, the Joint Forum produced a compendium of documents on issues relating to conglomerates.<sup>2</sup> These papers document the combined thoughts of representatives of various and different financial sectors across many nations with regard to what supervisory measures are needed to adequately oversee a conglomerate. The compendium of documents address coordination among regulators, information sharing, capital adequacy, fit and proper tests on

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<sup>1</sup> The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. Thirteen countries are represented in the Joint Forum: Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the U.S.

<sup>2</sup> <http://www.bis.org/publ/joint02.pdf>

management’s capabilities and effectiveness, intra-group transactions and exposures, and risk concentrations.

The European Parliament and the Council of the European Union issued a directive on December 16, 2002 (EU Directive) outlining measures to address the risks with regard to financial groups with financial activities across more than one sector.<sup>3</sup> The articles of the EU Directive and objectives therein outline a supervisory approach similar to that spelled out in the Joint Forum documents. U.S. companies engaged in financial activities in a member state of the European Union<sup>4</sup> may fall within the scope of the EU Directive.

The EU Directive defines a conglomerate as a group of companies under common control that engage predominantly in financial activities (insurance, securities, and banking). Conglomerates must have a significant interest in insurance and at least one other financial activity (banking or securities), to fall within the scope of the EU Directive. In addition, the ratio of aggregate assets of all financial sector entities to total consolidated assets of the conglomerate should exceed 40 percent.

An interest in a financial sector is considered significant if:

- The ratio of that sector’s assets to the total financial sector assets exceeds 10 percent; and
- The ratio of the capital requirements imposed by the regulator of that sector to the total aggregate capital requirements for all financial sectors in the group exceeds 10 percent.

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<sup>3</sup> [http://europa.eu.int/eurlex/pri/en/oj/dat/2003/l\\_035/l\\_0352003021en00010027.pdf](http://europa.eu.int/eurlex/pri/en/oj/dat/2003/l_035/l_0352003021en00010027.pdf)

<sup>4</sup> As of November 2003, the member states include Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, and the United Kingdom. The following countries are in process of fulfilling the requirements to accede to the European Union: Estonia, Latvia, Lithuania, Poland, Hungary, Slovakia, the Czech republic, Slovenia, Malta, and Cyprus.

The EU Directive also recognizes that it may be appropriate to apply this guidance in situations where these thresholds are not met or maintained. For instance, if one or more of the ratios noted herein fell below threshold levels during the current annual cycle, but is expected to return to prior levels. Similarly, there may be situations where these thresholds are never met, but the characteristics of the conglomerate warrant reviewing it as if it were.

The EU Directive requires that one single authority be appointed for the overview of each conglomerate and that such authority ensure that information is coordinated and exchanged between the different supervisors involved in the supervision of the conglomerate's component parts.

The regulator that will perform the supplemental supervision is typically identified through mutual agreement among all concerned member states, however, where an agreement is not reached, authority is assigned to the regulator of the parent regulated entity. If the parent is not a regulated entity, certain geographic and quantitative tests are employed to assign the role to the member state with the most significant connection to the group. Regulators in third-party countries (countries like the U.S. that are not members to the European Union) can serve in this role if their supervisory approach is deemed to be equivalent to the supplementary supervision regime. While an equivalency determination will ultimately be made by the regulatory authorities of the member states, OTS believes that its supervisory approach is equivalent. Section 940 is designed to ensure that the scope of our holding company examination of a conglomerate is sufficient to fulfill these responsibilities under the EU Directive.

If OTS is deemed equivalent, you must ensure that our responsibilities in this role are fulfilled. Our responsibilities would include gathering and disseminating relevant or essential information. We would also need to ensure that there are procedures for sharing information on an ordinary basis as well as in emergency situations. Close coordination with fellow regulators is achieved through periodic meetings, input on the content of the enterprise's supervisory plan, and sharing of information obtained in regulatory reports filed by each agency. Information sharing or regulatory cooperation agreements may be in place, but are not required by the EU Directive.

If a holding company enterprise is subject to the EU Directive, a primary staff contact will be designated to communicate with international regulatory authorities to initiate information sharing procedures and develop an appropriate Supervisory Plan for the conglomerate.

## Appendix B: Methods to Assess Capital Adequacy

## Section 940B

The prescribed methods to assess group-wide capital include the Accounting Consolidation method, the Deduction and Aggregation method, and the Book Value / Requirement Deduction method. In addition, if necessary, you can also combine two or more of these methods to conduct your capital adequacy analysis. The following pages outline the three methods and provide examples of each.

The following is an abbreviated consolidated balance sheet divided into the individual subsidiaries including a banking company that is the parent, an insurance subsidiary that is wholly owned by the parent, a securities company that is 60 percent owned by the parent, and an unregulated finance subsidiary that is wholly owned by the parent. The examples in this appendix are based on the financial information shown below.

	Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned	Eliminations	Consolidated
<b>Most Assets</b>	\$315	\$150	\$225	\$120		\$810
<b>General Reserves</b>	-4	-2	-2	-2		-10
<b>Investment In:</b>						
Insurance Sub.	10					
Securities Sub.	12					
Finance Sub.	<u>5</u>					
<b>Totals</b>	27	0	0	0	-\$27	0
<b>Total Assets</b>	338	148	223	118		800
<b>Total Liabilities</b>	275	138	203	113		729
<b>Minority Interest<sup>1</sup></b>					8	8
<b>Equity Capital</b>	63	10	20	5	-35	63
<b>Liabilities &amp; Equity Capital</b>	\$338	\$148	\$223	\$118		\$800

<sup>1</sup> In this example, it is assumed that a third party minority investor owns 40 percent of the securities subsidiary. This minority ownership interest equals \$20 of equity capital at the securities subsidiary multiplied by 40 percent, or \$8.

**Accounting Consolidation Method:**

- Uses consolidated financial information to eliminate intra-group transactions and capital gearing.
- Breaks down the consolidated balance sheet into its major sectors.
- Compares the conglomerate's consolidated available capital to capital needs.
- Calculates the capital requirement for each regulated entity and a notional capital proxy for each unregulated entity. If a proxy cannot be developed for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.
- Determines the transferability of capital.
- Aggregates the individual capital requirements and notional capital proxies (or deduction for unregulated entities for which no proxy can be developed) of each entity or sector and compares this to the group-wide available capital to identify a group-wide capital surplus or deficit.

The group-wide capital surplus equals \$12 in the second table on the following page. However, this assumes that the capital surpluses of the other entities are available (transferable) to offset the capital deficit at the finance subsidiary. In such an instance, you will need to determine if the surplus capital is transferable to capital deficient sectors and is also eligible as capital in the capital deficient sectors. If the surplus capital is not transferable or eligible, then capital is considered inadequate at the finance subsidiary.

When minority interests are present, you will need to decide whether to include or exclude the minority interests in your capital assessment. The first table on the following page "Accounting Consolidation Capital Assessment Using Full Consolidation" includes the minority interest as available capital while the second table excludes the minority interests from capital. As a result, the \$5 capital surplus of the securities subsidiary is pro rated 60 percent, or \$3, reducing group-wide capital by \$2. See Appendix C for additional discussion of majority and minority interests. Generally, you are expected to exclude or pro rate capital surpluses when the conglomerate holds less than a 100 percent ownership interest in an entity.

However, you are expected to include, and not pro rate capital deficits, when the conglomerate has less than 100 percent ownership in an entity. For example, if the parent's ownership interest in the finance subsidiary were only a majority interest, you would still include the entire \$3 capital deficit in your analysis.

<b>Accounting Consolidation Capital Assessment Using Pro Rata Consolidation</b>					
	<b>Regulated Banking Parent</b>	<b>Regulated Insurance Subsidiary 100% Owned</b>	<b>Regulated Securities Subsidiary 60% Owned</b>	<b>Unregulated Finance Subsidiary 100% Owned</b>	<b>Group-Wide Totals</b>
<b>Equity Capital</b>	\$63	\$10	\$12.0	\$5	<b>\$90.0</b>
<b>General Reserves</b>	4	2	1.2	2	<b>9.2</b>
<b>Available Capital<sup>2</sup></b>	67	12	13.2	7	<b>99.2</b>
<b>Deduct Investment In Subsidiaries</b>	-27	0	0	0	<b>-27</b>
<b>Capital Required / Proxy<sup>3</sup></b>	-32	-10	-10.2	-10	<b>-62.2</b>
<b>Capital Surplus / - Deficit</b>	\$8	\$2	\$3.0	-\$3	<b>\$10.0<sup>4</sup></b>
<b>Accounting Consolidation Capital Assessment Using Full Consolidation</b>					
	<b>Regulated Banking Parent</b>	<b>Regulated Insurance Subsidiary 100% Owned</b>	<b>Regulated Securities Subsidiary 60% Owned</b>	<b>Unregulated Finance Subsidiary 100% Owned</b>	<b>Group-Wide Totals</b>
<b>Equity Capital</b>	\$63	\$10	\$20	\$5	<b>\$98</b>
<b>General Reserves</b>	4	2	2	2	<b>10</b>
<b>Available Capital</b>	67	12	22	7	<b>108</b>
<b>Deduct Investment In Subsidiaries</b>	-27	0	0	0	<b>-27</b>
<b>Capital Required / Proxy<sup>3</sup></b>	-32	-10	-17	-10	<b>-69</b>
<b>Capital Surplus / - Deficit</b>	\$8	\$2	\$5	-\$3	<b>\$12</b>

<sup>2</sup> Note that the capital amounts include general reserves as part of available capital. The use of general reserves, or other items, as available capital will vary in different sectors or industries.

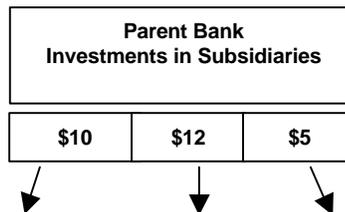
<sup>3</sup> In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate's group wide totals. In this example you would need to deduct the unregulated finance subsidiary's \$7 of available capital and the \$10 capital proxy from the group totals. You would not need to change the \$27 deduction for investment in subsidiaries because you would still want to eliminate the parent's \$5 investment in the finance subsidiary. Once you have deducted the unregulated entity, you would assess the remainder of the conglomerate's balance sheet as described in this Section of the Handbook. You will need to rely on other tools to assess the capital adequacy of the unregulated entity such as peer comparisons, debt to equity ratios, and cashflow analyses as described in Section 300 of the Handbook.

<sup>4</sup> The table above, "Accounting Consolidation Capital Assessment Using Full Consolidation" includes the minority interest as available capital while the first table "Accounting Consolidation Capital Assessment Using Pro Rata Consolidation" excludes the minority interests from capital. As a result, in the first table the \$5 capital surplus of the securities subsidiary is pro rated 60 percent, or \$3, reducing group-wide capital by \$2, which is the difference in the group-wide capital results of \$10 versus \$12. See Appendix C for additional discussion of majority and minority interests.

**Deduction and Aggregation Method:**

- Uses unconsolidated statements and is predicated on pro rata inclusion of subsidiaries.
- Sums the available capital for each regulated and nonregulated entity or sector.
- Sums the capital requirements for each regulated and nonregulated entity or sector with the book value of the investments in the entities or sectors in the group.
- Determines the transferability of surplus capital.
- Compares required capital to available capital to identify a surplus or deficit on a group-wide basis.

The group-wide capital surplus equals \$10 in this example. However, this assumes that the capital surpluses of the other entities are available to offset the capital deficit at the unregulated finance subsidiary. In such an instance, you will need to determine if the surplus capital is transferable to capital deficient sectors and if the company is regulated, the surplus capital is also eligible as capital in the capital deficient sectors. If the surplus capital is not transferable, then capital is considered inadequate at the finance subsidiary. Generally, you are expected to exclude or pro rate available capital and required capital when the conglomerate holds less than a 100 percent ownership interest in an entity. However, you are expected to include and not pro rate capital deficits when the conglomerate has a majority interest in an entity. For example, if the parent’s ownership interest in the finance subsidiary were less than 100 percent, you would still include the entire \$3 capital deficit in your analysis. See Appendix C for additional discussion of majority and minority interests.



	<b>Regulated Banking Parent</b>	<b>Regulated Insur- ance Subsidiary 100% Owned</b>	<b>Pro Rated Regu- lated Securities Subsidiary 60% Owned</b>	<b>Unregulated Finance Subsidiary 100% Owned</b>	<b>Group-Wide Totals</b>
Available Capital <sup>5</sup>	\$67	\$12	\$13.2	\$7	<b>\$99.2</b>
Capital Required / Proxy <sup>6</sup>	-32	-10	-10.2	-10	<b>-62.2</b>
Inv. in Subsidiaries	-27				<b>-27.0</b>
Capital Surplus / - Deficit	\$8	\$2	\$3.0	-\$3	<b>\$10.0</b>

<sup>5</sup> Note that the capital amounts below include general reserves as part of available capital. The use of general reserves, or other items, as available capital will vary in different sectors and countries.

<sup>6</sup> In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate’s group wide totals. In this example you would need to deduct the unregulated finance subsidiary’s \$7 of available capital and the \$10 capital proxy from the group totals. You would not need to change the \$27 deduction for investment in subsidiaries because you would still want to eliminate the parent’s \$5 investment in the finance subsidiary. Once you have deducted the unregulated entity, you would assess the remainder of the conglomerate’s balance sheet as described in this Section of the Handbook. You will need to rely on other tools to assess the capital adequacy of the unregulated entity such as peer comparisons, debt to equity ratios, and cashflow analyses as described in Section 300 of the Handbook.

**Book Value / Requirement Deduction Method:**

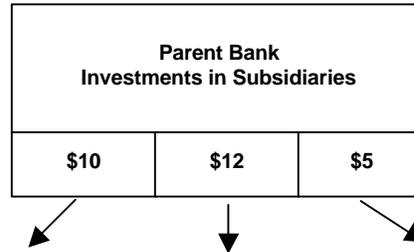
- Uses unconsolidated statements.
- Performs analysis from parent company perspective.
- Predicated on pro rata consolidation of subsidiaries.
- Focuses on capital surplus or deficit of each dependent (subsidiary) and the transferability of available capital to the parent or elsewhere in the group.

**Summary Steps to Complete the Book Value / Requirement Deduction Method:**

- Calculate the parent's available capital according to the relevant capital rules for that sector.
- Calculate the parent's required capital according to the relevant capital rules for that sector.
- Calculate the higher of the book value of the parent's investment in other entities or sectors, or these entities' capital requirements, pro rated as appropriate.
- Sum the parent's required capital and the higher of the book value of the parent's investment in other entities or sectors and these entities' capital requirements.
- Determine the transferability of surplus capital.
- Calculate the group-wide capital surplus / deficit by comparing the parent's available capital to the sum of the parent's required capital and the higher of the book value of the parent's investment in other entities or sectors, or these entities' capital requirements.

The group-wide capital surplus equals \$3 in this example. While this method excludes the available capital of the subsidiaries, it also only takes into account the higher of the subsidiary capital requirements or the investment in the subsidiary, ignoring the lower of the two items. The net result in this case is that surplus capital is estimated to be \$3 versus \$10 in the prior two methods. While the example calculates a capital surplus, it assumes that the capital surpluses of the other entities are available to offset the capital deficit at the unregulated finance subsidiary. In such an instance, you will need to determine if the surplus capital is transferable to capital deficient sectors and if the company is regulated, the surplus capital is also eligible as capital in the capital deficient sectors. If the surplus capital is not transferable, then capital is considered inadequate at the finance subsidiary. Generally, you are expected to exclude or pro rate required capital when the conglomerate owns less than 100 percent of an entity. However, you are expected to include and not pro rate capital deficits when the conglomerate has a majority interest in an entity. For example, if the parent's ownership interest in the finance subsidiary were less than 100 percent, you would still include the entire \$3 capital deficit in your analysis. See Appendix C for additional discussion of majority and minority interests.

**Book Value / Requirement Deduction Method (Continued):**



	Unconsolidated Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned
<b>Available Capital</b> <sup>7</sup>	\$67	\$12	\$13.2	\$7
<b>Capital Required / Proxy</b> <sup>8</sup>	32	10	10.2	10
<b>Surplus/ (Deficit)</b>	\$35	\$2	\$3.0	-\$3
Parent's Available Capital (\$63 Equity Capital plus \$4 General Reserves)				\$67
Sum:				
Parent's Capital Required				\$32
Calculate the higher of the book value of the parent's investment in each individual entity or sector or these entities' capital requirements:				
Insurance Subsidiary				10
Securities Subsidiary				12
Unregulated Finance Subsidiary				<u>10</u>
Total Capital Required				64
<b>Group-Wide Capital Surplus / - Deficit</b>				<b>\$3</b>

<sup>7</sup> Note that the capital amounts below include general reserves as part of available capital. The use of general reserves, or other items, as available capital will vary in different sectors and countries.

<sup>8</sup> In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate. In this example you would need to eliminate the \$10 deduction for the capital proxy and instead subtract the Parent's \$5 investment in the Finance Subsidiary from the \$64 of Total Capital Required. Once you have deducted the unregulated entity, you would assess the remainder of the conglomerate's balance sheet as described in this section of the Handbook. You will need to rely on other tools to assess the capital adequacy of the unregulated entity such as peer comparisons, debt to equity ratios, and cashflow analyses as described in Section 300 of the Handbook.

## Appendix C: Prudential Treatment of Minority and Majority Interests in Subsidiaries

## Section 940C

In reviewing financial conglomerates, you are likely to encounter a variety of different types of control structures ranging from wholly owned subsidiaries to ownership and/or voting interests that may be insignificant. These situations sometimes present difficulties in assessing capital adequacy. In those instances where a lower tier company maintains surplus capital and the conglomerate's investment is less than 100 percent, you will need to decide what portion of the lower tier company's surplus capital is available to the parent. In addition, when a lower tier company has insufficient available capital, the liability to fund the capital deficit may exceed the conglomerate's pro rata interest in that particular company and the entire deficiency should be reflected in your assessment of the conglomerate's capital adequacy.

When you conduct a capital adequacy assessment of a financial conglomerate where minority interests are present, you will need to decide how to apportion any surplus capital, or a capital deficiency, on a group-wide basis. The following example demonstrates: 1) the impact that minority interests and double gearing can have on your capital adequacy assessment, and 2) that full consolidation can produce a more liberal result than the pro rata method.

In this example, a regulated parent holding company has \$2,000 of equity capital and invests \$300 for a 60 percent ownership in a regulated bank. There is a \$200 minority interest in the bank held by a separate third party. The bank has total capital of \$500 as shown in the next table. The parent and the bank have required capital levels of \$1,700 and \$250, respectively. Both entities easily exceed their required capital levels by \$300 for the parent and \$250 for the bank subsidiary on a stand-alone, unconsolidated basis. The combined, but unconsolidated group-wide capital surplus is \$550, as shown in the second table.

	Parent Holding Company	60 % Owned Bank	Eliminations	Consolidated
<b>Assets:</b>				
Most Assets	\$1,850	\$900		\$2,750
Inv. in Bank	300		-\$300	0
Totals	\$2,150	\$900		\$2,750
<b>Liabilities</b>	\$ 150	\$400		\$ 550
<b>Minority Interest</b>			200	200
<b>Equity Capital</b>	2,000	500	-500	2,000
<b>Liabilities &amp; Equity Capital</b>	\$2,150	\$900		\$2,750

However, we need to eliminate the double gearing of downstreamed capital, the parent's \$300 equity investment in the bank, through consolidation. As a result, the parent's \$300 investment is eliminated and the consolidated surplus capital position declines from \$550 to \$250 and the parent's available capital now equals its required capital level.

Capital Adequacy Analysis			
	Parent Holding Company	60 % Owned Bank	Group-Wide Totals
<b>Available Capital</b>	\$2,000	\$500	<b>\$2,500</b>
<b>Capital required</b>	-1,700	-250	<b>-1,950</b>
<b>Capital Surplus / - Deficit Before Adj. for Gearing</b>	300	250	<b>550</b>
<b>Adj. For Gearing</b>	-300	0	<b>-300</b>
<b>Capital Surplus / - Deficit After Adj. for Gearing</b>	\$0	\$250	<b>250</b>
<b>Adjustments for Minority Interest</b>			<b>-100</b>
<b>Capital Surplus / - Deficit After Adj. for Gearing &amp; Minority Interest</b>			<b>\$150</b>

You will need to assess the \$200 minority ownership interest for any legal and tax restrictions, consider, for example, shareholder rights and regulatory restrictions and decide if all of the \$250 surplus capital at the bank is available on a group-wide basis. If you decide that the minority owner's interest in the surplus capital precludes using the surplus capital in your capital adequacy analysis group-wide, you should adjust your analysis accordingly. Generally you should pro rate the surplus capital to recognize that the parent is only entitled to 60 percent of the surplus capital position should the bank decide to pay out the surplus capital. In this example, assume that the minority interest is not available as capital outside of the bank because it is not transferrable to the parent. As a result, \$100 (\$250 capital surplus multiplied by the minority ownership interest of 40 percent = \$100) is deducted from the combined results and the group-wide capital surplus is reduced from \$250 to \$150. The preceding example demonstrates how double gearing and the presence of a minority interest can significantly overstate capital adequacy group-wide.

The following example demonstrates the practical implications of assessing capital adequacy when the parent only has a minority interest in a lower tier company and that company has a capital deficiency. Generally you will include the entire capital deficiency of a subsidiary if the conglomerate maintains a majority interest, you also need to consider minority interests between 20 and 50 percent if there are factors present that would create a controlling interest. In this example, it is assumed that although the ownership interest is 40 percent, the conglomerate holds the majority of the board seats which would give it effective control of the insurance company. In this instance, a parent holding company holds a \$150 investment in a 40 percent owned insurance company that is accounted for using the equity method.<sup>1</sup> Since the

parent's ownership interest is less than 50 percent, the equity method of accounting is applicable. The insurance company has a total capital base of \$375 comprised of the 60 percent third-party majority interest of \$225 and the holding company's \$150 minority investment.

Assume that the parent and the insurance company have required capital levels of \$1,700 and \$450, respectively. The parent has a capital surplus of \$300 on a stand-alone basis and the insurance company has a \$75 capital deficit on a stand-alone basis. On a combined basis, the group-wide capital surplus is \$225.

	<b>Parent Holding Company</b>	<b>40 % Owned Insurance Company</b>
<b>Assets:</b>		
Most Assets	\$2,000	\$550
Investment in Insurance Co.	150	0
Totals	\$2,150	\$550
<b>Liabilities</b>	\$150	\$175
<b>Equity Capital</b>	2,000	375
<b>Total Liabilities &amp; Equity Capital</b>	\$2,150	\$550

However, the parent's \$150 equity investment in the insurance company represents capital that is double geared and therefore needs to be deducted to properly assess capital adequacy on a group-wide basis. This deduction reduces the group-wide capital surplus from \$225 to \$75.

<b>Capital Adequacy Analysis</b>			
	<b>Parent Holding Company</b>	<b>40 % Owned Insurance Company</b>	<b>Group-Wide</b>
<b>Available Capital</b>	\$2,000	\$375	<b>\$2,375</b>
<b>Capital Required</b>	1,700	450	<b>2,150</b>
<b>Capital Surplus / - Deficit Before Adjustment For Gearing</b>	300	-75	<b>225</b>
<b>Deduct Double Gearing</b>	-150		<b>-150</b>
<b>Capital Surplus / - Deficit After Adj. For Gearing</b>	\$150	-\$75	<b>\$75</b>

<sup>1</sup> While the equity method of accounting is appropriate for minority interests, if you decide that the conglomerate actually maintains a controlling interest in the entity because of other factors, then GAAP may require full consolidation of the entity.

The \$75 capital deficit at the insurance company is attributed to the parent in its entirety until the capital deficit is resolved and is not pro rated for the parent's 40 percent minority interest. The entire deficit is assessed against the parent holding company in the event that the majority owner cannot, or will not provide the needed capital. By ignoring this possibility, you may be overstating the capital adequacy of the group. As a result, the capital deficit is not pro rated for the split ownership interest in the insurance company.

Fully aggregating non wholly owned entities with capital surpluses, or not including the entire capital deficit where the parent's interest is less than 100 percent may overstate capital adequacy, if the above assessment is not conducted. In situations where group-wide capital appears satisfactory, but an individual entity has a capital deficit, you will then need to determine if surplus capital from other entities can be transferred to the entity with the capital deficit, and if any additional capital support is available from the third-party majority or minority interests. Note that an actual transfer of capital may not need to be made. You are assessing whether a transfer could be made, if necessary. In doing so, you need to determine if there are any restrictions on the transferability of the surplus capital.

In general, the following guidelines will apply:

- If the group does not maintain control of a subsidiary, normally less than a 20 percent interest, and does not maintain any significant influence through board membership or other avenues, then the parent's investment should be treated in accordance with the applicable regulatory capital rules for that entity. In those instances where capital rules are silent or the subsidiary is unregulated, generally accepted accounting principles (GAAP) should prevail.
- If the ownership interest in a subsidiary gives the group shared control, only the pro rata share of surplus capital should be considered as available to the parent. Typically, pro rata treatment will be applied to ownership interests

between 20 and 50 percent. However, careful assessment of the ownership structure is required. In cases where shared control is less than 50 percent, in particular if voting control is under 20 percent or the parent does not exercise any significant control or influence over the subsidiary, the parent's investment should be treated in accordance with the applicable regulatory capital rules for that entity. In those instances where regulatory rules are silent or the subsidiary is unregulated, GAAP should prevail.

When a parent company owns between 20 and 50 percent of a subordinate organization's outstanding voting common stock, the parent should generally reflect the investment on its books under the equity method. The parent initially records its investment in the entity at cost. The parent makes subsequent adjustments to the carrying value to reflect its share of the subordinate's earnings or losses in the period that the subordinate reports its operating results. Also, the parent adjusts its investment to reflect dividends received from a subordinate organization. Under the equity method, the parent does not report a subordinate organization's dividends as income, but rather as cash dividends that reduce the subordinate's net assets and stockholders' equity. Accordingly, the parent should record a proportionate decrease in its investment account for dividends received from the subordinate organization.

The equity method may require other adjustments to the investment account similar to those made in preparing consolidated statements. These include eliminating intercompany gains and losses and to account for any differences between the parent and the subordinate organization in the measurement of the subordinate's expenses. You can refer to APB No. 18, The Equity Method of Accounting for Investments in Common Stock for further details.

- For interests in excess of 50 percent, interests that confer effective control are usually consolidated in full and minority interests are shown separately in the financial statements. Surplus capital can be counted as available to support the risks in the parent company, if ap-

appropriate. However, your assessment will need to take into account any types of restrictions on the transferability of the surplus capital in the lower tier entities. There may be legal, tax, shareholder rights, policyholder rights, restrictions imposed by functional regulators, and other considerations that will need to be weighed in assessing if the surplus capital is transferable. If you decide that restrictions are present that prohibit the transfer of all of the surplus capital, then you will need to pro rate the surplus capital to properly reflect the amount available to the group in your capital adequacy analysis.

When a company owns more than 50 percent of a subordinate organization's outstanding common stock, GAAP generally requires the parent to consolidate the subordinate's assets on its financial reports. In a consolidation, the parent's financial reports reflect the financial position, operating results, and cash flows of both the parent and subordinate as if they were a single business entity. The reconciliation process involves the elimination of intercompany accounts and transactions, such as loans and payments between the two entities. Typical intercompany elimination entries pertain to intercompany stock ownership, intercompany debt, and intercompany revenue and expenses. This includes open account balances, security holdings, sales and purchases, interest, dividends, gain or loss on transactions among entities in the consolidated group, and intercompany profit or loss on assets remaining within the group.

When a subordinate organization is majority (but not wholly) owned by a parent company, the subordinate separately reports the minority interest of shareholders owning less than 50 percent of outstanding voting common stock. The minority shareholders have an interest in the subordinate's net assets and in profits and losses.

You should consult Accounting Principles Board Opinion (APB) No. 16, Business Combinations, when there are complex consolidation matters, such as intercompany profits in assets, goodwill, and income taxes on undistributed earnings.