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

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

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

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

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

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

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

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

The following example demonstrates the practical implications of assessing capital adequacy when the parent only has a minority interest in a lower tier company and that company has a capital deficiency. Generally you will include the entire capital deficiency of a subsidiary if the conglomerate maintains a majority interest, you also need to consider minority interests between 20 and 50 percent if there are factors present that would create a controlling interest. In this example, it is assumed that although the ownership interest is 40 percent, the conglomerate holds the majority of the board seats which would give it effective control of the insurance company. In this instance, a parent holding company holds a $150 investment in a 40 percent owned insurance company that is accounted for using the equity method.[1] Since the parent's ownership interest is less than 50 percent, the equity method of accounting is applicable. The insurance company has a total capital base of $375 comprised of the 60 percent third-party majority interest of $225 and the holding company's $150 minority investment.

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

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

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

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

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

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

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

In general, the following guidelines will apply:

- If the group does not maintain control of a subsidiary, normally less than a 20 percent interest, and does not maintain any significant influence through board membership or other avenues, then the parent's investment should be treated in accordance with the applicable regulatory capital rules for that entity. In those instances where capital rules are silent or the subsidiary is unregulated, generally accepted accounting principles (GAAP) should prevail.
- If the ownership interest in a subsidiary gives the group shared control, only the pro rata share of surplus capital should be considered as available to the parent. Typically, pro rata treatment will be applied to ownership interests between 20 and 50 percent. However, careful assessment of the ownership structure is required. In cases where shared control is less than 50 percent, in particular if voting control is under 20 percent or the parent does not exercise any significant control or influence over the subsidiary, the parent's investment should be treated in accordance with the applicable regulatory capital rules for that entity. In those instances where regulatory rules are silent or the subsidiary is unregulated, GAAP should prevail.

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

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

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

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

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

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

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