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SUPERVISION  
OF  
FINANCIAL  
CONGLOMERATES

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## Table of contents

Introduction .....	1
<b>Capital Adequacy Principles paper</b>	
Objective, Summary of principles .....	5
Measurement Techniques and Background .....	6
Assumptions .....	7
Definitions .....	7
Guiding principles .....	7
Annex 1: Supervisory Measurement Techniques .....	15
Annex 2: Summary and Examples of Measurement Techniques.....	19
<b>Supplement to the Capital Adequacy Principles paper</b>	
Introduction .....	27
Illustrative examples.....	28
<b>Fit and Proper Principles paper</b>	
Objective and Background .....	39
Principal elements of fit and proper criteria .....	40
Guiding principles .....	41
<b>Framework for Supervisory Information Sharing paper</b>	
Purpose and objectives .....	45
Definitions .....	46
Background and Observations of the Task Force.....	47
Framework for Identifying Supervisory Information Needs.....	50
Exchange of Information Between Supervisors under Various Circumstances.....	55
Annex A: Conglomerate Questionnaire.....	61
Annex B: Outline of Types of Information that would be Useful in an Emergency Situation .....	92
<b>Principles for Supervisory Information Sharing paper</b>	
Objective and Background .....	100
Guiding principles .....	101
Annex 1: G-7 Ten Key Principles on Information Sharing .....	108

“

## Coordinator paper

Objective and Background .....	112
Factors affecting the choice of options .....	113
Guiding principles .....	114
Annex 1: Catalogue of possible elements of coordination .....	118
Annex 2: Possible basis to assist in identifying a Coordinator .....	119

## Supervisory Questionnaire

Introduction .....	121
Stated purpose and objectives of supervision.....	121
Legal authority .....	121
Methods of assessing financial condition .....	123
Tools of supervision .....	124
Other mechanisms to enhance sound practices.....	125
Information flows among supervisors .....	125
Matrix record.....	126

## **Introduction**

The Joint Forum on Financial Conglomerates (Joint Forum) was established in early 1996 under the aegis of the Basle Committee on Banking Supervision (Basle Committee), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to take forward the work of the Tripartite Group whose report was released in July 1995. 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 United States. The EU Commission is attending in an observer capacity.

In accordance with its mandate which was agreed by the Basle Committee, IOSCO and the IAIS (collectively "the parent organisations"), the Joint Forum has reviewed various means to facilitate the exchange of information between supervisors within their own sectors and between supervisors in different sectors and has investigated legal or other barriers which could impede the exchange of information between supervisors within their own sectors and between supervisors in different sectors. Also, based on its mandate, the Joint Forum has examined ways to enhance supervisory coordination, including the benefits and drawbacks to establishing criteria to identify and define the responsibilities of a coordinator, and is working on developing principles toward the more effective supervision of regulated firms within financial conglomerates.

The Joint Forum prepared a number of papers dealing with these matters which were released by the Basle Committee, IOSCO and the IAIS for consultation with industry and the supervisory community on a global basis from mid-February 1998 to 31 July 1998.

About 60 written submissions were received on the papers. These came from a mix of governmental and supervisory agencies, industry and other interested parties worldwide. The views of industry were largely provided through their associations and in some cases through supervisory agencies.

The submissions received were supportive of the work of the Joint Forum. Numerous suggestions for modifying, refining or otherwise clarifying the papers were made.

In addition to the global consultation process, the Joint Forum conducted practical testing exercises on its work on capital adequacy and considered further the practical issues involved in the identification of coordinators. The Joint Forum finalised the papers in light of the comments received during the consultation process and the results of its additional work. The Basle Committee and the Technical Committees of IOSCO and the IAIS have endorsed the papers and are now prepared to release these with a recommendation to members of the parent organisations to implement the principles therein. The Basle Committee and the Technical

Committees of IOSCO and the IAIS also commend the regulatory tools, techniques and other guidance set out in the papers to those members.

The Basle Committee and the Technical Committees of IOSCO and the IAIS have noted concerns expressed in a number of comments from industry to the effect that the adoption of new international standards would result in an increase in the regulatory burden. The Committees would like to avoid this to the greatest extent practical and encourage supervisors, in applying the principles and other guidance in the papers to avoid any unnecessary duplication including wherever possible by acting in coordination with other supervisors.

It is noted that the Joint Forum's focus has been, primarily, on diversified financial firms with complex organisational and management structures whose large scale activities cross national borders and sectoral boundaries. However, the lessons drawn and the guidance prepared could also apply to smaller conglomerates or conglomerates that only operate domestically.

The papers are as follows:

- A. *Capital Adequacy Principles* paper
- B. *Supplement to the Capital Adequacy Principles* paper
- C. *Fit and Proper Principles* paper
- D. *Framework for Supervisory Information Sharing* paper
- E. *Principles for Supervisory Information Sharing* paper
- F. *Coordinator paper*
- G. *Supervisory Questionnaire*.

The *Capital Adequacy Principles* paper outlines measurement techniques and principles to facilitate the assessment of capital adequacy on a group-wide basis for financial conglomerates. This paper was significantly refined as a result of the consultation process and testing of the principles. The more significant changes include:

- emphasising that the suggested measurement techniques do not replace existing sectoral rules for the assessment of capital adequacy but are used to complement existing approaches
- addressing the treatment of unregulated non-financial entities
- dealing with the combining and tailoring of the measurement techniques
- making it clear that the choice of measurement technique is left at the supervisors' discretion.

The *Supplement to the Capital Adequacy Principles* paper illustrates situations that can be faced by supervisors in practical applications of the measurement techniques.

The *Fit and Proper Principles* paper provides guidance to ensure that supervisors of entities within a financial conglomerate are able to exercise their responsibilities to assess whether those entities are soundly and prudently managed.

The *Framework for Supervisory Information Sharing* paper sets out a general framework for facilitating information-sharing between supervisors of regulated entities within internationally active financial conglomerates.

The *Principles for Supervisory Information Sharing* paper provides to supervisors involved in the oversight of regulated financial institutions residing in financial conglomerates guiding principles with respect to supervisory information sharing. The Ten Key Principles on Information Sharing issued by the G-7 Finance Ministers in May 1998 which complement the principles developed by the Joint Forum, are annexed to this paper.

The *Coordinator* paper provides to supervisors guidance for the possible identification of a coordinator or coordinators and a catalogue of elements of coordination from which supervisors can select the role and responsibilities of a coordinator or coordinators in emergency and non-emergency situations. In May 1998, the G-7 Finance Ministers endorsed the principles in this paper and urged the supervisory bodies to take quickly the decisions on the implementation of these proposals, as some national supervisors move towards establishing coordinators for their major groups. Many of the submissions received from industry and the supervisory community suggested modifying the principles in various ways generally with a view to enhancing effective coordination. After examining actual experiences in supervisory coordination, the Forum concluded that it would be preferable to proceed to implementation of the principles rather than to attempt further refinement at this stage.

The *Supervisory Questionnaire* is a tool to assist supervisors in better understanding each others' objectives and approaches. It is expected that experience gained in using the Questionnaire, will result in changes to enhance its coverage and make it a more useful tool to better understand supervisors' objectives and approaches.

Capital Adequacy  
Principles  
paper

## **Capital Adequacy Principles**

### **Objective**

1. To provide banking, securities and insurance supervisors with principles and measurement techniques (a) to facilitate the assessment of capital adequacy on a group-wide basis for heterogeneous financial conglomerates; and (b) to identify situations such as double or multiple gearing which can result in an overstatement of group capital and which can have a material adverse effect on the regulated financial entities. The principles and measurement techniques put forward in this paper do not replace existing sectoral rules and regulatory responsibilities.

### **Summary of Principles**

2. Supervisors should assess the capital adequacy of financial conglomerates. In so doing, measurement techniques should be designed to:
- I. detect and provide for situations of double or multiple gearing, i.e. where the same capital is used simultaneously as a buffer against risk in two or more legal entities;
  - II. detect and provide for situations where a parent issues debt and downstreams the proceeds in the form of equity, which can result in excessive leverage;
  - III. include a mechanism to detect and provide for the effects of double, multiple or excessive gearing through unregulated intermediate holding companies which have participations in dependants or affiliates engaged in financial activities;
  - IV. include a mechanism to address the risks being accepted by unregulated entities within a financial conglomerate that are carrying out activities similar to the activities of entities regulated for solvency purposes (e.g. leasing, factoring, reinsurance).
  - V. address the issue of participations in regulated dependants (and in unregulated dependants covered by principle IV) and to ensure the treatment of minority and majority interests is prudentially sound.

### ***Measurement Techniques***

3. This paper recognises the existence of capital adequacy rules in each sector and does not seek to impose specific techniques for giving effect to the principles. Rather, the paper sets out techniques that usefully complement existing approaches to the assessment of capital adequacy. The Joint Forum has identified three measurement techniques outlined in Annex 1.

### ***Background***

4. The emergence of corporate groups which provide a wide range of financial services, known as financial conglomerates and typically incorporating at least two of banking, securities and insurance, has created an additional dimension for the solo supervisors of entities within those groups. Supervisory concerns have been explored from the perspective of each of the three supervisory disciplines and also from a broader perspective by the three groups of supervisors working together.

5. A central issue has been to ensure that the objectives of individual supervisors as they relate to the entities for which they have regulatory responsibility are not impaired as a result of the existence of financial conglomerates. Supervisors collectively recognise the need for individual supervisors of businesses within a conglomerate to satisfy themselves that there is sufficient capital available to the individual regulated entities to ensure their viability. Different supervisors attach different weights to the relative importance of the two objectives identified in the opening paragraph of this paper while recognising that neither is exclusive of the other.

6. The solo capital adequacy requirements of each of the banking, securities and insurance sectors are different with varying definitions of the elements of capital, and varying approaches to asset and liability valuations. Each sector's capital adequacy requirements reflect the nature of the different businesses undertaken by each sector, the differing risks to which they are exposed, and the different ways in which risk is managed by the firms and assessed (and/or constrained) by supervisors.

7. The elaboration and application of capital adequacy measurement techniques on a group-wide basis, and the possibility of the exercise of supervisory powers including those providing for remedial action which may prove necessary, is not intended to create an expectation that the full extent of regulation extends to unregulated entities within a financial conglomerate. The supervisory measures adopted should be construed so as to take this into account.

### ***Assumptions***

8. The capital adequacy requirements (and other features of the financial control regimes) that banking, securities and insurance supervisors prescribe for the institutions and groups within their own jurisdictions are taken as given. Supervisors may wish to exercise their judgement on the degree to which they will rely on the application of these requirements in jurisdictions which do not apply similar standards of supervision. The requirements within each sector are not in all cases uniform, but the trend is towards convergence within each sector. Further progress on the elaboration and convergence of capital adequacy requirements in the insurance sector is however desirable, including for insurance groups.

9. The elaboration of acceptable techniques of capital measurement for heterogeneous financial conglomerates does not preclude the use of an accounting-based consolidation approach, or other prudent approaches that meet objectives analogous to those in paragraph 1, for financial conglomerates made up of homogeneous entities.

### ***Definitions***

10. For the purposes of this paper, heterogeneous financial conglomerates are conglomerates whose primary business is financial, whose regulated entities engage to a significant extent in at least two of the activities of banking, insurance and securities business, and which are not subject to uniform capital adequacy requirements.

11. Group-wide basis is a term employed to indicate that the entire group, including the parent and all its regulated and unregulated entities, are being considered.

12. Capital and regulatory capital are used interchangeably to mean the aggregate amount of elements eligible for inclusion in the regulatory definition of capital.

13. Regulatory capital requirement is the minimum amount of regulatory capital required by a supervisor, which if not maintained will usually permit or require supervisory intervention.

### ***Guiding Principles***

14. The objective in developing measurement techniques for the assessment of capital adequacy on a group-wide basis for heterogeneous financial conglomerates has been to identify approaches that should yield broadly equivalent results, not to promote a single technique for universal application.

15. In principle, the use of the different techniques outlined in the annex to this paper should yield broadly equivalent results if applied to any particular group; in practice, the exercise of reasonable discretionary judgement by supervisors will give results within a range of acceptable outcomes.

16. The use of these techniques does not diminish the need for solo supervisors to establish the solo capital position against solo capital requirements for individual regulated businesses, that are required by sectoral capital adequacy regimes.

17. In order to fulfil the objectives in paragraph 1, acceptable capital adequacy measurement techniques should be designed to:

**I. detect and provide for situations of double or multiple gearing, i.e. where the same capital is used simultaneously as a buffer against risk in two or more legal entities;**

18. Double gearing occurs whenever one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet. In that situation, external capital of the group is geared up twice; first by the parent, and then a second time by the dependant. Multiple gearing occurs when the dependant in the previous instance itself downstreams regulatory capital to a third-tier entity, and the parent's externally generated capital is geared up a third time. Although double and multiple gearing are normally associated with a parent downstreaming capital to its dependant, it can also take the form of an entity holding regulatory capital issued by an entity above it in the group's organisation chart (upstreamed capital) or by a sister affiliate. Supervisors need to be alert to the implications of double or multiple gearing in the entities that they supervise, regardless of whether those entities hold capital issued by a parent company, a dependant, or an affiliate.

19. The principal issue raised by double or multiple gearing is not the ownership structure as such (although some structures may also raise broader supervisory concerns), but the consequences of that structure for the assessment of a financial conglomerate's group-wide capital. When double or multiple gearing is present, assessments of group capital that are based on measures of solo capital are likely to overstate the external capital of the group. Supervisors should bear in mind that only capital issued to external (i.e., non-group) investors provides support to the group, although some forms of internally generated capital may provide support for individual companies on a solo basis. Consequently, assessments of group capital should exclude intra-group holdings of regulatory capital. Three capital adequacy measurement techniques for making that adjustment are described in annex 1 to this paper. Annex 2 provides numerical illustrations.

20. The situation is somewhat different when two entities within a group each holds regulatory capital issued by the other. In that case, none of the reciprocal holdings represents externally generated capital. The solution, however, is the same: both intra-group holdings should be excluded from assessments of group capital.

21. The structure of corporate groups means that it is inevitable that at least one entity will own shares and possibly other capital instruments issued by other entities within the group. While from a commercial perspective such structures are not inherently unsound, some may pose a prudential concern. For example, large intra-group holdings of capital can permit difficulties in one entity to be transmitted more quickly to other entities within the group. Thus, in addition to making the necessary adjustment to measurements of group capital, supervisors should be alert to ownership structures that pose such prudential concerns.

22. Paragraphs 17 to 20 deal with double or multiple gearing within a group. Supervisors should also be aware that similar problems of double or multiple gearing can also occur between different conglomerates holding cross participations in each other or in each other's dependants.

**II. detect and provide for situations where a parent issues debt and downstreams the proceeds in the form of equity, which can result in excessive leverage;**

23. A situation of excessive leverage can occur when a parent issues debt (or other instruments not acceptable as regulatory capital in the downstream entity) and downstreams the proceeds to a dependant in the form of equity or other elements of regulatory capital. In this situation, the effective leverage of the dependant may be greater than its leverage computed on a solo basis. While this type of leverage is not necessarily unsafe or unsound excessive leverage can constitute a prudential risk for the regulated entity if undue stress is placed on the regulated entity resulting from the obligation on the parent to service that debt. A similar problem can arise where a parent issues capital instruments of one quality and downstreams them as instruments of a higher quality.

24. In the particular case of an unregulated holding company, (i.e. one not subject to any sectoral capital adequacy requirement), at the top of a financial conglomerate, an assessment of group-wide capital adequacy by supervisors will need to encompass the effect on the group of the capital structure (and liquidity when appropriate) of such a company. To achieve this supervisors will need to be able to obtain information about the unregulated holding company e.g. via the regulated entities or via public domain information, and so to make an assessment of its ability to service all external debt. This is one aspect of a more general need for

supervisors to consider the impact on regulated entities of unregulated parent holding companies.

**III. include a mechanism to detect and provide for the effects of double, multiple or excessive gearing through unregulated intermediate holding companies which have participations in dependants or affiliates engaged in financial activities.**

25. Assessment techniques need to be able to address situations where the intermediate holding company provides regulatory capital to another group entity. The group-wide capital adequacy measurement technique used should effectively eliminate the effect of intermediate holding companies and yield the same results as would be produced if there were no such intermediate holding company, or if it were consolidated in the relevant sector for risk assessment purposes. The unregulated intermediate holding company could be a non-trading financial holding company whose only assets are its investments in dependants, and/or a company engaged in activities ancillary to the regulated entity (e.g. a service company to the group).

**IV. include a mechanism to address the risks being accepted by unregulated entities within a financial conglomerate that are carrying out activities similar to the activities of entities regulated for solvency purposes (e.g. leasing, factoring, reinsurance).**

26. For unregulated entities, supervisors have a number of analytical alternatives, including the substitution of a capital proxy for the relevant sector, the application of other ad hoc treatments that represent a prudent treatment of the risks being accepted, or as a fallback, use of total deduction treatment described in paragraph 39 and annex 1. For unregulated entities whose activities are similar to regulated entities (for example, leasing, factoring, reinsurance), a comparable or "notional" capital proxy (including any valuation requirements for assets and liabilities) may be estimated by applying to the unregulated industry the capital requirements of the most analogous regulated industry. Normally, the capital proxy treatment is applied to a reinsurance company in a group. If the capital proxy treatment is not applied to reinsurance within the group, the supervisor of any insurance company in the group should consider whether it is prudent to give credit for reinsurance placed with the reinsurer in assessing the solo capital adequacy of the regulated group insurers.

27. Unregulated non-financial entities should normally be excluded from the assessment of the group. However, where it is clear that one or more regulated entities in the group have effectively provided explicit support, such unregulated entities should be brought into the group wide assessment, via capital proxy or through total deduction.

28. More generally, where risk has been transferred from regulated companies in a group to unregulated companies in the group, supervisors of the regulated companies may need to look through to the overall quantum and quality of assets in the unregulated companies, especially where a notional capital proxy has not been used.

**V. address the issue of participations in regulated dependants (and in unregulated dependants covered by principle IV.) and to ensure the treatment of minority and majority interests is prudentially sound.**

29. The framework and mechanism for identifying and mapping group relationships is embodied in company law and accounting conventions. For the purposes of prudential supervision, the accounting treatment should be used as the point of departure although the precise way in which capital is measured and aggregated will need to be determined by the supervisor in the light of his assessment of group relationships.

30. Where the group has neither control of nor significant influence by virtue of its participation(s) in a regulated company, the regulated entities' investments should be treated in accordance with the solo supervisors' rules for capital adequacy assessment for investments in similar companies. This approach will normally be applicable to group participations of less than 20%, and it will normally result in the participation(s) being treated on the same basis as participations of less than 20% in unregulated companies.

31. Where group participations in a regulated dependant are such as to give the group shared control, only the pro-rata share of regulatory capital in excess of the dependant's own regulatory capital requirements should normally be regarded as available to support risks in the parent company or in other entities in the group and to be recognised in a group-wide capital adequacy assessment, subject to the conditions in paragraphs 32-35. Where in the view of supervisors, group participations in a regulated dependent are such as to give significant influence and exposure to risk, but falling short of control, supervisors should normally use the same approach. The test of significant influence and exposure to risk can usually be expected to apply to participations of 20% or more (and on occasion between 10 and 20%), but under 50%.

32. Such participations below 50% may occasionally be treated as not conferring significant influence or exposure to risk, in particular if voting participation is under 20%, there is no right to board membership, large exposure or asset spread rules are met, and there is no co-ordination of business plans and development. Conversely, the test may exceptionally be met by participations in the range 10-20%.

33. Under accounting conventions, participations which confer effective control and/or meet company law definitions of subsidiaries are usually consolidated in full and minority interests shown separately from the group shareholders' funds. This is on the basis that if the subsidiary were disposed of, or funds corresponding to its assets transferred to the shareholders (usually through a dividend), the minority shareholders would receive their proportion of the proceeds. For prudential purposes, regulatory capital in excess of such a subsidiary's own regulatory capital requirements, and which can be regarded as in principle available to support risks in the parent company or in other entities in the group should a shortfall arise, can be recognised in a group-wide capital adequacy assessment, subject to the conditions set out in paragraphs 32-35. This treatment can be expected to apply to group participations in excess of 50%, including 100% participation.

34. A group-wide assessment of any participations covered by paragraphs 29-31 needs to determine whether an adequate distribution of capital exists within the group. This may lead supervisors to judge that although group-wide capital covers the risks of the group, its improper distribution may endanger regulated entities within the conglomerate; in other cases it may point to a shortfall in group-wide capital overall. Such an assessment should take into account restrictions (e.g. legal, tax, rights of other shareholders' and policyholders' interests, restrictions which may be imposed by solo regulation of dependants, foreign exchange, specific local requirements for branch operations) on the transferability of excess regulatory capital (whether by the transfer of assets or by other means) in such dependants.

35. The requirement is not that such transfers should actually take place, but it should be ascertained that funds equivalent to any capital in excess of the capital requirement of a dependant and included in the group-wide capital assessment could legitimately be moved should the need arise. This test may lead supervisors in their group wide assessment of capital, to limit the inclusion of excess capital in such dependants to the funds which they judge to be available to the parent or other parts of the group, taking account of any restrictions of the kind identified in paragraph 33.

36. Supervisors should be aware that fully integrating non-wholly-owned subsidiaries may overstate the extent to which excess regulatory capital is available to the group as a whole, unless the assessment described in paragraphs 32-33 has been carried out, while this treatment of deficits may overstate the group's responsibility to inject capital.

37. Conversely, a pro rata attribution of any deficit may understate a parent's de facto responsibility to provide additional capital. Any solo deficits in dependants should therefore be attributed in full in the group capital assessment if it appears to the supervisor that the parent is likely to have to support the dependant without assistance from other external

participants in the dependant. The larger the group participation in a dependant, the more likely such support will be required.

38. Regulatory capital in a dependant and the matching capital requirements should be calculated according to the rules applicable to the financial sector and jurisdiction in question. The supervisor of the parent should establish that any excess capital in the dependant and to be recognised in the parent or group balance sheet comprises capital elements acceptable under his own rules.

### *Total deduction*

39. If it is not possible or practicable to make a prudent valuation of the capital in a regulated dependant, the value of the participation to the rest of the group should be set at zero, i.e. the book value of the investment should be fully deducted, unless circumstances (e.g. the existence of a guarantee from the parent to the dependant) suggests that an even more prudent treatment should be applied. This approach is likely to be appropriate if the regulatory competence of the dependant's jurisdiction is uncertain, and may also be appropriate where the local regulatory requirements and/or type of business undertaken is markedly different from those prevailing in the same sector in the parent/group jurisdiction.

### *Market risk*

40. An emerging issue for supervisors is the treatment of market risk. In many cases, the existence of market risks in different parts of a group may lead supervisors to judge that full offset of positions is not appropriate, and that an aggregation or deductive approach may give the best group wide assessment of risks; in others a consolidation approach that fully offsets market risk may give a more accurate picture. This is an area where the appropriate guidance to supervisors is likely to evolve over the next few years.

### *Techniques*

41. The Joint Forum has identified three techniques of capital measurement which are capable of yielding comparable and consistent assessments of the capital adequacy of financial conglomerates: the **building-block prudential approach**, the **risk-based aggregation method** and **risk-based deduction method**. In addition the "total deduction" technique can also be of value, especially in addressing problems of double/multiple gearing. The particulars of these techniques are set out in annexes 1 and 2 to this paper.

42. This paper endeavours to build on existing methods developed by sectoral supervisors in their respective jurisdictions to evaluate group-wide capital adequacy. Although these

existing methods frequently capture risks present across the range of conglomerates' activities, they may not always do so, or only do so in a limited manner. Where agreed by the supervisors involved with an individual conglomerate, coordination of the application of a capital adequacy measurement technique can help minimise duplicated reporting and other regulatory burdens for financial institutions.

43. In applying the techniques outlined in this paper, or other prudent techniques that may be developed in the future, supervisors have discretion to exclude entities which are immaterial to the risk profile of the group or its capital adequacy. Furthermore, supervisors may have to exercise judgement in other areas, such as the definition of regulatory capital, the determination of participation levels of subsidiaries, the application of accounting and actuarial principles, the treatment of unregulated entities and the treatment of minority and majority interests. Supervisors need to be aware that differences in the treatment of these elements may result in material differences in the overall assessment of the capital adequacy of the conglomerate.

44. The techniques consolidate or aggregate existing capital requirements and recognise risk reducing techniques (e.g hedging) to the extent that they are incorporated in sectoral capital adequacy regimes. As sectoral capital rules are developed to take more account of risks and as efforts continue to bring closer the rules in different sectors, so future measurement techniques for conglomerates may be developed to provide a better overall assessment of their capital adequacy.

45. The techniques presented have been tested by Joint Forum members on a limited number of financial conglomerates to ensure the equivalency of results between techniques and the feasibility of their application. In conducting the testing, some supervisors found it necessary to combine or tailor the techniques depending on the specific circumstances of the financial conglomerate. For example, in some cases the techniques were tailored depending on whether consolidated or unconsolidated information was available. Supervisors should have this flexibility in implementing the techniques.

46. The Joint Forum recognises that financial conglomerates operate under various types of corporate and management structures. It is not intended that the implementation of the techniques will be more favourable to one organisational structure over another.

47. If a financial conglomerate is considered not to have adequate capital, relevant supervisors should discuss and determine what appropriate measures need to be taken.

## Supervisory Measurement Techniques Relating to Heterogeneous Financial Conglomerates

### Use and Description of Techniques

The three techniques, described below, are recognised as useful alternative methodologies for assessing capital adequacy, and each technique, while analysing capital from different perspectives, should provide a similar conclusion regarding capital adequacy. Supervisors may wish to use those techniques that are best suited to the way readily accessible financial data on the conglomerate are structured. Supervisors should have the flexibility to utilise the individual techniques on their own or in combination and may need to modify these for the specific circumstances of the particular financial conglomerates with which they deal. Moreover, supervisors may use those techniques best suited to identify or highlight the nature of the risks assumed by the financial conglomerate or that identify potential weaknesses relevant to the structure of a particular financial conglomerate. Another analytical technique, which is similar to those used to evaluate group-wide capital adequacy, is provided as a fall back treatment to address the problem of double gearing and is directed at the parent company only.

#### 1. Building Block Prudential Approach

The “building block” approach essentially compares the fully consolidated capital of the financial conglomerate to the sum of the regulatory capital requirements for each group member. The regulatory capital requirements are based on those required by each group member’s supervisor or, in the case of unregulated entities, a comparable or notional capital proxy.

Specifically, the "building block" prudential approach takes as its starting point and basis the fully consolidated accounts of the financial conglomerate as a single economic unit. By definition, all intra-group on- and off-balance sheet accounts or exposures have been eliminated. For prudential purposes, the consolidated balance sheet and off-balance sheet commitments are split into four different blocks (or sectors) according to the supervisory regime of the individual firms involved: banks, insurance companies, securities firms, and unregulated firms. Then, the regulatory capital requirements for each regulated entity or sector are calculated (these requirements could be different from those applicable on a solo basis because of the elimination of intra-group exposures). Each member’s capital level is compared to its individual capital requirement to identify any capital deficits. Those deficits should be evaluated in terms of the availability of freely transferable capital of other sectors as defined in the statement of principles. Finally, the regulatory capital requirements of each regulated entity and the proxy for the unregulated entity are added together and the total is compared with the aggregate amount of capital across the group.<sup>1</sup> Such an approach can be complemented by a review of the distribution of risks and capital within the economic unit,

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<sup>1</sup> The use of proxy capital requirements is one alternative for dealing with unregulated entities. Another method is to remove the unregulated entity’s assets, liabilities and capital from the consolidated entity.

that is, whether the apparent risks within the unit are covered by an adequate type and quantity of capital.

For financial conglomerates with a regulated parent company whose activities dominate the group (i.e. banking, securities or insurance), a variation of the building block approach, which provides the same result, may be more suitable. The modified building block approach deducts from the regulatory capital of the parent company the capital requirement for its regulated dependants in other financial sectors and the notional proxy of any unregulated dependants carrying out similar business. The resulting adjusted capital amount is then compared with the capital requirement for the parent's own activities, including any capital required for the activities of any of its dependants in the same financial sector.

## 2. Risk-Based Aggregation

The risk-based aggregation approach is very similar to the building block approach but differs by tailoring its methodology to situations in which either fully consolidated financial statements are unavailable or intra-group exposures may not readily be netted out. This methodology is also helpful for situations in which the calculation of regulatory capital is more easily derived from unconsolidated statements and where the elimination of intra-group exposures may not be appropriate. Risk-based aggregation involves summing the solo capital requirements of the regulated group and capital norms or notional capital amounts of unregulated companies and comparing the result with group capital. As a simple example, in a group comprising a parent bank with insurance and securities dependants, the capital requirements of the parent bank are summed with the capital requirements of the insurance and securities dependants (as determined by their respective regulators). Capital adequacy is assessed by comparing the result with the group's regulatory capital.

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

An alternative technique for calculating the group's regulatory capital is to identify the externally generated capital of the group. This technique is particularly useful in the following situations: when dependants are not held at cost; when it is difficult to determine the amount of capital downstreamed from the parent; or when other intercompany transactions add complexity. The externally generated capital of the group is found by adding the externally generated regulatory capital of the parent to that of its dependants. Externally generated capital refers to regulatory capital not obtained elsewhere in the group including equity supplied by minorities, qualifying third party debt finance, retained profits arising from transactions with third parties, or other qualifying capital that is not reflected in the parent's own capital.

For externally generated capital to "belong" to the group it should be, in principle, payable to the group on the winding up or sale of the dependant. However, it may be judged that funds equivalent to such capital could readily be transferred to other parts of the group notwithstanding any restrictions that might apply on the winding up or sale of the dependant.

A more prudent form of risk-based aggregation involves aggregating the greater of either the regulatory capital requirement/notional capital proxy or the investment of the group in each dependant. The aggregate figure of the dependants is then added to the regulatory capital requirement of the parent company itself to produce the overall group capital requirement. This requirement is then compared with the externally generated capital of the group (as described above).

### 3. Risk-Based Deduction Method

The risk-based deduction method is very similar to the risk-based aggregation method but focuses on the amount and transferability of capital available to the parent or elsewhere in the group. Essentially, this approach takes the balance sheet of each company within the group and looks through to the net assets of each related company, making use of unconsolidated regulatory data.

Under this method, the book value of each participation in a dependant company is replaced in the participating company's balance sheet by the difference between the relevant share of the dependant's capital surplus or deficit. Any holdings of the dependant company in other group companies are also treated in a similar manner. However, any reciprocal interest, whether direct or indirect, of a dependant company in a participating company is assumed to have zero value and is therefore to be eliminated from the calculation.

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

### 4. Fallback treatment for double gearing

Each of the three techniques for evaluating group-wide capital adequacy of the financial conglomerate explicitly take into account adverse effects of double gearing by examining capital adequacy of the parent and each of its dependants on a solo and group-wide basis. For supervisors that wish to quickly evaluate the extent to which double gearing may have compromised the capital adequacy of the parent company, there is a simple methodology that may be employed, referred to as the total deduction method.

The total deduction method is based on the full deduction of the book value of all investments made by the parent in dependants. Some supervisors may also wish to deduct any capital shortfalls in those dependants (as indicated by the capital standards of their solo supervisors) from the parent's own capital. In other words, under this technique the supervisor attributes a zero value, or in some cases a negative value, to the parent's investments. The parent's adjusted capital level is then compared with the parent's solo regulatory capital requirement, assuming that the parent is a regulated entity.

The total deduction method implicitly assumes that no regulatory capital surpluses within dependants of the group would be available to support the parent's capital or debt

service and that there is no regulatory capital deficit. Again, this procedure is designed to evaluate the extent that double gearing might impair the capital adequacy of the parent organisation and is not designed to evaluate the group-wide capital adequacy of the financial conglomerate.

## Summary and Examples of Measurement Techniques

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

### 1. *Building Block Approach*

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

### 2. *Risk-Based Aggregation*

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

### 3. *Risk-Based Deduction*

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

## Building Block Prudential Approach

- Identifies solo and group-wide capital surplus or deficit using consolidated financial statements

### Summary of Method

- Consolidated balance sheet broken down into its major firms
- Solo capital requirement/proxy is calculated for each firm or sector
- Requirement/proxy is deducted from each dependant's actual capital to calculate surplus/deficit
- Items deemed non-transferable are deducted (none shown)
- Solo capital requirements/proxies are aggregated and compared to actual group-wide capital to identify group-wide surplus or deficit

**Consolidated Statement Divided By**  
(No Intra-Group Accounts)

	Banking (Parent Co.)	Insurance	Securities (60% owned)	Unreg.	
	<i>(Full Consolidation)</i>				<b>Aggregate Group-Wide Total</b>
Capital Required/Proxy	32	10	17	10	<b>69</b>
Actual Capital (solo)	<u>40</u>	<u>12</u>	<u>22</u>	<u>7</u>	<b>81</b>
Surplus (Deficit)	8	2	5	-3	<b>12</b>
————— <b>Aggregation</b> —————▶					
	<i>(Pro Rata Consolidation)</i>				<b>Aggregate Group-Wide Total</b>
Capital Required/Proxy	32	10	10.2	10	<b>62.2</b>
Actual Capital (solo)	<u>40</u>	<u>12</u>	<u>13.2</u>	<u>7</u>	<b>72.2</b>
Surplus (Deficit)	8	2	3.0	-3	<b>10.0</b>
————— <b>Aggregation</b> —————▶					

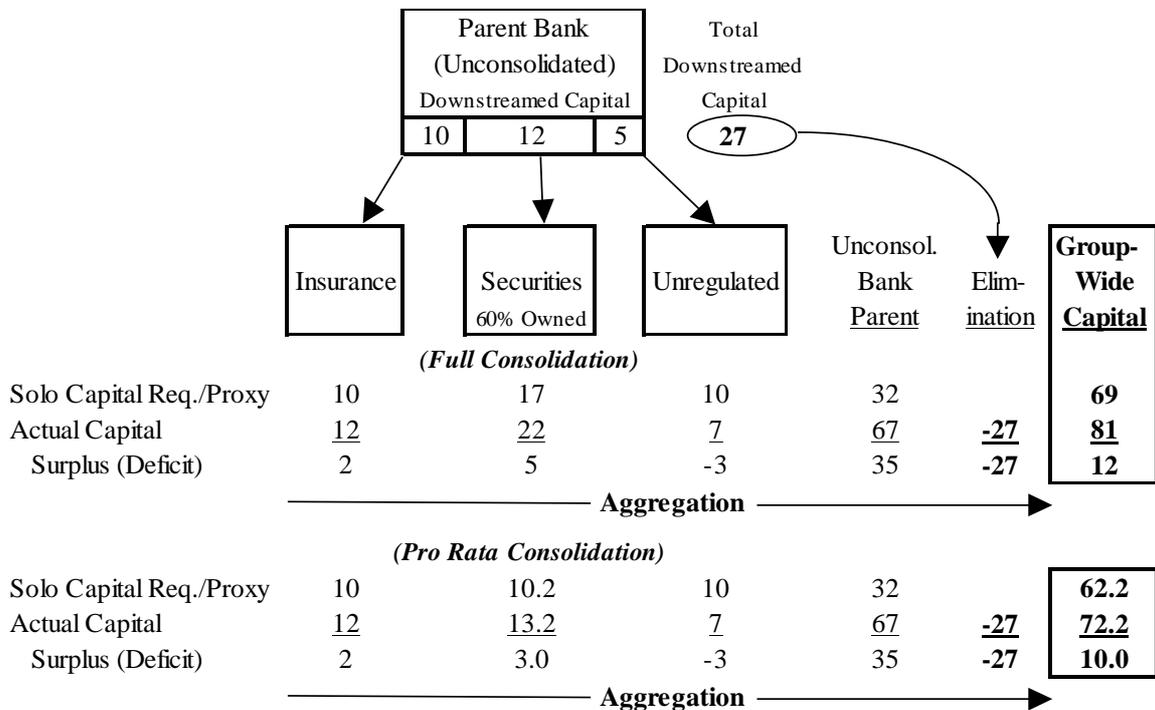
Variant: Modified Building Block Approach: Deduct from the capital of the parent company, the capital requirement for its regulated dependants and notional capital proxy amounts for unregulated dependants in other financial sectors. Recommended when a dominant financial activity is undertaken by the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

### Risk-Based Aggregation

- Similar to building block, but tailored for situations in which:
  - only unconsolidated statements are available
  - intra-group exposures cannot be readily netted out

Summary of Method:

1. Sum solo capital requirements/proxy of parent and dependants
2. Sum actual capital held by parents and dependants
3. Deduct any upstreamed or downstreamed capital
4. Eliminate any non-transferable items (none shown)
5. Compare aggregate requirement/proxy to aggregate group-wide capital to identify surplus or deficit

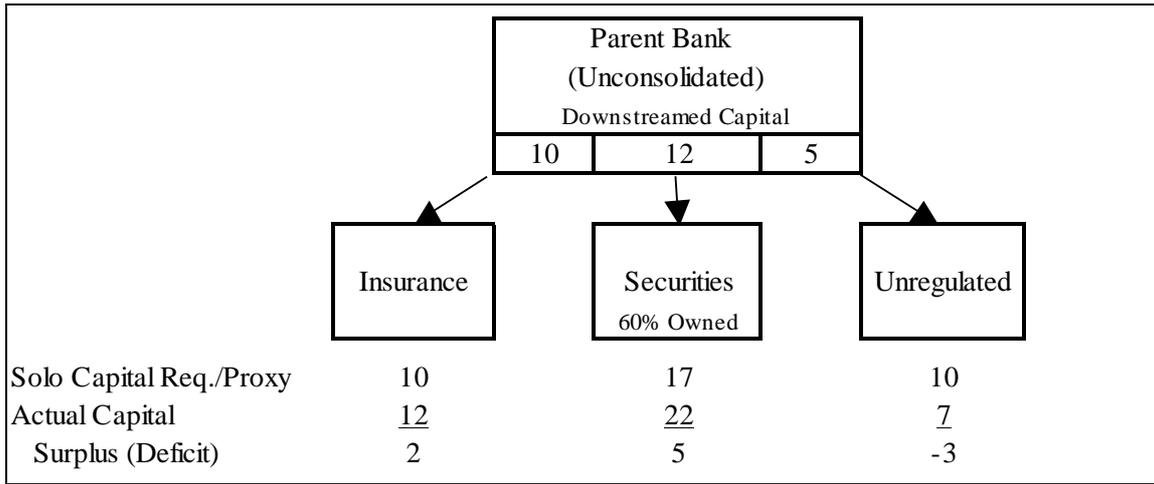


### Alternative Method to Deal With Double Leverage:

- If the amounts of capital downstreamed or upstreamed within the group are unclear, an alternative technique involves identifying *externally generated capital* of the group
- Externally generated capital:
  - is not obtained elsewhere from the financial conglomerate
  - includes retained earnings from business conducted outside conglomerate
  - may include any equity supplied by minorities or third party debt finance

## Risk-Based Deduction

- Very similar to Risk-Based Aggregation, differences include:
  - Analysis performed from perspective of parent company
  - Focuses on capital surplus or deficit of each dependant
  - Predicated on pro-rata integration
  
- Summary of Method:
  1. Start with parent's capital accounts
  2. Deduct investments in dependants from parent's capital
  3. Add to adjusted capital, surplus or deficit values from each dependant
    - Take into account any limits on transferability of capital
    - Use pro rata consolidation method for non-wholly-owned dependants
    - Treat any holding of the dependant in other downstream group companies in a similar manner to this calculation
    - Eliminate any reciprocal holdings of a dependant in other upstream group companies
  4. Subtract parent's solo capital requirement from adjusted capital
  5. Resulting figure is surplus or deficit from a group-wide perspective



<b>Parent Capital</b>	<b>67</b>
<u>Deduct Capital Investments in Dependents</u>	
Insurance Firm	-10
Securities Firm	-12
Unregulated Firm	-5
<u>Substitute Dependents Surplus or Deficit</u>	
Insurance Firm	2
Securities Firm (@ 60% Pro Rata)	3
Unregulated Firm	<u>-3</u>
<b>Adjusted Parent Capital</b>	<b>42</b>
Subtract Parent Solo Cap Req.	<u>32</u>
<b>Resulting Group-Wide Surplus</b>	<b>10</b>

**Memo:**

<u>Reconciliation With Full Consolidation of Other 2 Methods:</u>	
Add Back 40% of Securities Firm	2
<b>Surplus with Full Consolidation</b>	<b>12</b>

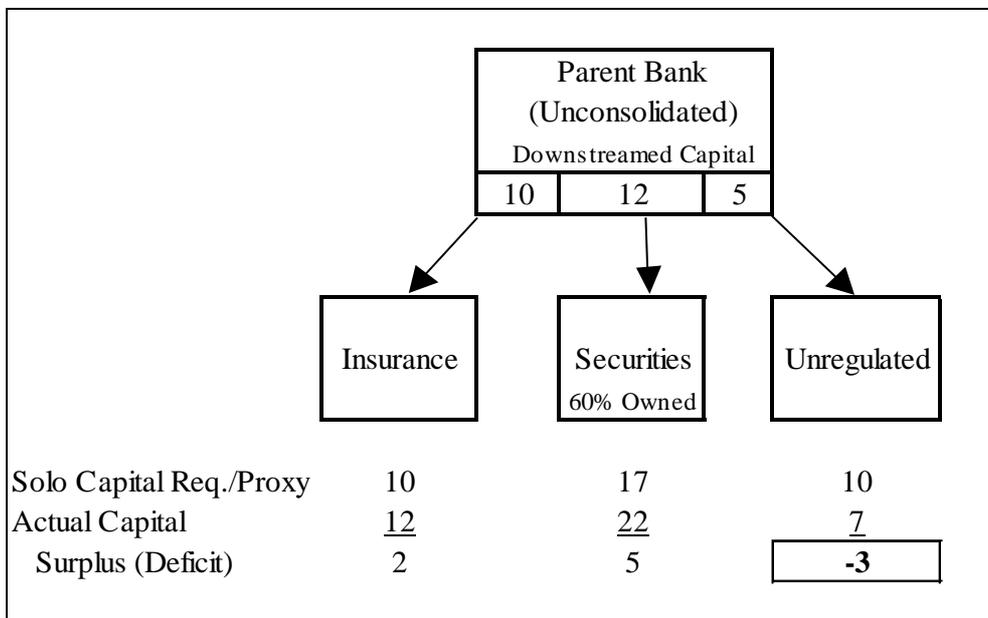


## Total Deduction Method (For Double Gearing at Parent Only)

- Quick test for potential double gearing at parent level
- Not a substitute for the other three techniques
- Almost identical to Risk-Based Deduction, but no credit given for any capital surpluses of dependants and no changes made for capital deficits

### Summary of Method

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



<b>Parent Capital</b>	<b>67</b>
<u>Deduct Capital Investments in Dependents</u>	
Insurance Firm	-10
Securities Firm	-12
Unregulated Firm	-5
<u>Add Dependant's Deficit</u>	
Unregulated Firm	<b>-3</b>
<b>Adjusted Parent Capital</b>	<b>37</b>
Subtract Parent Solo Cap Req.	<u>32</u>
<b>Resulting Parent Surplus</b>	<b>5</b>

## Appendix To Annex 2 Summary Balance Sheets of Financial Firms

The example financial conglomerate is assumed to be comprised of a parent banking company with regulated insurance and securities dependants and an unregulated commercial finance firm. It is assumed that apart from the parent's investment in its dependants, there are no intra-group exposures (or that these have been netted out). For this simple example, capital is assumed to be comprised of shareholders equity and reserves.

Parent Banking Firm Excluding Dependants			
Assets		Liabilities	
Loans	200	Deposits	250
Other assets	115	Borrowings	25
		General reserves	4
		Total Liabilities	279
Total Assets	315	Total Equity	36
		Capital = equity & reserves	40

Insurance Firm (Dependant)			
Assets		Liabilities	
Investments	125	Policy obligations	138
Other assets	25	General reserves	2
		Total Liabilities	140
Total Assets	150	Total Equity	10
		Capital = equity & reserves	12

Securities Firm (60% Owned Dependant) (100% Presentation)			
Assets		Liabilities	
Investments	200	Borrowings	203
Other assets	25	General reserves	2
		Total Liabilities	205
Total Assets	225	Total Equity	20
		Capital = equity & reserves	22

Unregulated Commercial Finance Firm (Dependant)			
Assets		Liabilities	
Loans	100	Borrowings	113
Other assets	20	General reserves	2
		Total Liabilities	115
Total Assets	120	Total Equity	5
		Capital = equity & reserves	7

Appendix to Annex 2 (cont'd)  
Consolidated and Unconsolidated Example Balance Sheets

Fully Consolidated Group			
Assets		Liabilities	
Loans	300	Deposits	250
Securities	325	Policy Obligations	138
Other assets	185	Borrowings	341
		General reserves	10
		Total Liabilities	739
		Minority Interests	7
Total Assets	810	Total Equity	63
Capital = minority interests, equity & reserves			81

Parent Firm With Unconsolidated Dependents			
Assets		Liabilities	
Loans	200	Deposits	250
Other assets	115	Borrowings	25
<u>Investments in subsidiaries</u>		General reserves	4
Insurance Firm	10	Total Liabilities	279
Securities Firm	12		
Commercial Finance	5		
Total investments in subs	27		
Total Assets	342	Total Equity	63
Capital = equity & reserves			67

Pro Rata Consolidated Group (Securities Firm Consolidated @ 60%)			
Assets		Liabilities	
Loans	300.0	Deposits	250.0
Securities	245.0	Policy Obligations	138.0
Other assets	175.0	Borrowings	259.8
		General reserves	9.2
		Total Liabilities	657.0
Total Assets	720.0	Total Equity	63.0
Capital = equity & reserves			72.2

Supplement  
to the  
Capital Adequacy  
Principles  
paper

## Supplement to the Capital Adequacy Principles paper Illustrative Examples

### Introduction

The Joint Forum on Financial Conglomerates, in the *Capital Adequacy Principles* paper, identified three techniques of capital measurement which are capable of yielding comparable and consistent assessments of the capital adequacy of financial conglomerates: the "**building-block prudential approach**", the **risk-based aggregation method** and **risk-based deduction method**. In addition the "total deduction" technique can also be of value, especially in addressing problems of double/multiple gearing.

The approach of the Joint Forum was to identify measurement techniques for the assessment of capital adequacy on a group-wide basis for heterogeneous financial conglomerates rather than to promote a single technique for universal application. As indicated in the paper, the measurement techniques have been found useful by a number of supervisors in assessing group-wide capital or in evaluating the impact of certain practices on regulated entities. Supervisors should have the flexibility to utilise the techniques appropriate for the specific circumstances of the particular financial conglomerates with which they deal.

The annexes to the *Capital Adequacy Principles* paper describe and provide examples of the measurement techniques.

The following theoretical examples illustrate situations that can be faced by supervisors in practical applications of the techniques. The purpose of the examples is to illustrate in a numerical way situations such as those described in the text of the *Capital Adequacy Principles* paper. The examples cross-refer to relevant text in that paper.

Only one technique, the risk-based aggregation method, is used in examples 3, 4, 5 and 6. It should be noted that similar problems to those depicted when using that technique would arise if the other techniques were used.

## 1. Double and multiple gearing.

This example illustrates a situation of double and multiple gearing as described in paragraphs 17 to 20 of the *Capital Adequacy Principles* paper

The parent is an insurance company which has a 100% participation in a bank which in turn has a 100% participation in a securities firm.

Insurance Company A1 (Parent)			
Assets		Liabilities	
Investments	5,000	Capital	1,000
Book value participations in:		General reserves	500
Bank B1	500	Technical provisions	4,000
Total	5,500	Total	5,500
Solvency requirement	800		

Bank B1 (Dependant)			
Assets		Liabilities	
Loans	8,750	Capital	500
Book value participations in		General reserves	400
Securities C1	250	Other liabilities	8,100
Total	9,000	Total	9,000
Solvency requirement	800		

Securities Firm B2 (Dependant)			
Assets		Liabilities	
Investments	4,000	Capital	250
		Reserves	250
		Other liabilities	3,500
Total	4,000	Total	4,000
Solvency requirement	400		

Without provisions to account for this corporate structure in measures of capital adequacy, it appears that solo capital requirements for the individual entities in this group are met. However, it is clear that a portion of the capital of the parent insurance company, i.e. the amount of 500 invested in bank B1 is levered twice, once in the parent and again in bank B1(double gearing). Furthermore, the amount invested by B1 in the securities firm B2 (250) which has already been levered twice is now being levered a third time, in the securities firm (when capital is being levered more than twice, it is said to be an instance of multiple gearing).

On the face of it, the group has total capital and reserves of 2,900 to cover total solvency requirements of 2,000. If the multiple gearing is eliminated the adjusted capital and reserves reduce to 2,150 leaving a surplus of only 150 over the capital requirements of 2,000. All three techniques should yield these results.

## 2. Undercapitalised unregulated holding company.

This example illustrates a situation of an undercapitalised group resulting from an undercapitalised unregulated parent holding company as described in paragraphs 23 and 25 of the *Capital Adequacy Principles* paper.

An unregulated holding company with two regulated 100% subsidiaries and one unregulated 100% subsidiary. Both regulated entities meet their solo requirements.

Unregulated Holding Company A1			
Assets		Liabilities	
Book-value participations in:		Capital	300
Bank B1	800	Other liabilities (long term loan)	800
Insurance company B2	200		
Leasing company B3	100		
Total	1,100	Total	1,100

Bank B1 (Subsidiary)			
Assets		Liabilities	
Loans	900	Capital	800
Other assets	400	Other liabilities	500
Total	1,300	Total	1,300

Insurance Company B2 (Subsidiary)			
Assets		Liabilities	
Investments	7,000	Capital	200
		General reserves	100
		Technical provisions	6,700
Total	7,000	Total	7,000

Unregulated Leasing Company B3 (Subsidiary)			
Assets		Liabilities	
Leases	2,000	Capital	100
		Other liabilities	1,900
Total	2,000	Total	2,000

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

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

	<u>Requirement</u>	<u>Actual Capital</u>	<u>Surplus/(Deficit)</u>
Bank B1	100	800	700
Insurance Company B2	300	300	0
"notional" capital proxy for the Leasing Company B3	150	100	(50)

(ii) Under the **building-block prudential approach**, the aggregated solo capital requirements and proxies (B1 : 100; B2 : 300; B3 : proxy of 150: Total : 550) are to be compared with the consolidated capital (300 + 100 = 400). The group has a solvency deficit of  $550 - 400 = 150$ .

(iii) Under the **risk-based aggregation** method, the solo capital requirements and proxies are again aggregated (550); the total requirements are compared to the sum of the capital held by the parent and its subsidiaries, deducted from the amount of the intra-group holding of capital [300 (parent) + 800 (B1) + 300 (B2) + 100 (B3) - 1,100 (participations) = 400]. Again, the group has a solvency deficit of 150.

(iv) Under the **risk-based deduction method**, in the balance sheet of the parent the book value of each participation is replaced by its surplus or deficit value, i.e. total assets minus liabilities and minus capital requirement/proxy of the subsidiary. The book-values of B1 (800), B2 (200) and B3 (100) are replaced by the solo surplus/deficit identified under (i): B1 (700), B2 (0), B3 (-50).

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

Assets		Liabilities	
Participations in:			
B1	700	Capital	-150
B2	0	Other liabilities	800
B3	-50		
Total	650	Total	650

Again, the result of the calculation shows a group solvency deficit of 150.

(v) When there is an unregulated holding company, the total deduction method is not applicable.

(vi) Conclusions

Although both regulated entities meet their own solo or sector solvency requirements, the financial conglomerate on a group-wide basis is undercapitalised. The explanation is twofold: first, there is excessive leverage in the group, as the parent has downstreamed debt to its subsidiaries in the form of equity capital, and secondly there is an undercapitalised unregulated entity in the group.

As explained in the main text, the undercapitalisation of the group is a potential risk for both regulated entities. As shown in the example, the undercapitalisation can be revealed by applying appropriate measurement techniques for the assessment of capital adequacy at group level.

### 3. Minority interests and double gearing.

This example shows that where minority interests are present the choice between full integration and pro-rata integration can have a material effect on the assessment of group capital adequacy, as described in paragraphs 35 and 36 of the *Capital Adequacy Principles* paper. Paragraphs 28-37 provide guidance to supervisors on these issues.

Under all methods described in Annexes 1 and 2 of the *Capital Adequacy Principles* paper a decision has to be made, explicitly or implicitly, as to how to deal with minority interests in the various entities of the group. Essentially, the question is whether to include them by using full integration or to exclude them by using a pro-rata approach.

The example, using the risk-based aggregation method, demonstrates that full consolidation may yield a less conservative result than the pro-rata approach in cases where there are important surpluses and no deficits at solo level elsewhere in the group and thus, may mislead supervisors about the situation of the group.

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

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

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

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

### Subsidiary 2 (60 %)

Capital	100
- parent	60
- minority interest	40
Capital requirements	- 25
SOLO SURPLUS	75

The group position would be as follows:

### Group (Parent + Subsidiary 1 + Subsidiary 2)

	full integration	pro rata integration
Capital	240	200
- parent	100	100
- subsidiary 1	40	40
- subsidiary 2	100	60
	(60 parent's share; 40 minority interests)	
Capital requirement	- 140	- 130
- parent	- 90	- 90
- subsidiary 1	- 25	- 25
- subsidiary 2	- 25	- 15
Participation 1 (book value)	- 40	- 40
Participation 2 (book value)	- 60	- 60
GROUP DEFICIT	0	- 30

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

#### 4. Inadequate distribution of capital

This example, which uses the risk-based aggregation method, illustrates, as did example 3, the implications of using a full-integration or a pro-rata approach. Paragraphs 28-37 of the *Capital Adequacy Principles* paper provide guidance to supervisors on these issues. At the same time, it shows the application of a notional capital proxy to an undercapitalised unregulated entity whose business activities are similar to those of the regulated entities, as described in paragraph 25 of the paper.

The existence of solo requirements should normally prevent deficits at solo level in firms of the group. In cases where one entity of the group has a solo deficit, supervisors should consider whether excess capital in other firms of the group can cover such solo deficit. In the following example this excess capital is needed to cover notional deficits in an unregulated entity.

##### Parent

Capital	100	
Capital requirement	75	
Participation	25	(historic cost)

##### Subsidiary 1 (50% participation)

Capital	60
- equity	50
- reserves	10
Capital requirement	10
SOLO SURPLUS	50

##### Group

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

The surplus at group level stems exclusively from the partly-owned subsidiary. However, in the event that the parent also had a participation in an undercapitalised unregulated entity, the group position would be as follows:

##### Unregulated Subsidiary 2 (100% participation)

Capital	20
- equity	10
- reserves	10
Notional capital requirement	-50
Notional solo deficit	-30

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

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

## 5. Suitability of capital structure

The following example shows it is possible, at group level, that insurance risks are covered by banking capital (or vice-versa), even when the bank and the insurer that constitute the group each fulfil their solo capital requirements. Definitions of capital eligible for regulatory purposes differ considerably between regulatory disciplines and regulators carrying out an analysis of capital adequacy at group level should duly take into account these differences when assessing the suitability of capital elements to cover certain risks, as described in paragraph 37 of the *Capital Adequacy Principles* paper.

- A parent life insurance company has own funds of 500, of which 200 is paid-up share capital (also recognised by banking regulators);
- The remaining 300 stems from profit reserves appearing in the balance sheet and future profits, capital components which are only recognised by insurance regulators;
- The insurance company has a 100% participation in a bank subsidiary with a book value of 250. It therefore complies with its capital requirement of 250.
- In addition to the 250 paid-up share capital furnished by the insurance parent, the banking subsidiary has hidden reserves and reserves for general banking risk of 50 which - by definition - are not elements recognised as liable funds by insurance regulators. Its capital requirement is 300.

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

Capital of Insurance Parent		Capital of Banking Subsidiary	
Profit Reserves, Future Profits	300	Paid-Up Share Capital	250
Paid-Up Share Capital	200	Hidden Reserves and Reserves for General Banking Use	50
Less Book Value of Participation	250		
Net Capital	250	Net Capital	300
Capital Req't	250	Capital Req't	300

Analysis reveals a deficit in group-wide capital for banking risk; leaving the question of overall capital adequacy to each individual supervisor:-

		Capital Requirements		
		Banking Risk	Insurance Risk	Excess/Deficit
Insurance Capital	300	300	250	50
Banking Capital	50	50	250	0
"All-round" Capital	200	200		
Excess/Deficit		- 50	0	

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

## 6. Quality of capital

As the previous example demonstrated, the divergence of capital definitions complicates the assessment of capital adequacy at group level in the sense that it introduces a qualitative element. The following example, using the risk-based aggregation method, shows that the importance of the qualitative aspect is not limited to the case of diverging capital definitions.

### Parent

Capital	110
Capital requirement	90
Participation (historic cost)	20
SOLO SURPLUS	0

### Subsidiary (100% participation)

Capital	50
- equity	20
- subordinated debt	30
Capital requirement	20
SOLO SURPLUS	30

Both, the parent's and the subsidiary's regulator recognise subordinated debt as capital elements eligible for regulatory purposes.

### Group

Capital	
- parent	110
- subsidiary	50 (100% of 50)
Capital requirements	
- parent	-90
- subsidiary	-20 (100% of 20)
Book value of participation	-20
GROUP SURPLUS	30

The solvency surplus at group level stems from the subsidiary's subordinated debt. Although subordinated debt is an acceptable form of capital under the parent's own regulatory rules as well, the group surplus in this example is arguably only available to the subsidiary, in which case the regulator of the parent will need to guard against the possibility that this excess is used to cover risks at group level (e.g. a notional deficit in an unregulated entity). The use of subordinated debt capital to cover losses is limited to the institution which has issued it. Its integration in a group wide assessment of capital adequacy raises the same type of issues as the inclusion of minority interests.

Fit and Proper  
Principles  
paper

## **Fit and Proper Principles**

### ***Objective***

1. To ensure that supervisors of entities within a financial conglomerate are able to exercise their responsibilities to assess whether those entities are soundly and prudently managed and directed and whether key shareholders (as defined below) are not a source of weakness to those entities.
2. To promote arrangements to facilitate consultation between supervisors and the exchange of information on individuals and regulated entities, on a case-by-case basis, when requested by other supervisors, to achieve the objective set out above.

### ***Background***

3. The probity and competence of the top management of banks, securities firms and insurance enterprises are critical to the achievement of the objectives of supervision. The primary responsibility for ensuring that regulated entities are prudently and soundly managed and directed rests with the regulated entities themselves. Supervisors' expectations are that the entities will take the measures necessary to ensure that managers, directors and shareholders whose holdings are above specified thresholds or who exercise a material influence on their operations ("key shareholders") meet the fitness, propriety or other qualification tests of their supervisors.
4. An effective and comprehensive supervisory regime should include controls designed to encourage the continued satisfaction of the fitness, propriety or other qualification tests of supervisors and to allow supervisory intervention where necessary. The application of such tests for managers, directors and key shareholders is a common regulatory mechanism for supervisors to ensure that the institutions for which they have supervisory responsibility are operated in a sound and prudent manner. Supervisors generally have at their disposal various sanctions to ensure remedial measures are taken in respect of managers, directors and key shareholders who do not meet the relevant fitness and propriety or other qualification standards.
5. Solo supervisors are subject to statutory and other requirements in applying fitness, propriety or other qualification tests to the entities under their jurisdiction. It is not intended

that such statutory and other requirements (as well as their procedures for the application of those tests) will be superseded by the elements of this principle. In exercising their statutory responsibilities, supervisors should consult, as applicable, the supervisors of other regulated entities in the financial conglomerate in question.

6. The organisational and managerial structure of financial conglomerates adds elements of complexity for supervisors seeking to ensure the fitness, propriety or other qualifications of the top management of regulated entities as the management and direction of such entities can be influenced by individuals who may not be managers or directors of the regulated entities themselves or of any regulated entity in the group.

### ***Principal elements of fit and proper criteria***

7. Fitness tests usually seek to assess the competence of managers and directors and their capacity to fulfil the responsibilities of their positions while propriety tests seek to assess their integrity and suitability. To determine competence, formal qualifications, previous experience and track record are some of the elements focused on by supervisors. To assess integrity and suitability, elements considered include: criminal records, financial position, civil actions against individuals to pursue personal debts, refusal of admission to, or expulsion from, professional bodies, sanctions applied by regulators of other similar industries, and previous questionable business practices.

8. Factors relative to the assessment of the fitness, propriety or other qualifications of key shareholders include business repute and financial position, and whether such ownership would adversely affect the regulated entity.

9. It is recognised that in addition to the factors identified in the previous paragraphs, the assessment of fitness, propriety and other qualifications is a judgmental matter and that supervisors may have additional information at their disposal that they can consider on a case-by-case basis.

### ***Issues arising from the emergence of financial conglomerates***

10. Managers and directors in unregulated entities, usually those upstream from the regulated entities, in a financial conglomerate can exercise a material influence over many aspects of the regulated entities' business and can also play a key role in controlling risks in the various entities in the whole group.

11. This element raises issues of supervisory jurisdiction as supervisors' reach may not extend beyond their geographical boundaries, i.e. to other regulated entities in the group which are

overseen by supervisors in other jurisdictions, and to unregulated entities in the group. Furthermore, measures taken to apply fitness, propriety or other qualification tests to unregulated entities in the group may create the false impression that supervision generally extends to those unregulated entities.

12. This also raises the issue of sharing of information among supervisors with respect to individuals and has implications with respect to the usual requirements of professional secrecy on supervisors. Most countries have legislation in place protecting the privacy of individuals and accordingly it is recognised that there may be limitations to a free exchange of information between supervisors.

### *Guiding Principles*

- 1. In order to assist in ensuring that the regulated entities within financial conglomerates are operated prudently and soundly, fitness and propriety or other qualification tests should be applied to managers and directors of other entities in a conglomerate if they exercise a material or controlling influence on the operations of regulated entities.**
- 2. Shareholders whose holdings are above specified thresholds and/or who exert a material influence on regulated entities within that conglomerate should meet the fitness, propriety or other qualification tests of supervisors.**
- 3. Fitness, propriety or other qualification tests should be applied at the authorisation stage and thereafter, on the occurrence of specified events.**
- 4. Supervisors' expectations are that the entities will take the measures necessary to ensure that fitness, propriety or other qualification tests are met on a continuous basis.**

13. The application of fitness, propriety or other qualification tests to managers, directors and key shareholders may vary depending on the degree of their influence and on their responsibilities in the affairs of regulated entities. It is recognised that an individual considered fit for a particular position within an institution may not be considered fit for another position with different responsibilities or for a similar position within another institution, and conversely, an individual considered unfit for a particular position in a particular institution may be considered fit in different circumstances.

14. There are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, there is a two tier board system consisting of a supervisory board which has the main, if not exclusive, function of supervising the executive body (the management board) to ensure that the latter fulfils its tasks. This means that the board has no executive functions. In other countries, with a unitary board system, the board has a broader competence in that it lays down the general framework for the management of the institution. In this regard, fitness, propriety or other qualification tests should be applied to directors in light of their role and responsibilities.

**5. Where a manager or director deemed to exercise a material influence on the operations of a regulated entity is or has been a manager or director of another regulated entity within the conglomerate, the supervisor should endeavour to consult the supervisor of the other regulated entity as part of the assessment procedure.**

**6. Where a manager or director deemed to exercise a material influence on the operations of a regulated entity is or has been a manager or director of an unregulated entity within the conglomerate, the supervisor should endeavour to consult with the supervisors of other regulated entities that have dealings with the unregulated entity as part of the assessment procedure.**

**7. Supervisors should communicate with the supervisors of other regulated entities within the conglomerate when managers, directors or key shareholders are deemed not to meet their fitness, propriety or other qualification tests.**

15. Such communications should take into account whether such disclosures could interfere with supervisory action.

16. Generally, channels to permit the exchange of information within sectors, e.g. banking, securities and insurance, have been established. Where there is no direct channel to a regulator in another jurisdiction, it may be possible to route information to the relevant domestic supervisor for onward transmission.

17. It may be that in some instances arrangements to exchange information between supervisors should be formalised in agreements, e.g. memoranda of understanding to establish a framework for the efficient transfer of such information.

*Notification*

18. Mechanisms should be in place to ensure that supervisors are advised, at the authorisation stage, of managers, directors and shareholders who can exert a material influence, directly or indirectly, on the operations of regulated entities, and thereafter, are notified of changes in such managers, directors and shareholders, on the occurrence of specified events.

Framework  
for  
Supervisory Information  
Sharing  
paper

## Framework for Supervisory Information Sharing

### I. Purpose and objectives

1. This paper outlines a general framework for facilitating information-sharing between supervisors of regulated entities within internationally active financial conglomerates. This paper is the result of the work of a Task Force established by the Joint Forum on Financial Conglomerates to examine the structure and operations of several large internationally active financial conglomerates (hereinafter referred to as the Task Force). Although the focus was on large international groups, the Joint Forum believes that the lessons drawn could also apply to smaller conglomerates or conglomerates that operate domestically.
2. Given the internationalisation of financial markets and the growth of emerging market economies, the paper draws attention to the need for enhancing communication links which currently exist primarily within each supervisory sector and facilitating information sharing between supervisors involved in the supervision of international financial conglomerates.
3. This paper is intended to complement the work of the Joint Forum on a number of topics relating to supervisory issues arising from the operations of financial conglomerates, e.g. the *Capital Adequacy Principles* paper, the *Fit and Proper Principles* paper, the *Coordinator* paper, and the *Principles for Supervisory Information Sharing* paper. The observations and recommendations in this paper should be considered in conjunction with those documents.
4. The framework presented takes account of existing networks of information sharing whereby information flows along established channels of communication<sup>2</sup>, particularly between supervisors in the same sector. Numerous bilateral arrangements exist between supervisors providing for the flow of general and specific supervisory information, in some cases in respect to individual financial conglomerates. This paper is intended to facilitate the evaluation, and where necessary, enhance and expand those information flows.

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<sup>2</sup>For example, in the European Union there are arrangements for sharing information between supervisors in different sectors and in different countries based on harmonised minimum confidentiality requirements (including with supervisors outside the EU provided certain conditions with respect to confidentiality are met).

## II. Definitions

5. The following definitions are provided for the purposes of this paper:

**Corporate legal structure** is defined as the legal framework of entities that make up the conglomerate.

**Business activities structure** is defined as the way in which the conglomerate organises and operates the primary business activities in which it is engaged.

**Management structure** is defined as the form of direct supervision and oversight exercised by management on the corporate and business activities structures, and on the corporate control functions of the conglomerate.

**Corporate control functions** are defined to be risk measurement, monitoring and control systems and include internal and external audit, financial control, compliance, human resources, and information technology.

The **Primary supervisor** is generally considered to be the supervisor of the parent or the dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements. Where the identity of the primary supervisor is not clear, the relevant supervisors should work cooperatively to identify, on a case by case basis, an appropriate information sharing structure.

### **III. Background and observations of the Task Force**

6. The Task Force was established by the Joint Forum for the purpose of enhancing its understanding of the operations of internationally active financial conglomerates and the impact of their rapidly changing and global nature on supervisory approaches.

7. The Task Force studied fourteen conglomerates which are diverse in their business activities, the extent of their international reach and in the complexities of their organisational structures. The Task Force has reviewed and refined the questionnaire that participants in the mapping exercise used to compile information. The Conglomerate Questionnaire which consists of a users guide, a glossary of terms, the questionnaire itself and the matrix form for recording findings is attached as Annex A.

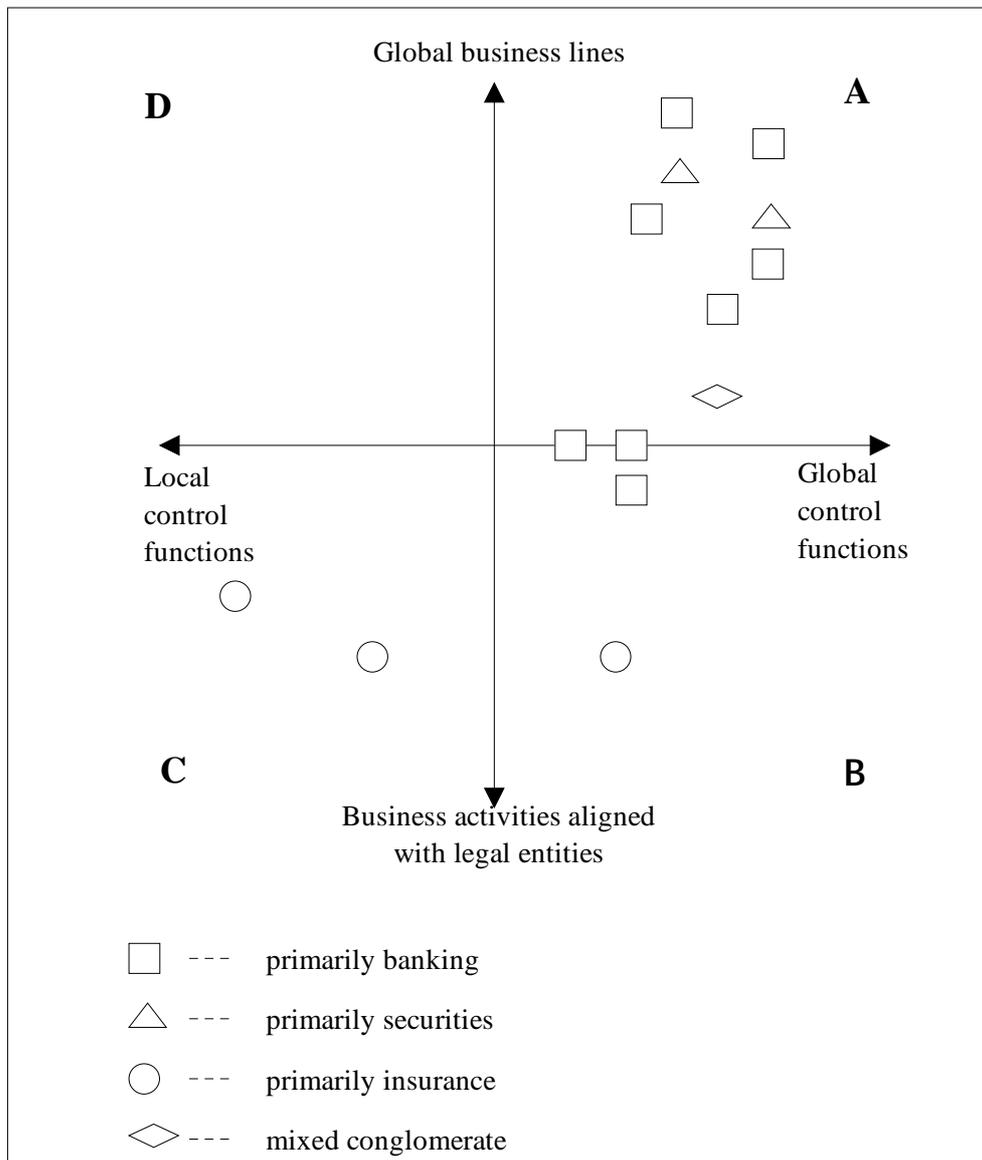
8. The Task Force also collected detailed information on supervisory objectives and approaches and on the authority of supervisors to share information in the countries represented in the Joint Forum. This information, which was collected through the completion of a Supervisory Questionnaire and recorded in a matrix format, has been shared amongst the supervisory agencies represented on the Joint Forum and provides a solid foundation to assist supervisors in each sector to better understand colleagues' responsibilities and their *modus operandi*.

9. Financial conglomerates take a wide variety of structures. Conglomerates may have a large number of legal entities, primarily as a result of historical, tax and regulatory considerations. Some conglomerates indicated a desire to simplify their business lines and legal entity structures by bringing them together, but viewed regulatory, fiscal and legal impediments as obstacles.

10. The Task Force examined the different structures of the conglomerates mapped to assess the implications of those structures on supervision and on the sharing of supervisory information between supervisors.

11. There are two key dimensions which tend to have particular implications for the supervision of regulated entities within financial conglomerates namely, 1) the organisation of business activities along business lines versus along the corporate legal structure and 2) the organisation of corporate control functions on a global or centralised basis versus on a local basis. The focus of the Task Force in classifying financial conglomerates into quadrants is based on these two key dimensions.

12. The findings of the exercise carried out with respect to the fourteen conglomerates mapped are plotted into the following chart using a quadrant categorisation. The X axis relates to the organisation of the conglomerate's controls, with local controls at one end and global controls at the other. The Y axis relates to the organisation of the management structure, along business lines at one pole and legal entity structure at the other.



13. The positioning of conglomerates within the particular quadrants, or bridging quadrants, does not result from a mathematical exercise. Rather, the position of individual conglomerates reflects the judgement of the Task Force members in the mapping exercise, based on an assessment of information collected during the exercise.

14. The proportion of conglomerates, whether primarily banking, securities or insurance or mixed, falling into a particular quadrant is strictly a function of the particular sample of conglomerates participating in the mapping exercise. Choosing a different sample of

conglomerates could result in a different proportion of conglomerates falling in one or the other quadrant.

15. Given the dynamic nature of diversified financial groups, the categorisation of a conglomerate in a particular quadrant is a determination at a point in time. The structure of business activities and of corporate control functions can shift over time, sometimes rather quickly, and the categorisation would need to be reviewed through the supervisory process.

#### **IV. Framework for Identifying Supervisory Information Needs**

16. The principal features of conglomerates categorised in each of the four quadrants and an indication of supervisory issues arising in respect to financial conglomerates in each quadrant are set out below.

17. Financial conglomerates tend to develop their own corporate identities and management styles and will not always have an obvious position in any one of the four quadrants. The supervisory issues outlined in this paper will need to be viewed within the context of the particular circumstances of each conglomerate.

18. The quadrant analysis and classification are designed to highlight supervisory information needs and to underscore the importance of information sharing. However, irrespective of the quadrants, information sharing is important to assist supervisors in supervising the operations of the conglomerate under their jurisdiction.

##### *Quadrant A: Global business lines, global control functions*

19. A conglomerate in Quadrant A organises its business activities along the products and services that it provides and the resulting business line structure may bear little relationship to the corporate legal structure. The matrix management approach generally found in Quadrant A conglomerates assigns management "front office" responsibilities along business lines, which cut across legal entities, geographic regions, and sometimes across business lines themselves. Management "back office" responsibilities for corporate control functions cut across both business lines and the legal entities. The corporate control functions are organised largely at head office or in a separate special purpose entity, although there is necessarily local involvement in control processes. The legal entity structure is highly influenced by tax and regulatory considerations.

20. Several issues arise for the supervisors involved in the oversight of entities in a Quadrant A conglomerate. Issues for the various supervisors may differ somewhat because key risk management and control functions for entities they oversee may be located in another jurisdiction - frequently, but not necessarily always, at head office. However, there is an enhanced need for all supervisors to understand the complexities of transactions and arrangements that are extensively used to transfer risk and income intra-group between affiliates in the "global" structure. Information exchange is useful in order for an overall view to be taken, because an individual supervisor may often see only part of the management matrix (a business line or a geographical area or a legal entity).

21. The information issues for supervisors involve understanding of, access to and responsibility for assessment of:

- the business strategy of the conglomerate, especially in business lines conducted by a given supervised legal entity,
- the matrix management structure and the extent to which global risk management and global business management are evaluated by the various supervisors,
- the group corporate structure,
- the key risks in other entities, including unregulated entities, and potential impact on parent and other regulated entities,
- the organisation of global corporate control functions and their effectiveness especially outside a particular supervisor's statutory jurisdiction,
- the local controls to assess the reliability of information being fed into the global risk management systems and the quality of those systems,
- intra-group exposures and transactions.

*Quadrant B: Business activities aligned with legal entities, global control functions*

22. In a Quadrant B conglomerate the business activities are aligned with the legal entities but corporate control functions are organised at the head office or in a separate dedicated legal entity. In addition, the management and boards of legal entities retain a substantial role, in some cases related directly to some business operations or specialised activities that are prevalent in a particular entity. Alternatively, the legal entities may be broadly responsible for their own business strategies and certain corporate control functions, but may be subjected to very close monitoring and oversight from their parent companies.

23. Several issues arise for the supervisors involved in the oversight of entities in a Quadrant B conglomerate. As is the case with Quadrant A conglomerates, the various supervisors have a need to assess the effectiveness of controls which may be located in a different country. The primary supervisor needs to be able to assess the adequacy of controls within the subsidiaries. For all supervisors, the issue is the division of management responsibilities centrally and in subsidiaries and the ensuing division of supervisory responsibilities. Additionally, the primary supervisor needs to understand how the local business strategies, derived and implemented on a legal entity basis, consolidate into a meaningful business strategy for the conglomerate as a whole.

24. The information issues for supervisors involve understanding of, access to and responsibility for assessment of:

- the group corporate structure,
- the key risks in other entities, including unregulated entities, and potential impact on parent and other regulated entities,
- management responsibilities and of the division thereof globally and locally,
- the organisation of global corporate control functions and their effectiveness, especially outside a particular supervisor's statutory jurisdiction where relevant,
- the local controls to assess the reliability of information being fed into the global risk management systems and the quality of those systems,
- the extent to which global risk management systems are evaluated by the various supervisors,
- intra-group exposures and transactions.

*Quadrant C: Business activities aligned with legal entities, local control functions*

25. The corporate structure of a Quadrant C financial conglomerate fully accords with management organisation. Also, the corporate control functions are aligned with the local legal entity structure, with few functions exercised globally. Local management operates rather autonomously from the parent entity.

26. Several issues arise for supervisors involved in the oversight of entities in a Quadrant C conglomerate. All supervisors need to understand the influence of the dominant or parent entity and the effectiveness of firewalls, particularly when there is an unsupervised holding company. The primary supervisor needs to have the ability to assess the effectiveness of local controls and the reliability of risk management information. Communication between supervisors will be important to assess the extent of de facto local and central controls. For all supervisors there is an enhanced need to understand group-wide risk exposures.

27. The information issues for supervisors involve understanding of, access to and responsibility for assessment of:

- the group corporate structure,
- the key risks in other entities, including unregulated entities, and potential impact on parent and other regulated entities,
- the group's approach to concentrations and control systems that reduce the need for global risk systems,
- intra-group exposures and transactions,
- the nature and scope of the group's local controls and/or firewalls.

*Quadrant D: Global business lines, local control functions*

28. A Quadrant D conglomerate is organised along business lines which cut across the legal entities but its corporate control functions are organised locally, within legal entities. This is an anomalous situation as the corporate controls located in legal entities are less integrated than the business line and therefore cannot fully monitor and control the risks in those business activities. This type of a conglomerate would carry inordinate risk that the controls that are intended to ensure the proper conduct of business would fail.

29. None of the conglomerates mapped were found to fall into Quadrant D. Determining that a conglomerate has the characteristics of a Quadrant D conglomerate may not be easy and can involve a high degree of subjective judgement by supervisors. For example, the group may describe itself as having centralised corporate control functions, and internal documentation may support that. But in reality, local management may not have effectively implemented the central controls, or they may even have circumvented them.

30. It may be difficult for the primary supervisor to discover this as access to controls in all localities may not be achievable on a practical basis. All supervisors therefore should be alert to this problem, particularly if the supervised legal entity is a major contributor to group profits, and inform the primary supervisor if concerns arise and assist in any ensuing analysis of the group. This emphasises the need for all supervisors to exchange information regularly in order to facilitate the assessment of the control environment.

*Implications for supervisors and information sharing*

31. In each type of conglomerate structure, it is clear that information sharing between supervisors is essential. Such information sharing will be useful in enhancing supervisors' understanding of the operations of the conglomerate and their effect on the regulated entity, and in assisting supervisors in determining the characteristics of the conglomerate in terms of the Quadrant structure. A conglomerate might describe itself to fit into Quadrants A, B or C but could actually be in D.

32. A prerequisite for assessing information sharing needs amongst supervisors is a good understanding of the organisational structures and business activities of the financial conglomerate. The findings and observations of the Task Force with respect to the participating conglomerates demonstrated that the conduct of a mapping exercise is an effective way to gain that understanding. It is acknowledged that this is but one supervisory tool available to further supervisors' understanding of complex financial conglomerates.

33. The Quadrant approach can be a useful tool in identifying situations where supervisors' information needs are increased or where management of conglomerates may not themselves be receiving sufficient information. For example, conglomerates which are theoretically managed on a global business line basis and have global corporate control functions (Quadrant A), but in fact still permit considerable local autonomy in some parts of the group and in practice are structured more along the lines of a Quadrant D conglomerate could raise supervisory concerns.

34. Supervisors need to be alert to highly autonomous local managers, weak global controls or any other evidence that theoretical and actual management structures are divergent. Other warning indicators might include separate audit arrangements and different accounting year ends among the conglomerate's legal entities.

35. Irrespective of the structure of the corporate and management organisation, and the corporate control functions of financial conglomerates, the key to ensuring that overall group management practice conforms to the understandings of individual supervisors is effective communication among supervisors, as no single supervisor is likely to have ready access to all pertinent information to fully understand and assess the conglomerate.

36. Supervisors should also exchange information regarding their own objectives and approaches. Familiarity with each other's supervisory techniques can facilitate mutual understanding and trust and sharing of information. The previously mentioned Supervisory Questionnaire is a useful tool for collecting information on supervisory objectives and approaches.

## **V. Exchange of Information Between Supervisors under Various Circumstances**

### *A. Creation of a new conglomerate*

37. The creation of a new conglomerate is usually an identifiable event which arises through merger, acquisition or the development of new businesses and may trigger the involvement of the supervisors with responsibility for the various legal entities in the new group. However, as groups expand and evolve they can also gradually develop the characteristics of a financial conglomerate. Supervisors therefore need to keep expanding groups under review. The emergence of a conglomerate will bring with it increased information needs for all supervisors involved including in instances relating to their authorisation, application or other supervisory processes.

38. Contact should be initiated among the relevant supervisors at the start of a conglomerate's life. The relevant supervisors should begin discussions to commence appropriate information sharing procedures with each other when the creation of a new conglomerate occurs.

39. It is important that measures be taken at that time to ensure that the structures of the conglomerate in terms of its corporate management and corporate control functions are well understood by the supervisors involved. One way of doing this would be for supervisors to undertake a mapping exercise, using the Conglomerate Questionnaire as previously referenced. Supervisors should weigh the advantages and disadvantages of the timing of a mapping exercise. In some cases it may be desirable to undertake such an exercise promptly whereas, in other cases, particularly in merger situations, it may be preferable to await the completion of the structural changes that usually result from such merger. Supervisors may also accomplish the desired goal of understanding a conglomerate via their supervisory approaches.

40. When a mapping exercise is conducted, it would normally be led by the primary supervisor with participation of other supervisors as deemed appropriate. The completed matrix record of findings which includes key information on the business and organisation of the conglomerate could be shared with the supervisors involved in the oversight of parts of the conglomerate.

41. The mapping exercise would, inter alia, facilitate the categorisation of the conglomerate in terms of the structure of management of its activities along business lines or legal entities and of its controls on local or global bases and determine its position within a quadrant.

42. Conducting a mapping exercise is also useful for supervisors in enhancing their understanding of each others' objectives, approaches and strategies. This could assist supervisors in establishing information sharing arrangements which are best suited to their individual needs, the nature of the business undertaken by the regulated entity for which they have responsibility and the nature and structure of the conglomerate itself.

*B. Authorisation of a new activity or activity in a new supervisory jurisdiction*

43. There are diverse supervisory approaches with respect to a financial conglomerate establishing a presence in a new jurisdiction. In some cases there may be a legal authorisation or approval process required whereby another supervisor will apply the relevant authorisation procedures for the new entity. In some cross-border sectoral arrangements, the prior consent of the primary supervisor is an integral part of the authorisation process, e.g. as set out in the Basle Committee's Minimum Standards. In other cases, there may be simply a notification requirement or no formal authorisation or approval requirement.

44. Irrespective of the mechanisms relating to the establishment of a presence in another jurisdiction, contact should be established between the relevant supervisors and efforts should commence to establish a supervisory relationship if one does not already exist. This could be an opportune time for supervisors to exchange information about their supervisory objectives and practices.

45. In order to facilitate the review process by another supervisor, the primary supervisor may provide appropriate information compiled through a mapping exercise or through the ongoing supervisory process for the conglomerate in question. If the supervisors concur, they may decide to jointly complete the Conglomerate Questionnaire.

46. A review of the existing arrangements for information exchanges should be carried out by the supervisors involved to ensure that there is a legal basis for the sharing of information and determine what impediments exist to such sharing of information, if any. Relevant supervisors should strive to develop or enhance, as necessary, formal or informal information sharing arrangements.

47. It is recognised that intra-sectorally, and in some cases cross-sectorally, there are many existing arrangements in place relating to such information exchanges. The proposals and recommendations in this paper are not intended to replace any such arrangements, but to supplement these information flows, as appropriate, where the financial entities in question are part of a financial conglomerate.

### *C. Developments in financial conglomerate structure*

48. The dynamic nature of financial conglomerates necessitates that supervisors keep apprised of developments including the undertaking of significant new business or a restructuring of controls. New developments should be assessed to determine their impact on the structure of the conglomerate, including the conglomerate's categorisation within the quadrant framework. Changes to the structure which would tend to shift the conglomerate from one quadrant to another could have implications for the information sharing arrangements in place between supervisors. Supervisors need to keep apprised of changes to the conglomerate's structure and make appropriate adjustments to their supervisory approaches and information sharing arrangements. Such adjustments could result from ongoing supervision or from carrying out a new mapping exercise.

### *D. Ongoing supervision*

#### i) Information needs with respect to the firm

49. The supervisors of regulated entities within a conglomerate have different information needs, determined by the legal and regulatory regimes within which they operate, their supervisory objectives and the nature of the business undertaken by the regulated entity in a particular jurisdiction. The primary supervisor is likely to have both the need for and access to the widest range of information, and other supervisors will often seek additional information or verification of information from the primary supervisor. All supervisors may have valuable insights or information to be shared with each other.

50. Supervisors need key descriptive information about the conglomerate: its organisational structure, management, financial condition, strategy and principal risks, and the main features of its policies, procedures and information systems for managing and controlling risk. This information may be included in organisation charts, financial statements, capital, liquidity and risk profiles, policy manuals and other written material. Also, discussion with the conglomerate's management may provide context for the information as well as management's perspective on the firm's strategy, risk profile and prospects. Supervisors also need sufficient financial and operational information to allow them to assess and determine how effectively a financial conglomerate is identifying, managing and controlling its risks and to recognise any incipient problems. The Conglomerate Questionnaire was found to be a useful way to obtain pertinent information about a conglomerate.

51. A general framework for identifying information needs, particularly the types of information that would be especially relevant for each type of conglomerate structure, is set

out in Section IV of this paper. However, in practice each financial conglomerate, although it may be structured along the lines of one or the other model, will be unique and the information needs of the primary and other supervisors will need to be assessed on an individual basis.

ii) Information needs with respect to supervisory activity

52. Key factors in the establishment of arrangements for the exchange of supervisory information relating to financial conglomerates are the supervisory objectives and approaches of the supervisors involved. A common understanding of these can be achieved through the completion of the Supervisory Questionnaire or from discussions among supervisors.

53. Supervisors of entities within financial conglomerates can benefit from familiarity with and understanding of the approaches of the supervisors of other entities within the conglomerate. Supervisory cooperation can also help to reduce unnecessarily duplicative or burdensome requirements and to ensure that the total supervisory strategy is sufficiently comprehensive. On an ongoing basis, it is useful for supervisors to be informed of other supervisors' planned oversight activities, including on-site inspections, in order to take these into account when planning their own oversight programme. Regularised communications regarding such oversight activities can be incorporated into information sharing arrangements among the supervisors of the entities within the financial conglomerate.

54. A review of the supervisory objectives and approaches, together with a review of the organisational structure and of the key risks of the conglomerate and of planned activities/coverage, will assist supervisors in identifying and assessing the level of supervision present within the financial conglomerate. Supervisory coverage can then be modified and adjusted, as necessary, to ensure appropriate oversight, without undue supervisory burdens and duplicative deployment of supervisory resources.

*E. Identifying and Addressing Supervisory Concerns*

55. Within a supervisory framework, a goal of the supervisors is to use information obtained on an ongoing basis to facilitate the understanding of the strategy, structure, financial position and performance of financial conglomerates, and to identify emerging problems that could affect regulated entities. A key objective is to identify problems early enough to encourage the management of regulated entities to take action to address concerns. This begins with a good baseline understanding of the regulated entity.

56. All supervisors need to consider adverse or out-of-the-ordinary developments of special interest, particularly as they may impact the regulated entities for which they have responsibility. Most supervisors have good access to financial information but see such data as lagging indicators of emerging problems.

57. Supervisors highly value the views and assessments of other supervisors. They are interested in being informed of the assessments and findings of relevant supervisors evaluating the risk taking activities of significant entities. In particular, supervisors will want to be informed of significant emerging issues and out-of-the-ordinary developments. Depending upon intercompany relationships within the conglomerate, other supervisors also have an interest in the relevant assessments and findings of other supervisors responsible for other entities. Communication of supervisory assessments could reduce the need for the exchange of excessive amounts of information and raw data.

58. Special emphasis should be given to information flows to the primary supervisor. This supervisor would normally be best equipped to assess developments and events which in isolation may not be of significant interest but which, in conjunction with other available information, could bring to light significant, potentially adverse trends. The timely communication of unusual findings and significant developments to the primary supervisor will permit their analysis and evaluation against other information and the assembly of the "supervisory puzzle". In particular supervisors should share information on issues of risk management and internal controls which could impact on the control environment of entities in other jurisdictions. On the other hand, since the primary supervisor may have the most comprehensive view of the "supervisory puzzle", it may be in the best position to alert other country supervisors to potential problems and to provide them with pertinent information.

59. The information needs of supervisors will intensify if emerging problems develop into more serious matters. This may relate to conglomerate-specific or broader market wide problems which may affect other financial institutions.

60. Once a problem develops into a matter for supervisory attention, information needs will likely move from understanding of the overall structure, financial condition, risk profile and corporate control functions and approaches of the financial conglomerate to increasingly specific and detailed information about the firm's risk exposures and risk management tactics, and the financial impact of current developments, especially those related to the current problem(s). Supervisors' needs will only be met if the financial conglomerate has in place good information systems which will permit accurate and detailed information to be retrieved in a timely and reliable manner.

61. In the face of very severe problems, highly detailed information may be needed, and communication between the firm and its key supervisors may be continuous. Examples of the types of information that may be useful in an emergency and on short notice are set out in Annex B. A key point in such situations is that financial conglomerates need to have the capacity to provide a potentially wide range of detailed information within short time frames.

62. The intensified need for timely and detailed information underscores the importance of developing a full understanding of the structure, strategy, and risk profile of the financial conglomerate by the relevant supervisors. Attention to the nature, quality and flexibility of management information systems and reporting should be part of the routine supervisory process. Equally important are good communication channels between the conglomerate's management and its supervisors in all its regulatory jurisdictions and amongst its supervisors.

## Conglomerate Questionnaire

## Table of contents

<b>I.</b>	<b>Introduction</b> .....	63
<b>II.</b>	<b>User Guide</b> .....	
	Using the Conglomerate Questionnaire .....	65
	Definition of Terms .....	67
	Technical Information .....	69
<b>III.</b>	<b>Conglomerate Questionnaire</b> .....	
	Organisational Structure, Corporate Governance and Management Oversight .....	73
	Risk Management.....	75
	Control Environment.....	77
<b>IV.</b>	<b>Conglomerate matrix</b> .....	80

## I. Introduction

The Conglomerate Questionnaire (Questionnaire) is an analytical tool created for financial conglomerate supervisory purposes. The Questionnaire is considered a dynamic instrument that can be modified to suit the particular circumstances of individual conglomerates being examined and of the supervisors involved. The continuing work of the Joint Forum and experience gained in using the Questionnaire may result in changes to enhance its coverage and make it a more useful tool in better understanding the functioning of financial conglomerates and the unique risks facing supervised entities that are part of such conglomerates.

In a concise format, the Questionnaire facilitates discussion by one or more supervisors with a financial conglomerate about its:

- Organisational Structure, Corporate Governance and Management Oversight;
- Risk Management; and,
- Control Environment.

The information obtained in completing the Questionnaire can be used as an aid in cross-border and cross-sector supervisory discussions, planning supervisory strategies, and responding to supervisory emergencies. Supervisors can use the Questionnaire to further their understanding of a financial conglomerate's risk profile, systems of controls, and organisational/management structure.

Most sections of the Questionnaire begin with a question on the availability of information, and continue with questions that put that information into an organisational, strategic, and management context. Additionally, the Risk Management section has been structured to allow a financial conglomerate to identify its principal risks and to describe as many of those risks as the conglomerate and the supervisor(s) believe appropriate.

Most of the questions in the Questionnaire are "open-ended," that is, they ask "how" or "what" type questions that tend to generate a more informative discussion. Such questions permit the conglomerate to discuss the broad areas of the Questionnaire within their own frame of reference rather than simply responding "yes" or "no."

The User Guide has been prepared to facilitate using the Questionnaire and is based on the experience of the Task Force members in completing a more detailed questionnaire on fourteen financial conglomerates during 1996 and 1997. The Matrix included at the end can

be used to capture brief responses to the questions across industry sectors and facilitate an overall supervisory strategy of the conglomerate among supervisors. Some of the information recorded in the matrix may be proprietary in nature, e.g. plans for the introduction of new products, and the consent of a mapped conglomerate should be sought prior to the sharing of such information with other supervisors.

## II. User Guide

### *A. Using the Conglomerate Questionnaire*

The Questionnaire is designed to be used by supervisors in evaluating and understanding financial conglomerates. By analysing the information contained in the Questionnaire, the user can obtain an overall picture of the financial conglomerate's organisational and management structure, risk profile, internal controls and can discover conditions or issues that might require further analysis and investigation. The Questionnaire is not designed to replace on-site examinations or investigations but to supplement supervisory practices. It can function as a starting point for discussion with conglomerate management and/or other supervisors of the conglomerate in supervising the conglomerate consistent with its risk profile. The Questionnaire can also be useful as a part of a conglomerate's own internal assessment process.

A thorough understanding of the three broad categories included in the Questionnaire and their interrelationships and limitations is essential in order to use the Questionnaire effectively. As a general rule, information obtained in response to the Questionnaire should be reviewed with the conglomerate's management to ensure its accuracy prior to analysis.

This User Guide does not present detailed in-depth instructions on completing or analysing the information obtained in the Questionnaire. Rather, it attempts to explain the experiences of the Task Force members and users might find the following examples helpful while completing the Questionnaire:

- It has often been revealing to pose the same questions to the senior management levels and to the business levels to see what similarities and differences emerge.
- It has been revealing to compare the results of discussions on the broad business strategy and organisation to the conglomerate's view of its principal risks and how they are managed.
- The Questionnaire asks the conglomerate for its principal risks. The supervisors might want to ask the conglomerate about the risks it does not mention. A partial list of major risks commonly found at financial conglomerates includes: credit, liquidity, operational, interest rate, foreign exchange, strategic, legal, reputational, market, insurance (underwriting, reinsurance and asset-liability management), compliance, information systems and settlement.

As noted above, the questionnaire is a dynamic instrument that can be modified to suit the particular circumstances of individual conglomerates being examined and of the supervisors involved. Regard should also be had to the desirability of avoiding the imposition of unnecessary or duplicative administrative burdens on conglomerates. Supervisors considering asking a conglomerate to respond to the questionnaire should consider whether modifications are appropriate in light of any information they already have about the conglomerate. Consideration should also be given to whether the questionnaire should be administered in conjunction with other supervisors who have an interest in the conglomerate on the basis that the resulting information would be shared.

## **B. Definitions of Terms**

**Financial Conglomerate** is a conglomerate whose primary business is financial and whose regulated entities engage to a significant extent in at least two of the activities of banking, insurance and securities.

**Corporate Legal Structure** refers to the legal framework of a financial conglomerate's organisation of entities that make up the conglomerate. This can include such entities as licensed commercial banks, licensed banking subsidiaries, licensed insurance subsidiaries, unsupervised or unregulated entities, etc.

**Business Activities Structure** refers to the way a financial conglomerate organises and operates the primary business activities in which it is engaged. For example, a conglomerate may be organised along business lines such as Foreign Exchange, Retail Banking, Corporate Lending, Life Insurance, Investment Advisory and other types of related activities.

**Regulatory and Supervisory Structure** refers to the body of supervisors and regulators which are charged with supervising any and all legal entities comprising the financial conglomerate, i.e., the banking, insurance, and/or securities supervisor and regulator in the countries where such entities operate.

**Management Structure** refers to the form of direct supervision and oversight exercised by management on the conglomerate. It is the individualised approach adopted by the financial conglomerate to conduct its business. The management structure of most conglomerates falls into one of three categories (or a combination thereof): Corporate Legal (legal entity basis), Business Line (product/service basis), or Geographic (region, country, municipality).

**Corporate Controls Functions** are the risk measurement, monitoring and control systems of a conglomerate and include internal and external audit, financial control, compliance, human resources, and information technology. Together, they comprise the Control Environment, the functions within the conglomerate charged with ensuring that actions of the conglomerate are prudent and compliant, and in line with the risk taking appetite approved by the Board of Directors.

**Risk** refers to the likelihood that expected or unexpected events will have a negative impact on the financial conglomerate. Risk categories will vary by conglomerate, but generally fall into one of two broad categories: financial risk (credit, market, liquidity, actuarial, reinsurance, etc.) and non-financial risk (operations, transaction, reputation, legal, compliance, etc.).

***Risk Profile*** refers to an assessment of the level of risk-taking activity in light of the existing risk management framework.

### ***C. Technical Information***

The wide variety of structures and systems of financial conglomerates and the uniqueness of their business requires that supervisors determine on a case-by-case basis the information that should be available. Supervisors need to obtain information that allows them to assess and monitor how effectively a financial conglomerate is identifying, managing, and controlling its risks and to recognise any incipient problems. The Questionnaire is a starting point in this process.

The following constitutes examples of the types of information supervisors may wish to have access to (the types of information fall into the three broad categories and parallel the structure of the Conglomerate Questionnaire).

#### *Organisational structure, Corporate governance and Management oversight*

- An organisational chart or other descriptive material that depicts
  - a) the supervised entity and any material holding companies, subsidiaries, or affiliates, with indications of which legal entities take or bear substantial risk,
  - b) the business line organisation structure, with the supervised entity's place in the business line(s), the location of relevant business line management, and
  - c) the supervisors of any material holding companies, subsidiaries, or affiliates.

An organisational chart is useful to identify how closely the conglomerate's business line structure is aligned with its corporate legal structure, which other legal entities interact with or otherwise affect the supervised entity, and which of those entities are supervised and by whom. Understanding of the organisation chart may also be deepened by discussion of the factors that influence the overall approach to corporate legal structure, the conglomerate's plans with respect to corporate legal structure and any impediments it sees to developing optimal structure. An important consideration in reviewing any organisational chart is the realisation that a financial conglomerate is quite complex and its true organisational chart may in actuality be multi-dimensional.

- A chart depicting the management structure of the conglomerate, descriptions of the responsibilities of different types of managers (e.g., legal entity, corporate, business line, etc.) within the conglomerate, the relationship among managers and important types of interaction.

The management information-related questions provide the supervisor with insight into how the conglomerate is managed and controlled (on a global basis, on a regional, country, or business line basis, or through some combination of these structures) and how the

conglomerate manages businesses that cut across geographic and legal boundaries. Discussions with management can assist supervisors in understanding the major incentives provided to management to meet the organisation's goals and objectives, the managers responsible for maintaining the conglomerate's control environment in business lines and legal entities, and the firm's mechanisms to identify and correct internal control breaches, violations, and other problems within the firm.

- A description of the roles and responsibilities of the conglomerate's board of directors, the composition of the board, and the roles and responsibilities of the board of the supervised legal entity, and its composition.

The information on the roles and responsibilities of the conglomerate's and the supervised legal entity's board of directors (if they differ in composition) provides the supervisor with an understanding of the conglomerate's governance and decision-making scope of regulated legal entities.

- The level and distribution of capital among the material legal entities of the conglomerate, the conglomerate's approach to capital allocation on an economic and on a regulatory basis, and whether the conglomerate is in compliance with its capital requirements in all regulated legal entities.

The capital information provides basic information on the conglomerate's capital structure and the impact of that structure on the current and future evolution of the financial condition of supervised legal entities, as well as an understanding of the regulatory factors influencing the manner in which capital is held within the conglomerate. Supervisors often discuss with management the approach to capital allocation and factors influencing capital allocation decisions.

- Financial information on the supervised entity and its ultimate holding company, if applicable, including balance sheets (as of the most recent fiscal quarter and financial year-end) and income statements (for the most recent year-to-date period and financial year end), and consolidated balance sheets and income statements, where available.

Financial information enables supervisors to assess trends in earnings and balance sheet categories as well as the contribution and/or significance of the piece of the conglomerate under their particular supervision. Information on relevant market developments, including acquisition and merger activity, should be accessible to enable supervisors' assessment of implications for the financial condition of supervised entities.

- A description of the nature of the conglomerate's intra-group and related affiliate transactions and exposures, and indications of the volume of such transactions and the size of material intra-group financial exposures.

The intra-group information allows the supervisor to evaluate the channels through which the holding company, subsidiaries and affiliates of a regulated legal entity can influence the financial health of that legal entity. These channels include arrangements such as servicing agreements. Supervisors can also discuss with management factors affecting legal entity booking decisions and thus the size and nature of intra-group exposures, as well as how such transactions are monitored, and what limits or other controls on exposure are in place among legal entities within a financial conglomerate.

### *Risk Management*

- A description of the conglomerate's broad business strategy, and the conglomerate's view of its principal risks; for each principal risk, a description of the approach to measuring, managing and controlling that risk, the organisation of risk management personnel and their reporting lines, limit structures or other risk control mechanisms in the regulated entity, and, where relevant, the role of stress testing or contingency planning in managing risk at the business line, legal entity or groupwide level.

The risk information provides the supervisor with management's perspective on the overall risk profile of the firm, the risk profile of the supervised legal entity, and management's approach to managing each risk within the legal entity structure. As part of measuring and monitoring certain risks, financial conglomerates may conduct stress testing and other contingency planning at the business line, legal entity or corporate-wide level which, if conducted thoughtfully, can shed additional light on potential risk concentrations and vulnerabilities to changes in the market environment.

Organisational information and discussions with management should clarify responsibilities in the risk management area and help the supervisor identify relevant risk management personnel to answer questions. Supervisors may also seek information about the limit structure or other measures to control risk-taking and the use and level of reserving or provisioning, such as the credit loss reserve at banks or the technical provisions at insurance companies. The conglomerate's approach to administering limits (e.g., the willingness of management to permit limit exceptions) or managing reserves/technical provisions is critical to understand the intended restraints on risk-taking at the firm-wide level and within the supervised legal entity.

- Policies and procedures of the conglomerate addressing the introduction of new products or business lines.

The new product information helps the supervisor understand how the potentially risky process of introducing new products is managed, and where responsibility for ensuring adequate controls and due diligence on these products lies within the conglomerate.

- A description of the approach to managing the liquidity and funding profile of the supervised entity, including the liquidity of the material assets, the nature and stability of the entity's current funding sources and the availability of alternative funding; large payables, including securities payables, aggregate insurance claims payments, and out-of-the-money over-the-counter derivative and foreign exchange contracts; and other significant cash and securities needs associated with exchange activities or clearing and settlement, as well as the conglomerate's approach to managing significant clearing and settlement arrangements through or for other firms.

The liquidity and funding profile of the supervised entity enables supervisors to determine the entity's cash needs to cover liabilities and settlement obligations, how quickly the entity can generate cash from its existing assets, liquidation of collateral, where appropriate, or through additional liabilities, and how effectively the entity can access credit-sensitive trading markets. Since counterparties to banking and securities firms are likely to assess their credit exposure to the firm across the full range of funding, counterparty exposures and settlement arrangements, a comprehensive assessment of liquidity will normally require access to information on all these elements.

#### *Control Environment*

- The conglomerate's significant accounting policies and actuarial policies (where relevant), the role(s) of any internal or external actuaries.
- A description of the roles, responsibilities and organisation of the financial control and compliance functions.

The information on accounting policies, actuaries, financial control, and compliance should provide a supervisor with an understanding of key elements of the framework for establishing internal control in the organisation and the location within the financial conglomerate of key financial, accounting and actuarial systems and personnel.

- A description of the roles, responsibilities, organisation and allocation of responsibilities between centralised and decentralised elements of the internal audit area and the role of external audit.

The internal audit information assists the supervisor in understanding the objectives of the internal audit department, its interaction with the external auditors, how audit responsibilities relating to a supervised legal entity are managed between the central audit staff and any staff assigned to the region, business line or legal entity, the recipients of audit reports and the nature of the process to follow up internal audit findings.

### **III. Conglomerate Questionnaire**

#### ***I. Organisational Structure, Corporate Governance And Management Oversight***

##### ***A. Legal Structure and General Information***

1. What information is available within the conglomerate on the legal corporate and business line structures (including any information on regional or geographic structures)? How well do public disclosures (e.g., annual reports, public financial statements, etc.) capture the legal and business line structures of the conglomerate?

2. What factors influence the overall approach to 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?

3. What is the conglomerate's strategy with respect to corporate legal structure? What does management feel is/would be the optimal structure? What impediments exist that prevent management from implementing the optimal structure?

4. Which legal entities are regulated and by whom? Who is responsible for coordinating regulatory relationships? How is this achieved in practice? How does management view the regulatory structure(s) within which it must operate?

##### ***B. Management Structure***

1. What information is available on the management structure of the conglomerate? To what level of management/employee is this information disseminated? How does management ensure that reporting lines are clear?

2. What is the overall management structure of the conglomerate? How closely does this structure align with business lines and/or corporate legal entities? What is the strategy in having this structure? What factors influenced the decision to adopt such a structure? What factors would cause management to reconsider its current management structure?

##### ***C. Corporate Governance and Management Oversight***

1. How is the conglomerate managed and controlled -- on a global basis, on a regional, country or business line basis, or some combination of these? How does the conglomerate manage businesses that cut across geographic and legal boundaries?

2. What responsibilities do different types of managers (e.g., legal entity, corporate, business line, etc.) have within the conglomerate and how do these managers interact? For those conglomerates with regional or geographic managers, who reports to these managers?

3. What roles and responsibilities does the conglomerate's board of directors have? What is the composition of the board (e.g., outside directors)? What roles and responsibilities do the boards of legal entities have? What is the composition of these boards?

4. What are the major incentives provided to management to meet the organisation's goals and objectives? What are the major disincentives to management actions that impede meeting the organisation's goals and objectives?

5. What is the conglomerate's approach to staff recruitment and development? How are the conglomerate's objectives (business or otherwise) communicated to staff? How are strategic business and individual goals developed and monitored?

6. What is the conglomerate's strategy with respect to compensation? How is the conglomerate's compensation strategy developed and implemented? How do the conglomerate's business objectives and compensation methodology interact?

#### ***D. Capital Resources***

1. What information is available on the allocation of capital on an economic and regulatory basis? What management information reports are produced on capital-related issues such as using assets to collateralise exposure to more than one liability and substantial double leverage?

2. What is the conglomerate's capital and capital allocation strategy? Where is capital held within the conglomerate and why is it held there? What factors affect the allocation of capital across the conglomerate (e.g., regulatory, risk factors, etc.)? How are decisions made on capital allocation? When regulators require capital in certain legal entities, how does this affect the consolidated conglomerate?

3. How are capital decisions affected by the legal entity and business line structures?

4. What restrictions are placed on the instruments available to the conglomerate for raising capital and what is the nature of the restrictions? What are the impediments to flows of

capital among legal entities? To what extent, if any, are some legal entities able to raise capital on more favourable terms than others?

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

1. What information is available on the range of intra-group and related entity transactions and exposures? What kinds of management information reports are produced? How frequently are these reports produced?

2. What is the conglomerate's overall strategy with respect to intra-group transactions and exposures? What kinds of intra-group/related entity transactions or other arrangements are used (e.g., servicing agreements, back-to-back transactions, etc.)? How are intra-group and related entity exposures and transactions monitored?

3. What is the volume of intra-group/related entity transactions? the level of financial exposure? Does the conglomerate have limit structures in place for such transactions or exposures? What is the level of financial exposure to entities that are not wholly owned (<100%)? Does the conglomerate have limit structures in place for transactions and exposures to entities that are not 100% owned?

4. What factors affect legal entity booking decisions?

## ***II. Risk Management***

### ***A. Risk Profile***

1. What are the conglomerate's principal risks?

2. What are the major risk-taking legal entities within the conglomerate?

3. For each of the risks identified in 1. above:

a. What risk information is available within the conglomerate and what is the frequency of the information? How does the conglomerate measure that type of risk (if applicable, indicate types of models, etc.)?

b. What kinds of risk reports are available to risk takers, risk managers, senior managers and the board of directors? How frequently are these reports produced (e.g., global reports, business line reports)?

c. Are there elements of the management of particular risks that are implemented on a centralised basis vs. decentralised basis (e.g., centralisation of information capture, decentralisation of limit setting process)? Which risks are managed centrally by one legal entity? What role do regional or geographic managers play in risk management?

d. What risk control mechanisms does the conglomerate have in place (e.g., limit structures, vacation policy, compensation package, etc.)? Who is responsible for setting limits and how are they established? Are limits established for legal entities? business lines? consolidated conglomerate? Who monitors the limits or other mechanisms? What are the normal procedures if limits need to be exceeded?

e. What are management's plans with respect to stress testing, contingency planning and back testing?

f. What plans are there to change or enhance aspects of the risk management function (e.g., enhancements to systems, development of new measurement tools, etc.)?

### ***B. New Products***

1. How does the conglomerate define a new product? How is the introduction of new products managed within the conglomerate? What management reports are produced on the new product process? What process is used to determine whether or not a new product will be introduced or used by the conglomerate?

2. Who is responsible for the new product process? What role does internal audit and business unit management play in the new product process?

3. What are the conglomerate's plans with respect to introducing or using new products in the coming year? (e.g., new to the firm but not to the industry, new to the industry)

### ***C. Liquidity Management***

1. What types of information are available on liquidity? How frequently is this information produced?

2. Who is responsible for liquidity management? Which elements of liquidity management are centralised (at head office) and which elements are conducted at the local or legal entity level? How was this management arrangement determined?

3. Who is responsible for crisis and contingency funding planning? To what extent have such plans been elaborated?

### ***III. Control Environment***

#### ***A. Accounting Issues***

1. What major accounting rules are used by the conglomerate? How are these rules applied across the conglomerate? How are the results of using the accounting rules of different jurisdictions reconciled on a global consolidated basis?

2. What area(s) of the conglomerate is responsible for accounting issues? What are the responsibilities and reporting lines of this area?

#### ***B. Actuarial Issues***

1. Where relevant, what actuarial rules are used in the conglomerate? How are these rules applied across the firm?

2. What area(s) of the conglomerate is responsible for actuarial issues? What are the responsibilities of the actuary (or actuarial department)? To whom does the actuary report?

3. How does the conglomerate address actuarial issues (in-house? external?) What is the role of those resources?

***C. Financial Control Function*** (responsible for the integrity of the conglomerate's books and records and financial reporting)

1. What types of management information reports are produced by the financial control function? What is the frequency and timeliness of these reports? How are reports produced? (e.g., for business lines? legal entities? consolidated conglomerate?)

2. How is the financial control function organised with respect to legal entities and business lines? How is it managed (centrally, along geographic lines, business lines)?

3. What is the role of the business unit in the development and implementation of internal control plans? To what extent are internal controls implemented at the local level vs. business line?

***D. Compliance*** (compliance with relevant laws and regulations)

1. What types of information are available to monitor/ensure compliance? What methods does the conglomerate use to identify and report non-compliance problems or issues?

2. What is the structure of the conglomerate's compliance function? (e.g., separate? centralised, etc.?) How are responsibilities for compliance issues assigned? (e.g., legal)? If a separate function, to whom does the compliance function report? In practice, how are the compliance requirements of the conglomerate monitored and managed?

3. What are the roles of the different levels and types (e.g., legal entity, business line, etc.) of management in developing, maintaining and ensuring the conglomerate's control environment? What mechanisms are in place to identify and correct internal control breaches, violations, and other issues of non-compliance?

4. How are other types of problems, such as a failing counterparty or employee misconduct, identified, reported, and managed?

***E. Internal Audit***

1. What types of information, summaries and other reports (e.g., Board reports, senior management reports) are available on internal audits (e.g., performance reports, unresolved issues, etc.)? To whom is this information available? What is the process for following up or acting on issues identified by internal audit?

2. How is the internal audit function structured? What roles and responsibilities belong to the centralised element of the audit function, if there is one? What roles belong to decentralised units of the internal audit function, if any?

3. How does the conglomerate ensure sufficient independence of the internal audit function? To whom does the internal audit function report?

4. How will the conglomerate's approach to internal audit and internal controls change or expand in the future?

5. Are there any aspects of the internal audit function that are outsourced? If so, to whom are they outsourced? How is the determination made i.e. whether or not to outsource?

***F. External Audit***

1. What types of information are available on external audit issues? To whom is this information available? What kind of follow-up is conducted with respect to deficiencies or other issues identified by external audit? Who is responsible for the follow-up? What is the process to correct deficiencies?

2. What are the responsibilities of the external auditors? How does the external audit firm interact with the internal audit function? How closely do the external and internal audit functions work? How does the firm go about selecting its external auditor?

3. How does the conglomerate ensure the independence of the external audit process? What is the role of the non-executive board members with respect to external audit?

## IV. Conglomerate Matrix

<i>I. Organisational Structure, Corporate Governance and Management Oversight</i>	
<b><i>A Legal Structure and General Information</i></b>	
1. <i>GENERAL INFORMATION</i> (Type of organisation, range of asset size, countries in which active, indication of general supervisory framework)	[Information available to supervisors, or obtained during mapping]
2. <i>ORGANISATIONAL STRUCTURE- CORPORATE</i> (list major subsidiaries and branches, locations, types of activities, indication of whether subsidiary is supervised). Attach in annex a "legal entities" corporate tree.	[Information available to supervisors, or obtained during mapping]
3. <i>ORGANISATIONAL STRUCTURE- BUSINESS LINE</i> (list major business lines e.g., fx, swaps, equity sales & trading, fixed income, derivatives, retail banking, private banking, custody, personal/commercial lines general insurance, reinsurance, individual/group life, pension, corporate banking, others). Attach in annex a "business line" organisational structure.	[Information available to supervisors, or obtained during mapping]

4. <i>DISCLOSURES (extent of legal and business line public disclosures-compare to information disseminated within the conglomerate)</i>	Question IA1
5. <i>FACTORS INFLUENCING LEGAL / BUSINESS LINE STRUCTURE (if divergent, explain reasons.)</i>	Question IA2
6. <i>TREND IN CORPORATE LEGAL AND BUSINESS LINE STRUCTURE (e.g., status quo vs. current and planned changes, management's views of optimal structure)</i>	Question IA3
7. <i>RESPONSIBILITY FOR COORDINATING REGULATORY RELATIONSHIPS (include how, who and location(s)). Attach in annex a listing of major regulated entities and relevant regulators.</i>	Question IA4
<b>B. Management Structure</b>	
1. <i>TYPE OF OVERALL MANAGEMENT STRUCTURE(including major corporate committees and their role)</i>	Question IB1 and information available to supervisors, or obtained during mapping
2. <i>DISCLOSURES (extent of public disclosures as to management structure-compare to information disseminated within the conglomerate)</i>	Question IB1

3. <i>MANAGEMENT STRUCTURE OF LEGAL ENTITIES (at what level and location is firm being run?; authority of legal entities)</i>	Question IB2
4. <i>MANAGEMENT STRUCTURE OF MAJOR BUSINESS LINES (alignment of such structure to corporate legal structure)</i>	Question IB2
5. <i>KEY BUSINESS LINE MANAGERS, LOCATIONS AND REPORTING LINES (indicate top business line managers, area of responsibility, location (home office vs. other -- sub. or branch?))</i>	[Information available to supervisors, or obtained during mapping]
6. <i>KEY FUNCTION MANAGERS' LOCATIONS, AND REPORTING LINES (e.g., Risk Management, Audit, Financial Control, etc., location(s), and whether manager has dual responsibilities)</i>	[Information available to supervisors, or obtained during mapping]
7. <i>DOES THE FIRM HAVE REGIONAL MANAGERS? (Indicate geographic location and area of responsibility)</i>	[Information available to supervisors, or obtained during mapping]
8. <i>FACTORS INFLUENCING MANAGEMENT STRUCTURE-LEGAL / BUSINESS LINE</i>	Question IB2
9. <i>TREND IN MANAGEMENT STRUCTURE (e.g., status quo vs. current and planned changes, management's strategy with respect to its structure)</i>	Question IB2

<b><i>C. Corporate Governance and Management Oversight</i></b>	
1. <b><i>DISCUSSION OF RELATIONSHIP BETWEEN MANAGEMENT OF BUSINESS LINES AND LEGAL ENTITIES</i></b> <i>(discussion of global business lines and how firm manages businesses that cut across geographic and legal boundaries)</i>	Question IC1
2. <b><i>GENERAL DISCUSSION OF MANAGEMENT RESPONSIBILITY FOR CONTROL ENVIRONMENT</i></b> <i>(including role of senior management/entity management; does the firm run like one entity or multiple different businesses? )</i>	Questions IC1 and IC2
3. <b><i>GENERAL DISCUSSION OF COMPOSITION AND ROLE OF BOARD OF DIRECTORS AND MAJOR BOARD-LEVEL COMMITTEES</i></b>	Question IC3
4 <b><i>PRINCIPAL INCENTIVES/ DISINCENTIVES TO MANAGEMENT, COMPENSATION AND RECRUITMENT STRATEGY</i></b> <i>(relate to the firm's goals and objectives)</i>	Questions IC4, IC5 and IC6
<b><i>D. Capital Resources</i></b>	

1. <i>TYPES AND SOURCES OF CAPITAL</i>	[Information available to supervisors, or obtained during mapping]
2. <i>DISCLOSURE OF CAPITAL ALLOCATION WITHIN CONGLOMERATE AND OF CAPITAL ADEQUACY OF REGULATED ENTITIES (public disclosure and management reporting)</i>	Question ID1
3. <i>ALLOCATION METHODOLOGY (factors, including regulatory requirements, determining allocation of capital and management strategy)</i>	Question ID2
4. <i>RESPONSIBILITY FOR CAPITAL RESOURCES AND ALLOCATION</i>	Question ID2
5. <i>DISCUSSION OF CAPITAL ALLOCATION : BUSINESSES LINES VERSUS LEGAL ENTITIES</i>	Question ID3
6. <i>RESTRICTIONS ON CAPITAL INSTRUMENTS AND ON FLOWS OF CAPITAL WITHIN THE CONGLOMERATE</i>	Question ID4
<b><i>E. Intra-group and related entity transactions and financial exposures</i></b>	
1. <i>DISCLOSURE (extent of public disclosure on intra-group transactions and exposures and other intra-group arrangements)</i>	Question IE1

4. <i>MANAGEMENT INFORMATION AND REPORTING SYSTEMS (including a discussion of location and responsibility for monitoring, types of reports, frequency and distribution)</i>	Question IE1
2. <i>DISCUSSION OF TYPES OF INTRA-GROUP TRANSACTIONS AND REASONS FOR TRANSACTIONS (management rationale for intra-group transactions.)</i>	Question IE2
3. <i>OTHER TYPES OF INTRA-GROUP RELATIONSHIPS (e.g., discussion of service agreements, etc.)</i>	Question IE2
4. <i>VOLUME OF INTRA-GROUP TRANSACTIONS AND EXPOSURES AND LIMIT STRUCTURES (including limits for participations of less than 100%)</i>	Question IE3
6. <i>FACTORS THAT AFFECT LEGAL ENTITY BOOKING DECISIONS</i>	Question IE4
<b><i>II. Risk Management</i></b>	
<b><i>A. Risk Profile</i></b>	
1. <i>PRINCIPAL RISKS OF CONGLOMERATE</i>	Question IIA1

2. <i>MAJOR RISK TAKING ENTITIES (relate principal risks being undertaken to the legal entities where such risks are borne)</i>	Question IIA2
3. <i>MANAGEMENT'S PERCEPTIONS OF RISKS TO FIRM AND TRENDS/CHANGES</i>	[Information available to supervisors, or obtained during mapping]
<b>B. New Products</b>	
1. <i>PROCESS FOR INTRODUCTION OF NEW PRODUCTS (initiation , development, approval implementation, reporting)</i>	Question IIB1
2. <i>MANAGEMENT RESPONSIBILITY (role of legal entity/business line manager)</i>	Question IIB2
3. <i>PLANS FOR THE INTRODUCTION OF NEW PRODUCTS (e.g. one year timeframe)</i>	Question IIB3
<b>Risk Management</b> <i>For each type of risk , the following information should be recorded, as applicable.</i>	
1. <i>STRUCTURE OF RISK MANAGEMENT</i>	
a. <i>Management Structure, Reporting Lines and Responsibilities (e.g. centralised/decentralised, role of geographic and regional managers)</i>	Question IIA3c and IIC2
b. <i>Role of Board of Directors</i>	Question II A3c

<p>c. <i>Current and Future Risk Appetite (management's views as to the conglomerate's willingness to accept risk)</i></p>	<p>[Information available to supervisors, or obtained during mapping]</p>
<p>2. <b>METHODOLOGIES AND MEASUREMENT TOOLS</b></p>	
<p>a. <i>Discussion of Risk Measurement (e.g. types of models, legal entity, business line, conglomerate-wide approach)</i></p>	<p>Questions IIA3a and IIC2</p>
<p>b. <i>Discussion of Risk Control Mechanisms including Limit Structures (responsibilities for setting and monitoring the application of limits and for remedial action)</i></p>	<p>Questions IIA3d and IIC2</p>
<p>c. <i>Stress Testing, Contingency Planning and Back Testing (including discussion of crisis and contingency funding planning)</i></p>	<p>Question IIA3e and IIC3</p>
<p>3. <b>RISK MANAGEMENT REPORTS</b></p>	
<p>a. <i>Types of Risk Management Reports</i></p>	<p>Questions IIA3b and IIC2</p>
<p>b. <i>Frequency and Distribution of Reports (e.g. to risk takers, risk managers, senior managers and the Board of Directors)</i></p>	<p>Questions IIA3b and IIC2</p>

<i>c. Discussion of Information Systems Development</i>	Questions IIA3f and IIC2
<i>d. Trends in Risk Management (e.g., changes in reporting systems, management's direction for risk management, new tools)</i>	Questions IIA3f and IIC2

<b>III. Control Environment</b>	
<b>A. Accounting Issues</b>	
1. <b>MAJOR ACCOUNTING RULES USED BY CONGLOMERATE</b> <i>(including reconciliation process for different jurisdictional requirements)</i>	Question IIIA1
2. <b>RESPONSIBILITY FOR ACCOUNTING DECISIONS</b> <i>(discuss functional responsibility lines, whether geographic location is important, whether multiple systems are used)</i>	Question IIIA2
<b>B. Actuarial Issues</b>	
1. <b>MAJOR ACTUARIAL RULES USED BY CONGLOMERATE</b> <i>(including reconciliation process for different jurisdictional requirements)</i>	Question IIIB1
2. <b>RESPONSIBILITY FOR ACTUARIAL DECISIONS</b> <i>(discuss functional responsibility lines, whether geographic location is important, whether multiple systems are used)</i>	Question IIIB2

3. <i>ROLE OF OUTSOURCING FOR ADDRESSING ACTUARIAL ISSUES</i>	Question IIIB3
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<b>C. Financial Control Function</b>	
1. <i>MANAGEMENT INFORMATION REPORTS (including type, frequency and whether along business lines, legal entities and/or consolidated)</i>	Question IIIC1
2. <i>STRUCTURE OF FINANCIAL CONTROL (including how the function is organised -- along business lines, legal entities; reporting lines)</i>	Question IIIC2
3. <i>ROLES AND RESPONSIBILITIES OF FINANCIAL CONTROL (including the role of business line management in the development and implementation of internal controls)</i>	Question IIIC3
<b>D. Compliance</b>	
1. <i>MANAGEMENT INFORMATION REPORTS (including type, frequency, distribution)</i>	Question IIID1
2. <i>STRUCTURE OF COMPLIANCE FUNCTION (including how the function is organised, e.g. centralised)</i>	Question IIID2
3. <i>REPORTING LINES OF COMPLIANCE FUNCTION</i>	Question IIID2

4. <i>DISCUSSION OF THE RESPONSIBILITIES OF COMPLIANCE (including mechanisms to identify, report and manage control and non-compliance problems)</i>	Questions IIID3 and IIID4
<b><i>E. Internal Audit</i></b>	
1. <i>MANAGEMENT INFORMATION REPORTS AS TO WORK OF INTERNAL AUDIT (including follow-up process on findings)</i>	Question IIIE1
2. <i>STRUCTURE OF INTERNAL AUDIT AND RESPONSIBILITIES (including how function is organised -- along business lines, legal entities; centralised vs. decentralised)</i>	Question IIIE2
3. <i>INTERNAL AUDIT REPORTING LINES (including independence of function)</i>	Question IIIE3
4. <i>FACTORS INFLUENCING SCOPE, COVERAGE AND FREQUENCY OF AUDITS (including management's future outlook for the conglomerate's internal audit function)</i>	Question IIIE4
5. <i>ROLE OF OUTSOURCING</i>	Question IIIE5

<b><i>F. External Audit</i></b>	
1. <i>MANAGEMENT INFORMATION AVAILABILITY AS TO EXTERNAL AUDIT WORK (including follow-up process on findings)</i>	Question IIIF1
2. <i>PRIMARY EXTERNAL AUDIT FIRM (including measures to ensure the independence of the external auditors)</i>	[Information usually available to supervisors, or obtained during mapping] and Question IIIF3
3. <i>OTHER FIRMS USED FOR OTHER LEGAL ENTITIES?</i>	[Information available to supervisors, or obtained during mapping]
4. <i>INTERACTION BETWEEN EXTERNAL AUDIT AND INTERNAL AUDIT</i>	Question IIIF2
5. <i>RESPONSIBILITIES OF EXTERNAL AUDIT (including consulting work)</i>	Question IIIF2

### **Outline of Types of Information that would be Useful in an Emergency Situation**

As the situation of a financial conglomerate worsens, the nature and scope of the problems being encountered will influence the types of information supervisors will be interested in accessing. As such, specific types of information needs cannot be anticipated in advance and will need to be determined on a case-by-case basis. Supervisors' needs will only be met if the conglomerate has in place good information systems which will permit accurate and detailed information to be retrieved in a timely and reliable manner.

In an emergency, supervisors' information needs will often be sharply focused and potentially very detailed. Supervisors may not seek the same types of information as set out below for any given emergency. While the primary information needs in an emergency will be firm-specific, there may also be a need for information relating to depositories, exchanges and clearing organisations. In order to respond to emergency situations in a timely and effective way, the information requirements of supervisors can be characterised as follows:

- Updates of information that should be on hand or readily available to supervisors;
- Information that supervisors will likely want to obtain during the course of an emergency;
- Information that will permit supervisors to assess the impact of an emergency on other financial firms under their supervision; and
- Information that provides the context of the emergency and its potential course.

In some unusual emergency circumstances, such as a major fraud or operational failure, the quality of some information from a supervised entity may be compromised. In such circumstances, supervisors will need to develop alternative sources of information or a strategy with which to obtain approximations of the financial and risk exposure information needed.

In an emergency, supervisors need to establish communication with a representative of their supervised entity (or entities) who can act as the contact person to provide requested information to the supervisors and to act as the primary liaison between the supervisors and the supervised entity. This person, which in unusual circumstances could be appointed from outside the supervised entity, should be designated as soon as possible once the emergency is detected.

The more familiar the supervisor is with the conglomerate's operations, the better positioned it will be to act in an emergency situation. Completing the Conglomerate Questionnaire and matrix in advance of an emergency can be a useful supervisory tool.

*A. Information That Should Be On Hand or Readily Available to Supervisors*

Supervisors' ability to gather and accurately interpret necessary financial and operational information about the conglomerate is critical to effective supervision in an emergency. Either through ongoing supervisory work or as a result of having carried out a mapping exercise using the Conglomerate Questionnaire, relevant supervisors should be familiar with the key management information reports available at the conglomerate and knowledgeable of where information gaps or weaknesses may exist. Examples of the types of information which supervisors will generally need are set out below.

- An organisational chart or other descriptive material that depicts the supervised entity and any material holding companies, subsidiaries, or affiliates, the business line organisation structure, with the supervised entity's place in the business line(s), and the location of relevant business line management.
- Financial information on the supervised entity and its ultimate holding company, if applicable, including balance sheets and income statements and the capital structure.
- The liquidity and funding profile of the supervised entity. This information would include:
  - the liquidity of the material assets, the nature and stability of the entity's current funding sources and the availability of alternative funding, and intercompany funding arrangements;
  - large payables, including securities payables, aggregate insurance claims payments, and out-of-the-money over-the-counter derivative and foreign exchange contracts; and
  - other significant cash and securities needs associated with exchange activities or clearing and settlement, and significant clearing and settlement arrangements through or for other firms.
- The principal market risk and credit risk exposures of the supervised entity, which should include: on- and off-balance sheet positions, as well as significant counterparty exposures; and insurance underwriting risk, interest rate risk and investment risk.

An up-to date organisation chart would provide supervisors with the ability (1) to verify their understanding of the entire organisation's legal entity structure and how the supervised entity fits into that overall structure and (2) to facilitate, given the nature and scope of an emergency situation, the identification of affiliates that may cause the supervised entity to be at risk. Updating information briefly describing the primary activities of the supervised entity, the geographic and legal entity location of the business heads of those activities, the supervisors of all material entities and, where not obvious from financial information, the scale of the activities would also be useful.

Current financial information, including the balance sheets and income statements, would allow supervisors to analyse and assess the supervised entity's current financial condition and results of operations and to gain insight into the potential impact of current risk exposures on the entity's financial condition.

A current liquidity and funding profile of the supervised entity would enable supervisors to determine the entity's cash needs to cover liabilities and settlement obligations, how quickly the entity can generate cash from its existing assets, liquidation of collateral, where appropriate, or through additional liabilities, and how effectively the entity can access credit-sensitive trading markets. Since counterparties to banking and securities firms are likely to assess their credit exposure to the firm across the full range of funding, counterparty exposures and settlement arrangements, a comprehensive assessment of liquidity will normally require access to information on all these elements. Given the importance of liquidity in emergencies, specifically with regard to banks and securities firms, the supervisor's liquidity information needs can be quite detailed, including a day-by-day breakdown of the liquidity profile and of assets, liabilities and other obligations.

Current market risk and credit risk information would provide supervisors with insights into the supervised entity's major exposures which may not be readily apparent from the financial statements. It also gives supervisors the ability to seek out additional information, such as large credit exposures by customer or counterparty or exposure to a specific counterparty. In most cases, this information should be current as of a day or two of generating the information for a periodic or requested report. For banks and securities firms, credit risk exposure information should include estimates of direct exposure (lending or placements of funds), counterparty credit exposures through over-the-counter contracts or large receivables, and clearing and settlement exposures. For insurers, market and credit risk exposure information should include the current constitution of the portfolio of insurance policies (including reinsurance protection), the composition of assets covering technical provisions and liabilities, the interest rate applied in the calculation of the

mathematical provisions, how these insurance liabilities have been assessed, and an estimate of the firm's exposure to large insurance risks.

*B. Information that supervisors will likely want to obtain during the course of an emergency situation*

In contrast to basic financial and operational information generally available to supervisors, the information that a supervisor will likely want to obtain from a supervised entity during the course of an emergency situation would not necessarily be available to the supervisor prior to an emergency situation. It would be the particulars of the emergency -- the nature and scope of the problem -- that would indicate what information would be required by supervisors. However, the supervised entity's risk-taking, risk management, financial, operational, and control systems should be sufficient to capture and provide the desired information. Although the nature and scope of the emergency situation will determine specific information needs, those needs would generally include the following:

- What is the nature and severity of the emergency situation within the supervised entity?
- How is the supervised entity responding to the emergency situation?

This information could include the person(s) managing the emergency situation within the firm with their location, the use of any contingency plan or other set of general instructions to managers of the firm during the emergency, and the awareness and involvement of the firm's board of directors.

- What is the impact of the emergency situation on the supervised entity's exposure to counterparties, including customers, depositories, exchanges, and clearing organisations?
- How has the emergency affected the supervised entity's liquidity and funding profile?

This information could include the exposure of counterparties, including customers, depositories, exchanges, and clearing organisations, to the supervised entity, their reaction to the emergency, including willingness to enter into new funding or trading transactions with the supervised entity, upcoming settlements, and actual and expected margin and collateral calls.

- Are customer assets sufficiently safeguarded from the effects of the emergency situation and these assets fully accessible to customers?

This information could include the location of client account information, the amount of client securities and client money by custodian or manager, whether assets can be transferred, liquidated or otherwise offset, whether custodial or cash account services are provided by the supervised entity or its affiliates, and, if so, the use of customer cash or securities to obtain funding for the supervised entity or an affiliate. Information about custodial or fiduciary services provided by the supervised entity may also be of interest. Additionally, it may be useful for insurance companies to provide information about assets that are held to cover insurance company technical provisions, as these assets generally have to be held apart from other assets of the group in accordance with national law.

- To what extent are affiliates of the supervised entity affected by the emergency situation and to what extent do the affected affiliates pose a risk to the supervised entity?

This information could include whether the supervised entities' affiliates are in compliance with their regulatory capital requirements and the size and nature of intercompany balances or exposures, current flows of funds, prospective cross-entity funding or capital needs, unusual flows of funds or impediments to flows of funds.

- What is the extent, if any, of operational or support functional difficulties resulting from the emergency situation?

This information could include strains in processing transactions in securities or processing of insurance claims, or other operations, such as backlogs, unusual number of fails to deliver, trade matching or reconciliation problems, the geographic and legal entity location of major operational centres, location of back-up operational personnel and contact names, and for outsourced arrangements, any change in the relationship between the supervised entity and the outsourcer.

- To what extent are the firm's shareholders willing to support the firm during the emergency situation?

This information could include data on the level of daily trading volume in the firm's stock since the announcement of the emergency situation compared with the level of daily trading volume for some period prior to the announcement. Information regarding the change in the firm's stock price since the announcement could also be relevant.

- What options are available regarding the sale of the entire supervised entity or part of its business to another company?

This information could include the number of serious offers (if any) that have been extended by other entities to purchase all or part of the entity since the announcement of the emergency situation.

- How has the media reacted to the emergency situation?

This information could include any articles printed in newspapers or trade journals that refer to the emergency situation. Any relevant press releases issued by the supervised entity would also be of interest.

- What plans have been made to restore the firm to sound financial condition?

This information could include details on any plans that have been developed and any specific measures that have already been taken in response to the emergency situation. It is important that the impact any such plans could have on other entities (e.g., if the implementation of the plan could affect another entity's financial position) should be considered.

The information received from supervised entities in response to requests by supervisors for information will, in turn, usually lead to more specific, detailed and in-depth questions based on the specifics of the emergency situation and the involvement of the supervised entity. A contact person should be identified at a supervised entity to act as the primary liaison between the supervisor and the supervised entity during an emergency.

*C. Information That will Permit Supervisors To Assess the Impact of An Emergency On Other Financial Firms Under Their Supervision*

The nature and scope of an emergency situation will usually indicate to supervisors which financial firms would likely be affected by the emergency. Gathering and updating financial and operational data along with emergency situation-specific information from one or more firms most deeply involved in the emergency situation may allow supervisors to ascertain what additional information is needed from other financial firms. In other circumstances, however, the supervisor will seek to collect information from a broad group of supervised entities in its jurisdiction in order to expedite the assessment of the emergency's impact.

For those other supervised entities within a supervisor's jurisdiction, the supervisor could choose to obtain financial and operational information as well as the emergency-specific information. Alternatively, the supervisor can choose to obtain only

information specifically relating to the emergency (such as specific market or credit risk exposures).

*D. Information That Relates to Actions That Could Influence the Course of the Emergency*

Finally, supervisors may also collect information from other supervisors and a variety of other sources in order to better understand the context of an emergency and how the course of events might develop.

- A calendar of key dates for the emergency, including important settlement dates, maturities of major funding arrangements, planned public announcements, contract announcements, and court decision dates.
- The role and involvement of other supervisors, including the existence of any actual or emerging situation that would have the potential to trigger action by the supervisor, such as a capital shortfall in another legal entity.
- Laws, regulations, bylaws and operating procedures that could be triggered as a result of technical or actual default by a supervised entity or its counterparty in an emergency.

In an emergency situation, supervisors will also need to consider the circumstances under which other supervisors and government agencies need to be contacted about the emergency.

Principles  
for  
Supervisory Information  
Sharing  
paper

## **Principles for Supervisory Information Sharing**

### ***Objective***

1. To provide to supervisors involved in the oversight of regulated financial institutions residing in financial conglomerates guiding principles with respect to supervisory information sharing, to build on and enhance existing information sharing arrangements, particularly cross sectorally.

### ***Background***

2. Technological innovation, the liberalisation of national financial markets and the removal of legal and trade barriers between countries have encouraged the development of diversified financial conglomerates with complex management and corporate structures. In addition, many conglomerates are organised along global business lines and still more manage some or all of their major risks across the various entities within the group, in a manner that cuts across legal entity lines.

3. The rapid evolution of such diversified financial conglomerates which offer a comprehensive range of financial services, including banking, securities and insurance services, on a global basis presents significant challenges to both the management of these firms and the supervisors with responsibility for the regulated entities within the conglomerate. The broad span of activities and locations alone create the need to understand the relationships among the legal entities within the structure and the potential for adverse developments in one part of the conglomerate to affect the operation of other parts.

4. The fields of responsibilities of supervisory authorities, by contrast, are determined by national legislation. They vary significantly in terms of their mandates and approaches.

5. As a result, the supervisory structure often does not align with the organisation of the business and risk management structure of the conglomerate. This has implications for the effective oversight of diversified financial conglomerates, underscores the importance of communication between supervisors and further requires the development of cooperative links between them.

6. Information exchanges intra sector are facilitated through protocols entered into at different times. For example, the Basle Committee's *Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments* (July 1992) as

supplemented by a *Report on the Supervision of Cross-border Banking* (October 1996) established a framework for the exchange of information between supervisors. Likewise, IOSCO's *Principles for Memoranda of Understanding* (1991) established a framework for facilitating comprehensive information sharing between securities supervisors and has encouraged the development of numerous such arrangements. The IAIS "Insurance Concordat" - *Principles applicable to the Supervision of International Insurers and Insurance Groups and their Cross-border Establishments* provides the basis for intra-sectoral cooperation. Also, numerous bilateral arrangements exist amongst supervisors providing for the flow of general and specific supervisory information, in some cases in respect of individual financial conglomerates.

7. These protocols and arrangements in large part determine a common set of principles with respect to information sharing among supervisors. This paper adapts and summarises basic principles drawn from those protocols and arrangements and applies them to communication among the broad community of supervisors of financial conglomerates, both within and between sectors. It should be noted that such principles can only be fully effective when virtually all legal and procedural impediments to appropriate supervisory information sharing have been removed.

8. In this regard, in May 1998 the G-7 Finance Ministers released the Ten Key Principles on Information Sharing which set out, among other things, a policy framework for legislative regimes facilitating information sharing among supervisors. The Joint Forum welcomes the Ten Key Principles and notes that:

- they complement the principles set out in this paper; and
- their implementation is substantially a matter for relevant legislative authorities.

The Ten Key Principles were published in the report entitled *Financial Stability - Supervision of Global Financial Institutions* and are set out in full in Annex 1 to this paper.

### ***Guiding principles***

9. The informational needs of supervisors vary considerably depending on several factors relating to the objectives and approaches of supervisors themselves and to the organisation and structures of the financial conglomerates. The principles set out below are intended to assist supervisors in enhancing information sharing arrangements that will contribute to a more effective supervisory framework for financial conglomerates. For the purposes of this paper, the primary supervisor is generally considered to be the supervisor of the parent or the dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements. Where the identity of the primary supervisor is not clear,

the relevant supervisors should work cooperatively to identify, on a case by case basis, an appropriate information sharing structure.

- 1. Sufficient information should be available to each supervisor, reflecting the legal and regulatory regime and the supervisor's objectives and approaches, to effectively supervise the regulated entities residing within the conglomerate.**

10. Financial conglomerates take a wide variety of structures reflecting historical, tax and regulatory considerations. Conglomerates' choices about the organisation of business activities and corporate control functions also reflect their efforts to operate more efficiently and to control risk more effectively. Some conglomerates operate in a manner consistent with their corporate legal structure, that is, business activities and legal entities are aligned. In other conglomerates, there is divergence of the corporate legal structure and the business activities structure. These latter structures have been driven largely by the increasing complexity of the financial services business, the wide dispersion of operations over product and geographic markets, and advances in risk management and information technologies. In some cases, conglomerates have organised their corporate control functions on a global or centralised basis, and that is especially true in firms that manage their activities along global lines. The different structures have implications for the types of information supervisors need to access and for supervisory information sharing between supervisors.

11. Supervisors need key descriptive information about the conglomerate: its organisational structure, management, financial condition, strategy and principal risks, and the main features of its policies, procedures and information systems for managing and controlling risk. This information may be included in organisation charts, financial statements, capital, liquidity and risk profiles, policy manuals and other written material.

12. The extent to which individual supervisors will need some or all of this information will depend not only on their supervisory objectives and the entity(ies) they supervise but on two important dimensions of the conglomerate's structure: the organisation of its business activities and the organisation of its corporate control functions, e.g. its risk measurement, monitoring and control systems (including internal and external audit, financial control, compliance, human resources, and information technology).

13. One way to facilitate supervisors' ability to enhance their understanding of the financial conglomerate and to obtain common knowledge of its strategies, organisation and management systems is through conducting a mapping exercise such as that carried out by a Task Force created by the Joint Forum to examine several large international conglomerates. There are other effective means of gaining similar insights into the structure and operations of

conglomerates. Communicating meaningful information regarding a conglomerate's organisational structure, corporate governance and management oversight, its risk management processes and its control environment, whether obtained from carrying out a mapping exercise or from ongoing supervision, a combination of the two or another method, is essential to information sharing.

14. Information needs of the various supervisors involved in a conglomerate will vary. The primary supervisor is likely to have both the need for and access to the widest range of information. Other supervisors may often not need to have access to extensive information, or may not have the resources to assess extensive amounts of information, and may seek additional information or verification of information from the primary supervisor. Supervisors with responsibility for only a minor portion of the financial conglomerate may need lesser amounts of information and may have more interest in the assessment carried out by the primary supervisor.

15. Financial conglomerates are encouraged to maintain contact and dialogues with all their supervisors, with a view to identifying efficient ways of providing to supervisors relevant information with respect to the corporate legal structure, the business activities structure, the management structure, and the organisation of corporate control functions, and the internal controls structure to assist supervisors in their oversight efforts.

**2. Supervisors should be proactive in raising material issues and concerns with other supervisors. Supervisors should respond in a timely and satisfactory manner when such issues and concerns are raised with them.**

16. Bilateral and multilateral information sharing arrangements between supervisors, including arrangements relating to individual conglomerates, are useful to supervisors' oversight and can be important where there are particular issues or concerns. However, the existence of information sharing mechanisms will not necessarily satisfy all supervisors' needs without the willingness of supervisors to bring forward material issues of interest or of concern to relevant supervisors and, as appropriate, the conglomerate itself.

17. It must be recognised that there are practical limits as to the amount of information which may impact an entity under their supervision that supervisors can efficiently and effectively receive and assess on all aspects of financial conglomerates. Among the information they could receive, supervisors particularly value the judgements of other supervisors and relevant information about the conglomerate when it is adverse, unusual or out-of-the-ordinary.

18. In order to avoid the flow of large amounts of extraneous information, it is important for supervisors to reach an understanding, on a bilateral or multilateral basis, that such adverse or out-of-the-ordinary information will be communicated to relevant supervisors. Supervisors that become aware of out-of-the-ordinary developments in carrying out their oversight responsibilities should initiate contact with and inform other relevant supervisors. It is especially important for supervisors to have the ability to contact other supervisors with

requests for specific information on material issues that are of concern and to receive a response in a timely and satisfactory manner.

19. Financial conglomerates are encouraged to provide to relevant supervisors, including the primary supervisor, information regarding unusual or out-of-the-ordinary developments and to initiate a dialogue, in this respect, with all their relevant supervisors.

**3. Supervisors should communicate emerging issues and developments of a material and potentially adverse nature, including supervisory actions and potential supervisory actions, to the primary supervisor in a timely manner.**

20. Generally, supervisors should readily communicate with the primary supervisor about material emerging issues and adverse developments in the entities for which they have supervisory responsibility, as well as any other information that they consider appropriate. This information should include supervisory actions an individual supervisor is taking or considering in order to address a supervisory concern in its jurisdiction. Such communications enhance the ability of the primary supervisor in identifying trends and developing issues in the conglomerate and recognise that the solution to problems, particularly as they relate to solvency, will likely involve the parent or dominant entity and the primary supervisor.

21. Supervisors should be mindful, in assessing whether issues or concerns or other information coming to their attention warrant communication to the primary supervisor, that the primary supervisor is often best placed to assemble disparate pieces of information that could be of themselves be considered less significant and to discern a material adverse trend or emerging concern.

22. There may be instances where supervisors may hesitate to alert the primary supervisor of emerging issues with respect to entities for which they have responsibility, for example, where the supervisor believes that actions by the parent or dominant entity or its supervisor could undermine an imminent resolution of a local situation. However, the building of relationships and experience gained from more frequent contacts between supervisors should foster a climate of cooperation and trust which can help dispel this reluctance to bring forward issues of concern.

- 4. The primary supervisor should share with other relevant supervisors information affecting the regulated entity for which the latter have responsibility, including supervisory actions and potential supervisory actions, except in unusual circumstances when supervisory considerations dictate otherwise.**

23. The primary supervisor should be forthcoming in communicating with other relevant supervisors information that could assist them in their supervisory activities. That information might include the nature and scope of: (1) control functions relevant to the supervisor's regulated entity falling outside its jurisdiction, (2) business activities and control functions in areas where risk appears to be growing rapidly, (3) problems identified in the organisational structure, control environment, or business practices that might be present elsewhere, and (4) planned supervisory activity with respect to relevant parts of the conglomerate. The primary supervisor should also, where possible, communicate with other relevant supervisors where supervisory actions are being undertaken which could have a significant impact on entities for which such supervisors have responsibility.

24. However, it is recognised that in an emerging or full-fledged crisis there can be tension between a primary supervisor's desire to share prudential information with other supervisors and concerns about maintaining the stability of the entity for which it has supervisory responsibility and of the conglomerate as a whole. Concerns might arise that other supervisors may take or be required to take measures that could be counterproductive to the primary supervisor's efforts to resolve the situation. Increasing exchanges between the primary and other supervisors and enhanced mutual understanding should encourage greater openness and reduce the primary supervisor's hesitations in keeping other supervisors informed in such situations.

- 5. Supervisors should purposefully take measures to establish and maintain contact with other supervisors and to establish a climate of cooperation and trust amongst themselves.**

25. The meaningful application of the preceding principles requires a foundation of strong, cooperative relationships among supervisors. To that end, it is important that contacts between supervisors be established to create the climate of cooperation and trust that is essential for channels of communication to function well on an ongoing basis.

26. A strong level of cooperation and trust needs to be supported through ongoing contact between supervisors. Face to face meetings to establish personal contact can be very useful in

establishing trust and enhancing communication. Discussion by supervisors of general matters such as supervisory approaches or industry developments and of more specific subjects as warranted improves mutual understanding between supervisors and builds trust. Supervisors should strive for a good mutual understanding of each others' objectives and approaches. The use of the Supervisory Questionnaire is a good way for supervisors to enhance their understanding of supervisory objectives and approaches.

27. Key elements to building trust are supervisors' participation in regional and international meetings and the development of bilateral and multilateral relationships between supervisors. Memoranda of Understanding between supervisors or other appropriate arrangements can contribute to enhancing supervisors' willingness to share information. Supervisors responsible for the oversight of entities in internationally active financial conglomerates should incorporate into existing information sharing arrangements a process for identifying among themselves relevant supervisory personnel involved.

### Ten Key Principles on Information Sharing

Set out below are the Ten Key Principles on Information Sharing issued by the G-7 Finance Ministers in May 1998. The principles were published in a report of the Ministers entitled *Financial Stability - Supervision of Global Financial Institutions*.

1. **Authorisation to share and gather information:** Each Supervisor<sup>3</sup> should have general statutory authority to share its own supervisory information with foreign supervisors, in response to requests, or when the supervisor itself believes it would be beneficial to do so. The decision about whether to exchange information should be taken by the Provider<sup>4</sup>, who should not have to seek permission from anyone else. A provider should also possess adequate powers (with appropriate safeguards) to gather information sought by a Requestor<sup>5</sup>.

*Lack of sufficient authority can impede information sharing. Without a power to gather information for other supervisors, a Provider may be limited to providing only information it already holds, or it can obtain from public files.*

2. **Cross-sector information sharing:** Supervisors from different sectors of financial services should be able to share supervisory related information with each other both internationally (e.g., a securities supervisor in one jurisdiction and a banking supervisor in another) and domestically.
3. **Information about systems and controls:** Supervisors should cooperate in identifying and monitoring the use of management and information systems, and controls, by internationally active firms.
4. **Information about individuals:** Supervisors should have the authority to share objective information of supervisory interest about individuals such as owners, shareholders, directors, managers or employees of supervised firms.

*Supervisors should be able to share objective information about individuals as they can about firms and other entities.*

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<sup>3</sup> “**Supervisor**” means the entity or entities with statutory, supervisory or regulatory powers over financial firms and/markets within their jurisdiction.

<sup>4</sup> “**Provider**” means the Supervisor to which a request for information has been made.

<sup>5</sup> “**Requestor**” means the Supervisor that has asked for information.

- 5. Information sharing between exchanges:** Exchanges in one jurisdiction should be able to share supervisory information with exchanges in other jurisdictions, including information about the positions of their members.

*Exchanges have a supervisory function in many jurisdictions. Where they do, they need to be able to share supervisory information to form a view on the potential impact of market events, on its members, and on the customers, counterparties, and financial instruments affected by it.*

- 6. Confidentiality:** A Provider should be expected to provide information to a Requestor that is able to maintain its confidentiality. The Requestor should be free to use such information for supervisory purposes across the range of its duties, subject to minimum confidentiality standards<sup>6</sup>.

*While most Providers, quite properly, require a Requestor to maintain the confidentiality of information, as a condition of providing it, they should not seek to limit its use, by the Requestor, in carrying out its supervisory duties, including use in connection with (depending on legal arrangements in the country) administrative, civil or criminal cases where the Requestor, or another public authority, is a party to an action which arise from the exercise of those duties.*

- 7. Formal agreements and written requests:** The Requestor should not have to enter into a strict formal agreement in order to obtain information from a Provider. Nor should a written request be a prerequisite to the sharing of information, particularly in an emergency.

*Information sharing arrangements, such as Memoranda of Understanding are often used to establish a framework among supervisors and can facilitate the efficient execution of requests. But the existence of such an agreement should not be a prerequisite for information sharing. Written requests can also be useful at times to provide an efficient and effective way of dealing with information requests, but, again, their absence should not be used to justify delaying a response.*

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<sup>6</sup> A Requestor should keep confidential non-public information that it receives from a Provider. This means that non-public information will not be disclosed, except in connection with supervisory purposes specified by the Requestor, or when asked for by the legislative body in the Requestor's jurisdiction – which may itself be subject to confidentiality rules – where that body could otherwise compel disclosure, or when required to produce documents or testimony by a court in a proceeding in which the Requestor or its government is a party. In any event, a Requestor will provide no less protection to non-public information received from a Provider than it affords its non-public domestic information. In cases involving requests by the legislative body or the courts the Provider should be notified of the outward disclosure, where possible. In all other cases – except in an emergency – the Requestor requires the permission of the Provider to disclose information.

- 8. Reciprocity requirements:** These, too, should not be a strict precondition for the exchange of information, but the principle of reciprocity may be a consideration.

*As with formal agreements, reciprocity can often be a way of encouraging and facilitating information exchange but the lack of reciprocity in a particular case should not be used by a provider as the only reason for not exchanging information that it would otherwise have been willing to share, especially in emergency cases.*

- 9. Cases which further supervisory purposes:** In order to ensure the integrity of firms and markets, the Provider should permit the Requestor to pass on information for supervisory or law enforcement purposes to other supervisory and law enforcement agencies in its jurisdiction that are charged with enforcing relevant laws, in cases which further supervisory purposes.

*The criminal, civil and administrative components of a jurisdiction's securities, banking and insurance laws are sometimes enforced by a number of agencies. Restrictions should not be so onerous that they can prevent the effective sharing of information. For example, exchange of information between supervisors, in cases which further supervisory purposes, should not be subject to the constraint that it cannot be passed to criminal authorities, though this should not be used to circumvent established channels of cooperation.*

- 10. Removal of laws preventing supervisory information exchange:** to facilitate cooperation between the supervisors of internationally-active groups, each jurisdiction should take steps to remove or modify those laws and procedures that prevent or impede the exchange of necessary supervisory information.

*Laws and procedures can impede information sharing unless there are suitable gateways which allow jurisdictions to share information for supervisory-related purposes.*

Coordinator  
paper

## Coordinator paper

### *Objective*

1. Given the goal of improving cooperation through information-sharing, the objective is to provide to supervisors guidance for the possible identification of a coordinator or coordinators and a catalogue of elements of coordination from which supervisors can select the role and responsibilities of a coordinator or coordinators in emergency and non-emergency situations.

### *Background*

2. As financial conglomerates are comprised of legal entities subject to the oversight of two or more supervisors, there is a greater need for supervisors to cooperate on a cross-border and cross-sector basis. Communication and information-sharing are the *sine qua non* of cooperation. This paper sets out principles for that cooperation and communication between and among supervisors with respect to, primarily, internationally active financial conglomerates.

3. In this context, it may be beneficial to designate one of the supervisors involved (the "coordinator") to facilitate information-sharing efforts in a timely and efficient manner. In many cases, the coordinator will be the supervisor that carries out consolidated supervision or which is responsible for the largest part of the conglomerate.

4. Among the factors that come into play in determining whether to appoint a coordinator and, if so, in defining the role and responsibilities of the coordinator are the legal framework, statutory authorities of individual supervisors and accountabilities to legislative and other bodies, the capabilities and resources of individual supervisors, the supervisory techniques and remedial actions employed by supervisors, the ability of supervisors to share information cross-sectorally and cross-border, the business activities, risk profile and structure of the conglomerates, and the availability of information from the conglomerate to individual supervisors. The differences in such factors preclude the elaboration of a single role and a single set of responsibilities for the coordinator. Rather those differences argue for developing a catalogue of elements of coordination that supervisors could turn to in defining the role and responsibilities for the coordinator, depending on the circumstances.

5. This catalogue would include different forms of information-sharing. Supervisors could make use of this catalogue to define the role of the coordinator in emergency and non-

emergency circumstances. Examples of possible roles that could be developed from the catalogue would include coordinating the exchange of information in emergencies, making group-wide assessments in emergency and non-emergency circumstances, and coordinating supervisory activities among the directly concerned supervisors. In certain circumstances, it may be appropriate not to appoint a coordinator. (For the purposes of this paper, an emergency would include, among other things, any event, regardless of geographic origination, that would likely have a material adverse effect on the solvency or liquidity of financial conglomerates).

### ***Factors affecting the choice of options***

6. Objectives and approaches, often determined by responsibilities and authorities under national law, vary among the various supervisors involved in the oversight of regulated entities which are part of financial conglomerates. These divergences in objectives and approaches have implications as to informational and other needs of the different supervisors and will affect whether a coordinator is necessary for a particular group, the choice of a coordinator and the role and responsibilities that coordinator may have. For example, in a situation where a regulated entity in a group is subject to significant structural or supervisory firewalls that insulate the entity from the affairs of other entities in the group and is not a material entity in that group, the informational and other needs of that entity's supervisor with respect to other entities may be less than or different from those of another more significant regulated entity that is more closely integrated into the operations of other entities in the group.

7. Differences in the organisational structure of groups also have implications as to informational and other needs of the various supervisors involved. For example, in a group whose legal, business line and managerial structures diverge significantly, the supervisors of the various entities may be more interested in information about related entities and about the location and functioning of relevant controls than supervisors of entities in a more traditional group whose business activities, management and controls are organised more along the lines of the legal entities. Likewise where a group is headed by a regulated entity and that entity is subject to consolidated supervision, the needs of a subsidiary's supervisor for information about significant parts of the whole group may be different from needs of the supervisor of a subsidiary in another group that is headed by an unregulated holding company and whose regulated entities are subjected to solo supervision only. Accordingly, the role and responsibilities of the coordinator will likely be different in each case.

8. The choice of roles and responsibilities of a coordinator will also be influenced by the need to balance the benefits of improved coordination against the risks of creating (or appearing to

create) a new level of supervisory oversight or an extension of a governmental safety net to additional entities, regulated and unregulated, within a conglomerate. Adding (or appearing to add) a layer of oversight or extending (or appearing to extend) a safety net can undermine market discipline, increase regulatory burden or increase moral hazard. In some jurisdictions, the desire to avoid these risks will be stronger than in others and will tend to result in a different role for the coordinator.

9. Recognition must also be given to the practical constraints facing a coordinator and these issues must be resolved before a coordinator is appointed and its role defined.. For example, the choice of a coordinator and the definition of its role will be influenced by the capabilities and the extent of resources of the supervisors involved. In addition, there is a limit to the number of supervisors with which the coordinator can be in effective contact. Judgements will also need to be made on the scope and nature of the information to be shared. While flows of information from various supervisors to the coordinator should be relatively unimpeded, there may be circumstances which affect the timing and comprehensiveness of information the coordinator shares with other supervisors, e.g. a delay may be necessary when a solution to a serious problem is in the sensitive stages of negotiation or when informing supervisors needs to be coordinated with the conglomerate's public disclosure obligations. Similarly, in an emergency, any proposed arrangements established for a coordinator cannot in any way interfere with the actions that need to be taken by relevant authorities to address the emergency. Therefore, any arrangements would necessarily have to be flexible to allow for adjustments to given circumstances.

### *Guiding principles*

10. The following principles provide guidance to supervisors of regulated entities in financial conglomerates in deciding on the need for and identification of a coordinator and on the role and responsibilities of such coordinator so identified.

**1. Arrangements between supervisors relating to the coordination process should provide for certain information to be available in emergency and non-emergency situations.**

11. Solo supervisors should identify the types of information needed for them to fully and efficiently discharge their supervisory responsibilities in respect of regulated entities residing in financial conglomerates. In emergencies, this would assist the information flow necessary for supervisors to assess the impact of the emergency on the entity subject to their oversight and to facilitate regulatory action, if necessary.

**2. The decision to appoint a coordinator and the identification of a coordinator should be at the discretion of the supervisors involved with the conglomerate.**

12. A single coordinator is considered generally preferable to multiple coordinators. However, there may be circumstances where it may be appropriate to share the responsibility for coordination, and more than one coordinator could be identified.

13. In most instances, it would be apparent which supervisor would act as a coordinator. In those cases where it is not apparent, the supervisors involved should decide amongst themselves who would be best suited to act in that capacity. Possible bases have been elaborated to provide some guidance in identifying a coordinator and are attached (Annex 2).

14. Information sharing in emergency situations will normally be easier if a coordinator has been identified previously since it will avoid burdening the resolution efforts by consultations on the identity and role of the coordinator. However, the circumstances of particular emergencies may require different coordinating mechanisms, including a different coordinator than the one previously identified.

**3. Supervisors should have the discretion to agree amongst themselves the role and responsibilities of a coordinator in emergency and non-emergency situations.**

15. Supervisors should establish amongst themselves the role and responsibilities of the coordinator. A catalogue of possible elements of those roles and responsibilities have been set out in Annex 1.

16. The coordinator should be expected to take the initiative in shaping the role of the coordinator and communicate its preferred approach to other relevant supervisors for their reaction.

**4. Arrangements for information flows between the coordinator and other supervisors and for any other form of coordination in emergency and non-emergency situations should be clarified in advance where possible.**

17. In order to facilitate the coordinator's activities, it would be beneficial for supervisors to agree to arrangements for providing and receiving information, the nature of information to be provided by supervisors to the coordinator and vice versa and under what circumstances, and for other supervisory coordination in light of the legal and organisational circumstances of

both the conglomerate and the supervisors involved. Such arrangements should specify the tasks to be performed by the coordinator in terms of information gathering from regulated entities, unregulated entities where permitted by law or the conglomerate, from the various supervisors involved or from a combination of those sources. In emergency situations, arrangements made in advance may require modifications to take into account the unique properties of the emergency.

**5. Supervisors' ability to carry out their supervisory responsibilities should not be constrained by reason of a coordinator being identified and a coordinator assuming certain responsibilities.**

18. Solo supervisors are subject to legislative requirements and national accountabilities which may influence the timing and nature of their actions, constrain their ability to act in particular circumstances and dictate specific supervisory responses to events and developments. The identification of a coordinator does not alter these legislative requirements and national accountabilities nor does it relieve solo supervisors of their responsibilities. Coordination arrangements cannot constrain a supervisor's lawful responsibility to take whatever actions are necessary or consult with any other party in resolving financial problems or crises.

**6. The identification of a coordinator and the determination of responsibilities for a coordinator should be predicated on the expectation that those responsibilities would enable supervisors to better carry out the supervision of regulated entities within financial conglomerates.**

19. There may be circumstances where a coordinator's role would be played by the supervisor carrying out consolidated supervision, so that little change would arise from the appointment of a coordinator.

20. There may be circumstances where a coordinator would not provide any added value in terms of efficiency in the supervision of regulated entities within a group. In such circumstances where other means of cooperation are assessed to be adequate by the supervisors involved, there would not be any reason to identify a coordinator.

21. Each component of the coordinator's role should be subjected to periodic critical review by the relevant supervisors to ensure that the component adds value in terms of enhanced supervision of regulated entities within a group. As the financial conglomerate's structure and activities change and as the legal and supervisory structure evolves, the need for and the role and responsibilities of the coordinator should be re-assessed.

**7. The identification and assumption of responsibilities by a coordinator should not create a perception that responsibility has shifted to the coordinator.**

22. It is recognised that the identification of a coordinator and the agreement between supervisors as to its role and responsibilities does not remove from the various supervisors involved their obligations under national legislation. Supervisors should avoid communications with the regulated entities or with other entities in the group which could give the impression to the group or to the market that the coordinator has assumed legal responsibility where this is in fact not the case.

*Catalogue of possible elements of coordination*

<b>Information sharing**</b>	<b>Group-wide assessment**</b>	<b>Supervisory activities**</b>
Adverse information is communicated by supervisors to the coordinator.	Availability of information on group-wide structure, financial condition, key group-wide exposures and intra-group exposures is ascertained periodically by coordinator.	Planned supervisory activities by supervisors is communicated to coordinator.
All relevant information is communicated by supervisors to the coordinator.	Key information on group-wide structure, "large" group-wide exposures, intra-group transactions and financial condition is maintained by the coordinator.	Planned supervisory activities by the coordinator and other supervisors are exchanged.
Coordinator stands ready to answer all inquiries from other supervisors.	Key information on group-wide structure etc. is provided to relevant supervisors if they wish to make a group-wide assessment.	Avoidance of overlap in supervisory activities through bilateral discussions of the coordinator and other supervisors.
Coordinator receives information from a variety of sources and provides key information to relevant supervisors if a problems appears to be emerging.	Coordinator makes an assessment of key areas (e.g. large exposures, financial condition and intra-group exposures) and addresses any issues with regulated entities in the conglomerate.	Participation of the coordinator in on-site visits or examinations of an institution's foreign activities where legal and appropriate.
Coordinator receives information from a variety of sources and provides key information to relevant supervisors.	Coordinator makes an assessment of key areas (e.g. large exposures, financial condition and intra-group exposures) and communicates potential problems to relevant supervisors.	Coordination of planned supervisory activities and supervisory actions when a serious problem arises crossing jurisdictional lines.
Coordinator facilitates extensive information flows under certain circumstances, e.g. emergencies.	Coordinator makes group-wide assessment and discusses observations with relevant supervisors.	Coordinated reviews or examinations of a business line crossing several legal entities, or a global risk management or control function.

\*\*Elements in one category are not linked in any way to the elements in other categories.

*Possible bases to assist in identifying a Coordinator*

The following are examples of approaches that supervisors may take in selecting a coordinator.

- Where the conglomerate is headed by a supervised bank, securities firm or insurance company, the supervisor of that parent entity, in normal circumstances, should be the Coordinator.
- Where the conglomerate is headed by a supervised bank, securities firm or insurance company but there is a dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements, an option would be for the supervisor of the dominant entity to be the Coordinator.
- Where the conglomerate is headed by a supervised holding company, the supervisor of the holding company, in normal circumstances, should be the Coordinator.
- Where the conglomerate is headed by a supervised holding company but there is a dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements, an option would be for the supervisor of the dominant entity to be the Coordinator.
- Where the conglomerate is headed by an unsupervised holding company, an option would be for the supervisor of the dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements, to be the Coordinator.

## Supervisory Questionnaire

## **Supervisory Questionnaire**

### **Introduction**

The Supervisory Questionnaire (the Questionnaire) was developed by the Mapping Task Force to collect information on supervisors' objectives and approaches. The continuing work of the Joint Forum and experience gained in using the Questionnaire may result in changes to enhance its coverage, make it a more useful tool in better understanding supervisors' objectives and practices, and in facilitating arrangements for the exchange of information relating to financial conglomerates. The Matrix included at the end can be used to capture responses to the questions.

The Questionnaire should be completed, to the extent that the conglomerates are involved in each sector, by each of the banking, securities and insurance supervisory agencies in those countries where the conglomerate has a significant presence. This will permit a comprehensive matching of supervisory structures to the conglomerates' business structures and the identification of areas where specific attention or measures are needed.

### **I. STATED PURPOSE AND OBJECTIVES OF SUPERVISION**

### **II. LEGAL AUTHORITY**

#### **A. Scope of licensing or registration authority/ability to grant, restricts or revoke license/registration**

1. Factors considered in granting, restricting or revoking license/registration (e.g., capital adequacy, organisational structure, management)
2. Conditions under which authority/ability is used or not used

**B. Changes in financial institution powers/structure**

1. Source of authority by type of institution (e.g., bank, securities and insurance institutions, affiliates of regulated entities)
2. Necessity of obtaining supervisor's approval for new activities
3. Necessity of obtaining supervisor's approval to invest in subsidiaries or associated companies
4. Necessity of obtaining supervisor's approval for change of ownership/control

**C. Authority to compel reports/information from institutions, from external auditors, from third parties**

1. Type of entity/source
2. Scope, including affiliates of the regulated entity

**D. Authority to share information**

1. Other supervisors or regulators
  - a. Banking, securities and insurance supervisors
  - b. Domestic vs. foreign
2. Law enforcement
3. Monetary authorities
4. Other third parties
5. Obligations of professional secrecy

**E. Authority to make on-site visits**

1. Type of entity
2. Scope of review
3. Frequency requirements
4. Affiliates of regulated entity

**F. Statutory/regulatory authority to take enforcement or remedial action**

1. Publicly disclosed
2. Undisclosed/non-public

3. Authority to enforce other regulators/supervisors laws
4. Authority of supervisor to stop activities of financial institution
5. Responsibility to refer matters to other regulators
6. Conditions under which authority is used or not used

**G. Obligation/authority to promulgate prudential standards**

**H. Obligation/authority to promulgate financial integrity standards**

**III. METHODS OF ASSESSING FINANCIAL CONDITION**

**A. Monitoring/Surveillance**

1. Routine reporting to supervisor
  - (a) Reporting institutions (e.g. regulated entity only or consolidated reporting)
  - (b) Coverage of reports (e.g., financial statements, intercompany funding)
  - (c) Frequency of reports
  - (d) Public availability of routine reporting
2. Types of monitoring/surveillance reports produced
  - (a) Institutions covered by monitoring/surveillance and method of selection (e.g., regulated entity alone or including affiliates of regulated entity)
  - (b) Types of analysis used to analyse reporting information (e.g., ratio analysis, predictive models)
  - (c) Frequency of monitoring/surveillance reports
  - (d) Types of follow up (e.g., meeting with management, targeted inspections)
  - (e) Access to monitoring/surveillance reports and analyses (e.g., public report, confidential report)
3. Non-routine reporting to supervisor

**B. On-site inspections**

1. Basic information
  - (a) Types of financial institutions covered (and not covered) by on-site inspections and method of selection (e.g., bank, securities and insurance institutions, affiliates of regulated entity)

- (b) Frequency of on-site inspections of institutions (and individual domestic and foreign entities)
- (c) Qualifications of personnel conducting on-site inspections (e.g., commissioned examiners, auditors, market specialists, self-regulatory organisations)
- (d) Aspects of condition and compliance reviewed during on-site inspections (e.g., capital, earnings, risk management, intercompany transactions)
- (e) Scope of work on risk management (e.g., credit risk, market risk, liquidity risk, settlement risk, underwriting, claims and reserving risks, asset risk, operational risk, support functions risk, compliance with laws and regulations, internal audit)
- (f) Process and procedures used to evaluate components of inspections (e.g., meetings with management, interviews with line personnel, transaction testing, review of risk management and valuation models)

2. Product of on-site inspections

- (a) Type of reports (e.g., letter to management, full report for board of directors)
- (b) Access to reports (e.g., public report, confidential report)

**C. External auditors/self-regulatory organisations ("SROs")**

- 1. Supervisor's ability to establish scope of the audit or review
- 2. Statutory obligation of auditor/SRO to supervisor
- 3. Access to reports
  - (a) Supervisors
  - (b) Others

**IV. TOOLS OF SUPERVISION**

**A. Prudential regulations (e.g., lending limits, capital adequacy) and scope of application (e.g., regulated entity alone or consolidated entity)**

**B. Supervisory guidance (e.g., risk management guidelines, sales practices guidelines, inspection manuals)**

**V. OTHER MECHANISMS TO ENHANCE SOUND PRACTICES (supervisor encouraged or purely private mechanisms)**

- A. Codes of conduct**
- B. Industry advisory groups**
- C. Other**

**VI. INFORMATION FLOWS AMONG SUPERVISORS**

**A. On-going, regular flow of information among supervisors**

1. Banking, securities and insurance supervisors
2. Domestic and foreign supervisors
3. Types of information
4. Frequency of information flows

**B. Flow of information under non-normal conditions**

1. Banking, securities and insurance supervisors
2. Domestic and foreign supervisors
3. Types of information
4. Frequency of information flows

**Matrix Record**

**I. STATED PURPOSE AND OBJECTIVES OF SUPERVISION**

	Supervisor One	Supervisor Two	Supervisor Three

**II. LEGAL AUTHORITY**

	Supervisor One	Supervisor Two	Supervisor Three
<b>A. SCOPE OF LICENSING OR REGISTRATION AUTHORITY</b>			
1. <i>FACTORS CONSIDERED IN GRANTING, RESTRICTING OR REVOKING LICENSE OR REGISTRATION</i>			
2. <i>CONDITIONS UNDER WHICH AUTHORITY OR ABILITY IS USED OR NOT USED</i>			
<b>B. CHANGES IN FINANCIAL INSTITUTION POWERS/STRUCTURE</b>			

1. <i>SOURCE OF AUTHORITY BY TYPE OF INSTITUTION</i>			
2. <i>NECESSITY OF OBTAINING APPROVAL FOR NEW ACTIVITIES</i>			
3. <i>NECESSITY OF OBTAINING APPROVAL TO INVEST IN SUBSIDIARIES, etc...</i>			
4. <i>NECESSITY OF OBTAINING APPROVAL FOR CHANGE OF OWNERSHIP/CONTROL</i>			
<b>C. AUTHORITY TO COMPEL REPORTS/INFORMATION FROM INSTITUTIONS, ETC...</b>			
1. <i>TYPE OF ENTITY/SOURCE</i>			
2. <i>SCOPE, INCLUDING AFFILIATES</i>			
<b>D. AUTHORITY TO SHARE INFORMATION</b>			
1. <i>OTHER SUPERVISORS</i>			
a. Banking, Securities and Insurance Supervisors			
b. Domestic and Foreign			
2. <i>LAW ENFORCEMENT</i>			
3. <i>MONETARY AUTHORITIES</i>			

4. <i>OTHER THIRD PARTIES</i>			
5. <i>OBLIGATIONS OF PROFESSIONAL SECRECY</i>			
6. <i>OTHER CONDITIONS EG RECIPROCITY</i>			
<b>E. AUTHORITY TO MAKE ON-SITE VISITS</b>			
1. <i>TYPE OF ENTITY</i>			
2. <i>SCOPE OF REVIEW</i>			
3. <i>FREQUENCY REQUIREMENTS</i>			
4. <i>AFFILIATES OF ENTITY</i>			
<b>F. AUTHORITY TO TAKE ENFORCEMENT OR REMEDIAL ACTION</b>			
1. <i>PUBLICLY DISCLOSED</i>			
2. <i>UNDISCLOSED/NON-PUBLIC</i>			
3. <i>AUTHORITY TO ENFORCE OTHER LAWS</i>			
4. <i>AUTHORITY TO STOP ACTIVITIES</i>			
5. <i>RESPONSIBILITY TO REFER MATTERS TO OTHERS</i>			

6. <i>CONDITIONS UNDER WHICH AUTHORITY IS USED OR NOT USED</i>			
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<b>G. OBLIGATION/AUTHORITY TO PROMULGATE PRUDENTIAL STANDARDS</b>			
<b>H. OBLIGATION/AUTHORITY TO PROMULGATE FINANCIAL INTEGRITY STANDARDS</b>			

**III. METHODS OF ASSESSING FINANCIAL CONDITION**

	<b>Supervisor One</b>	<b>Supervisor Two</b>	<b>Supervisor Three</b>
<b>A. MONITORING/SURVEILLANCE</b>			
<i>1. ROUTINE REPORTING</i>			
a. Reporting Institutions			
b. Coverage of Reports			
c. Frequency of Reports			
d. Public Availability			

e. Changes Expected in the Future (discuss any changes in reporting requirements contemplated in the near- term)			
2. <i>TYPES OF MONITORING/ SURVEILLANCE REPORTS</i>			
a. Institutions Covered and Method of Selection			
b. Types of Analysis Used to Analyze Information			
c. Frequency of Monitoring/ Surveillance Reports			
d. Types of Follow-Up			
e. Access to Monitoring/ Surveillance Reports			
f. Expected or Planned Changes in Surveillance/Monitoring Systems			
3. <i>NON-ROUTINE REPORTING</i>			
<b>B. ON-SITE INSPECTIONS</b>			
1. <i>BASIC INFORMATION</i>			
a. Types of Institutions Covered by On-site Inspections and Method of Selection			

b. Frequency of On-site Inspections			
c. Qualifications of Personnel			
d. Aspects of Condition and Compliance Reviewed During On-site Inspection			
e. Scope of Work on Risk Management			
f. Process and Procedures to Evaluate Components of Inspections			
g. Changes Planned or Expected in On-site Inspections (discuss changes in scope, frequency, specific work on internal controls and risk management)			
2. <i>PRODUCT OF ON-SITE INSPECTIONS</i>			
a. Type of Reports			
b. Access to Reports			
<b>C. EXTERNAL AUDITORS/INDEPENDENT ACTUARIES/SROs</b>			
1. <i>SUPERVISOR'S ABILITY TO ESTABLISH SCOPE OF AUDIT/REVIEW</i>			

2. <i>STATUTORY OBLIGATION OF AUDITOR/ACTUARY/SRO TO SUPERVISOR</i>			
3. <i>ACCESS TO REPORTS</i>			
a. Supervisors			
b. Others			

**IV. TOOLS OF SUPERVISION**

	Supervisor One	Supervisor Two	Supervisor Three
<b>A. PRUDENTIAL REGULATIONS AND SCOPE OF APPLICATION</b>			
<b>B. SUPERVISORY GUIDANCE</b>			

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**V. OTHER MECHANISMS TO ENHANCE SOUND PRACTICES**

	Supervisor One	Supervisor Two	Supervisor Three
<b>A. CODES OF CONDUCT</b>			
<b>B. INDUSTRY ADVISORY GROUPS</b>			

<b>C. OTHER</b>			

**VI. INFORMATION FLOWS AMONG SUPERVISORS**

	<b>Supervisor One</b>	<b>Supervisor Two</b>	<b>Supervisor Three</b>
<b>A. ON-GOING, REGULAR FLOWS</b>			
<i>1. BANKING, SECURITIES AND INSURANCE SUPERVISORS</i>			
<i>2. DOMESTIC AND FOREIGN SUPERVISORS</i>			

3. <i>TYPES OF INFORMATION</i>			
4. <i>FREQUENCY OF FLOWS</i>			
<b>B. FLOWS UNDER NON-NORMAL CONDITIONS</b>			
1. <i>BANKING, SECURITIES AND INSURANCE SUPERVISORS</i>			
2. <i>DOMESTIC AND FOREIGN SUPERVISORS</i>			
3. <i>TYPES OF INFORMATION</i>			
4. <i>FREQUENCY OF FLOWS</i>			