INTRODUCTION

Section 10(l) of the Home Owners' Loan Act (HOLA), permits a state savings bank (or a cooperative bank) to elect to be treated as a savings association for purposes of regulating its holding company. The only requirement that a state savings bank or cooperative bank must satisfy in order to make this election is that it must be a qualified thrift lender.[1] By making such an election, the holding company is regulated by OTS as a savings and loan holding company for purposes of Section 10 of HOLA, rather than as a bank holding company.

Insured subsidiary state savings banks are primarily regulated by the FDIC and the state. However, being deemed a "savings association" for purposes of Section 10 of HOLA results in not only OTS regulation of the holding company, but also OTS regulation of certain requirements that apply directly to the insured subsidiary institution. For example, Section 10(d) subjects the insured subsidiary institution to transactions with affiliate restrictions (as implemented by OTS at 12 CFR Sections 563.41 and 563.42). In addition, Section 10(f) (as implemented by 12 CFR 563.140, Subpart E) requires the subsidiary insured institution to file advance notices of dividend declarations with the OTS.

OTS will need to coordinate with both the chartering authority(state) and insurer(FDIC).

OTS PHILOSPHY IN REGULATING 10(l) HOLDING COMPANIES

Although it is clear that OTS has the authority to examine 10(l) holding companies, this can present a challenge because OTS does not directly supervise the insured subsidiary institution. Our holding company examination approach is designed to assess the holding company enterprise's effect on the insured institution. This examination process may initially seem awkward, but has proven effective when closely coordinated with the FDIC and State examination of the subsidiary savings bank. By comparison, the Federal Reserve Banks also examine bank holding companies that own national banks, state nonmember banks, or savings associations that they do not regulate directly.

In order to accomplish the examination objectives, you will have to work closely with the depository institution regulators to assess the effect of the holding company's operations on the insured subsidiary institution. It is generally best to conduct the holding company examination in conjunction with the examination of the insured subsidiary institution. Whether you conduct the examination concurrently or not, you must establish and maintain open communication channels with the other regulators. The importance of such communication, from scheduling to examination findings, will be made clear in this Section.

SCHEDULING AND SCOPING THE 10(l) EXAMINATION

Because our databases do not contain information on the insured subsidiary institution, the default holding company examination due date is based on an annual cycle. This due date should serve as only a general guide and reminder to coordinate the scheduling and scope of the holding company examination with the examination of the insured subsidiary institution.

In setting the scope, you should contact the insured subsidiary institution's regulators and inquire whether they have any special concerns with the holding company relationship. You should address any such concerns in the course of your examination of the holding company. As a means to familiarize yourself with the subsidiary insured institution, you should also:

[1] A company that controls a state savings bank or cooperative bank seeking to take the 10(l) election that is not already a registered savings and loan holding company must also file an H-(e) Acquisition Application and receive OTS approval to become a savings and loan holding company. As part of that application process, the OTS reviews the financial and managerial resources, as well as the future prospects, of the proposed holding company and the insured subsidiary institution.

- Obtain and review the latest examination reports of the subsidiary.
- Review financial information available on the FDIC website.
- Obtain financial statements and monitoring reports used by holding company management to oversee their investment in the insured subsidiary institution.

As you review the books and records of the holding company, you should not only review the areas of concern specifically noted by the regulators, but also watch for red flags that would raise concerns if the subsidiary were directly regulated by OTS. This includes high risk activities engaged in by the holding company or other affiliates that could adversely affect the insured institution. You should bring all concerns that may affect the insured subsidiary institution to the attention of the state and federal regulators.

As with any other holding company examination, you should start with the Administrative Program Section 710 to identify the holding company's risk classification. You then use the Abbreviated Holding Company Examination Program Section 720 for low risk holding company enterprises (Category I), recognizing that you may need to consult the CORE Holding Company Examination Program Section 730 to address specific areas of risk. You should use the CORE Holding Company Examination Program Section 730 for all higher risk or complex holding companies (Category II).

You should review all four of the CORE technical areas of a holding company examination: Capital, Organizational Structure, Relationship and Earnings.

Capital

As discussed in Section 300, OTS does not uniformly impose either consolidated or unconsolidated numerical regulatory capital requirements on holding companies. An institution may view this as a benefit of OTS regulation, and, therefore, may elect 10(l) status to avoid standardized application of a numerical capital requirement on its holding company.

OTS expects all thrift holding companies to have a prudent level of capital based on their risk profile. This holds true for 10(l) holding companies. You should evaluate the 10(l) holding company's capital position to determine its effect on the insured subsidiary institution. As part of that analysis, you should determine whether or not the 10(l) holding company's capital position has deteriorated since the last examination, and whether or not significant asset/liability restructuring, acquisitions, or divestitures have occurred that may negatively affect the financial or managerial relationship between the institution and the holding company.

As also noted in Section 300, capital provides a secondary source of financial protection for the holding company if earnings and cash flow prove insufficient. During the examination, you should fully evaluate the capital of the holding company; especially for companies that are experiencing cash flow problems, or weak earnings capacity, or rely on the institution for working capital since this may result in the institution being pressured to upstream funds. A 10(l) holding company that has capital does not necessarily have sufficient cash flow to meet contractual obligations when they are due.

In the report of examination, you should discuss dividends and stock repurchases that occurred during the review period, as well as those that are planned. Further, you need to state to what extent, if at all, the holding company is reliant on insured institution funds to support the parent's dividend payments or stock repurchases.

You also need to closely analyze the level of debt at the holding company. You should investigate how the holding company has historically serviced its debt, and what factors caused the holding company to increase its debt level. Does it assume additional debt to provide for the payment of dividends? Does it rely on the insured subsidiary institution to upstream funds? You should contact the depository institution's regulators concerning significant levels or increases in

debt at the holding company level that may negatively affect the insured subsidiary institution.

You must also evaluate whether double leveraging is occurring and what risks it may pose. Double leverage exists when funds obtained by the holding company from debt proceeds are invested into the institution subsidiary as equity. Increasing the capital base of the institution allows it to increase its borrowings/leverage as well, thereby compounding the original holding company debt and resulting in higher consolidated debt/ leverage. In this situation, the institution's earnings must be sufficient to service both levels of debt and typically the parent will rely upon dividends from the insured subsidiary institution to provide the funding for its debt service requirements. If the institution is unable to maintain earnings to support future dividend payments, the holding company will be unable to pay its debt obligations as well. In this regard, it is important to assess the financial strength of the insured subsidiary institution, as well as the holding company, to ensure that debt requirements can be met.

Organizational Structure

In this Section, you will focus on the structure and activities of the holding company. You will also look at the issue of control of the holding company in order to determine if there have been changes in the ownership structure and what regulatory processes apply. Then you need to analyze the various activities in which a holding company may be involved. As discussed thoroughly in Section 400, there is a correlation between how a holding company is structured and the kind of activities in which it may engage.

Many of the 10(l) holding companies that we regulate are holding companies of federal savings associations that converted to state savings banks. These entities were familiar with OTS holding company regulation, or otherwise perceive advantages to being treated as a savings and loan holding company, and, thus, elected 10(l) status.

Some holding companies may elect 10(l) status after such a conversion as a means to be able to engage in broader activities. Such holding companies may qualify as exempt if they continue to control a savings association that they controlled on May 4, 1999, and that institution is a qualified thrift lender (QTL). Further, an insured institution must be a qualified thrift lender to elect and maintain 10(l) status. Accordingly, you must verify the institution's QTL status at each examination.

Once the holding company structure and activities are determined, the review will then focus on what risks, if any, exist that may affect the insured subsidiary institution. However, consistent with the current regulatory approach, this assessment should not be limited to current risks that may be evident, but also to prospective risks. You need to determine whether there are elements regarding the structure or business interests that hold potential risks for the institution.

Relationship

This Section addresses the effectiveness of the holding company's board and executive management, as well as issues associated with the interdependence of the insured subsidiary institution. You should analyze the degree of influence the holding company has over the institution and how this influence affects the institution's operations.

Specifically, identify the principal decision makers of the holding company. Are these individuals also directly involved in managing the affairs of the insured institution? Does the holding company have policies and procedures in place to ensure that the insured institution has a separate corporate identity, and conflicts of interest are avoided? Does the board of directors provide adequate oversight of the affairs of the holding company and its subsidiaries? How actively involved is the holding company in the management of the institution? Does the organizational structure of the holding company foster interdependency risk that could hurt the institution if the holding company becomes financially distressed? You should communicate any significant concerns about the management of the

holding company, especially potential conflicts of interest, to the insured subsidiary's regulators.

Assess the risks posed by integrated systems, common risk management practices, central decision making, joint marketing and delivery systems, linked market reputation, size of the institution in relation to the holding company, and common controls.

Moreover, it is important that the principles of an arm's length transaction be applied to all transactions between the insured institution and its affiliates. This approach provides protection for all the interests involved. In addition, payments should be made within a reasonable time of the rendering of the services. During the examination, you must determine that present practices are consistent with internal policy. Once you establish that the fee structure is reasonable and consistently followed, then determine if the insured subsidiary institution is actually receiving the services for which it is charged. This can usually be ascertained by discussing the services with the EIC of the insured subsidiary institution.

The affiliate transaction regulations apply to the insured subsidiary institution. Therefore, the insured subsidiary's regulators will in all likelihood review this area.[2] Nevertheless, while you are conducting your examination of the holding company, possible transaction with affiliate issues may arise. Keep in mind that all covered transactions of the insured subsidiary institution must comply with the affiliate regulations contained in Federal Reserve Act Sections 23A and 23B and the additional prohibitions contained in section 11(a)(1) of the HOLA.[3]

Covered transactions with a single affiliate, may not exceed 10 percent of a bank's capital and surplus, and transactions with all affiliates may not exceed 20 percent of the bank's capital and surplus. In addition, all transactions must be conducted on market terms. To ensure that the insured institution appropriately reports all transactions, you should advise the other regulators of any transactions that you identify in your review of the books and records of the holding company and other affiliates. This would also include loans or other extensions of credit to insiders of the holding company subject to Regulation O.

In general, you should help facilitate the other regulators' review of this area and verify aspects of affiliate transaction as they are recorded on the holding company's books and records. Furthermore, you should review transactions between affiliates that are outside the scope of the affiliate regulations but, nonetheless, may indirectly impact the subsidiary institution. For example, an unsecured loan made by the holding company to another affiliate or insider. While these transactions are not covered by the affiliate regulations, they do have the potential to deplete the holding company's financial resources and indirectly affect the subsidiary institution.

As you review the relationship of a 10(l) holding company with its insured subsidiary institution, you must remind yourself that although OTS is only the primary regulator for the holding company, you cannot ignore the insured subsidiary institution. As reiterated throughout this Handbook, the OTS approach to regulating holding companies considers both the financial condition and operations of the holding company and the impact of the holding company on the insured institution.

You may encounter transactions or restructurings within the enterprise that do not appear, independently, to be in the best interest of the holding company. Keep in mind that situations do occur where it is appropriate for risky assets or risky lines of business to be transferred from the insured institution or a subsidiary of the insured institution to the holding company. While ultimately we may prefer, from a supervisory perspective, that the assets be sold to a third party or the risky activity discontinued altogether,

[2] In addition, OTS may also review these transactions under statutory authority set forth at Section 10(d) of HOLA (as implemented by 12 CFR 563.41 and 563.42).

[3] Section 11(a)(1) of the HOLA prohibits loans to affiliates engaged in nonbank holding company activities. It also prohibits purchases and investments in securities issued by affiliates.

sometimes there may be sound business reasons for these transactions.

Therefore, just because a transaction is not in the best interests of the holding company, or does not improve its consolidated financial condition, does not automatically mean you should criticize it. Some transactions may, in fact, be structured to safeguard the insured institution. Just because OTS is not the primary regulator for the insured institution does not mean that we do not consider its best interests as we would if OTS regulated all entities within the structure.

Earnings

The key areas to review in the Earnings component of the examination are the holding company's cash flow, profitability, and exposure to highly leveraged investments such as futures contracts. Once again, you should advise the insured subsidiary's regulators of any excessive debt or liquidity concerns that may affect the insured subsidiary institution.

Additionally you should review the funds the holding company receives from the institution. This includes dividend payments, fees for services rendered, and payments made under tax sharing arrangements. You should advise the EICs of the other regulators of the funds that the holding company reports that it receives from the insured subsidiary institution. In addition, you should ensure that the insured institution filed the appropriate dividend notifications with the OTS.[4]

COMMUNICATING WITH THE PRIMARY REGULATOR OF THE INSTITUTION

As reiterated throughout this Section, it is important that you coordinate examinations and communicate with the other regulators of the 10(l)'s insured subsidiary institution. Open communication sets the stage for information exchange and serves two vital purposes:

1) It ensures that we have the opportunity to obtain the primary regulator's perspective and supervisory concerns with respect to the insured institution or its relationship with the holding company.

2) It promotes sharing of our supervisory concerns and examination findings and conclusions.

While the examination report is the appropriate vehicle to communicate conclusions to the holding company, it may not necessarily cover everything that you should communicate with the other regulators. Your communication with the insured subsidiary's regulators will usually be done during concurrent holding company and insured subsidiary institution examinations. Communication efforts should begin, however, with the scheduling of the examinations and continue through finalizing your conclusions with regard to the 10(l)'s impact on the insured subsidiary institution.

For ease of reference, the following list summarizes some of the key points you should communicate:

- The timing, scheduling and preliminary scope of the holding company examination. The examination should be scheduled, to the extent possible, concurrently with the examinations of the lead subsidiary institution by the other regulators.
- The adequacy of the holding company's consolidated capital, and any trends or deterioration since the last examination.
- Significant cash flow or liquidity concerns.
- Any significant restructurings, acquisitions, or divestitures that may affect the institution.
- Any dividends or stock repurchases that the holding company depends on institution funds to support or are otherwise significant.
- Significant levels or increases in consolidated debt or double leverage, considering how re-

[4] As a "savings association" controlled by a "savings and loan holding company," the insured institution is subject to Section 10(f) of HOLA (as implemented by 12 CFR 563.140).

liant the holding company is on the insured subsidiary institution to service such debt.

- How the insured subsidiary institution fits within the corporate structure, and how the holding company's goals and objectives or strategic plans may affect the insured subsidiary institution.
- Any activities conducted within the holding company structure that are high risk or could otherwise adversely affect the insured subsidiary institution.
- Any concerns about the management of the holding company, especially potential conflicts of interest.
- Transactions between the holding company or other affiliates and the insured subsidiary institution, as well as transactions between affiliates that may indirectly impact the subsidiary institution. Include funds the holding company receives from the institution (for example, dividends, fees for services rendered, or payments made under tax sharing arrangements).

Upon completion of your review, you will need to consult with the other regulators to enable you to rate the holding company based on its effect on the insured subsidiary institution. You should complete the holding company examination report and outline any areas of concern that you and the other regulators conclude are significant. If corrective action is necessary, you should work closely with the other regulators to formulate a joint strategy. It may be appropriate to address concerns at either the insured subsidiary institution or the holding company, or both simultaneously. Coordinated enforcement actions generally ensure that the full attention of both the holding company and the insured subsidiary institution are devoted to taking the necessary corrective action.

You need to be aware that while OTS examination authority is clear, our ability to conduct formal investigations is limited to violations of Section 10 of HOLA. The other regulators of the insured subsidiary institution should take the lead on enforcement or other corrective action required of the insured subsidiary institution itself or with regard to its relationship with the holding company. OTS should take the lead on enforcement or corrective actions relating to violations of Section 10 of HOLA and concerns at the holding company.

INTRODUCTION

This Section will help you recognize the unique issues presented by a mutual holding company (MHC) structure. An MHC structure is fundamentally different from a traditional savings and loan holding company structure. An MHC structure combines the elements of a mutual thrift, which is owned and controlled by its depositors and, in some cases by its borrowers, with elements of a stock thrift and holding company.

An MHC is the result of a conversion of a mutual institution to become a stock institution. The MHC becomes the corporate repository of the mutual members' economic and legal interests. It must own a controlling interest in the newly created stock institution, but it may sell up to 49.9% of the institution's voting stock, as well as any nonvoting stock, as a means to raise capital. Even when there is no issuance of stock to the public, there is still stock that has been issued to form the structure.

Not all MHC structures will look the same. In all cases, the thrift becomes a stock institution. Some structures will include a mid-tier stock holding company between the stock thrift and the MHC.[1] Other structures will include only the stock thrift that is directly owned by the MHC.

By creating the MHC structure in 1987, Congress provided an alternative to a full conversion from a mutual to stock form.[2] It provides a means for the members to continue to influence and control the operations of the institution, while also providing a means to raise capital. Mutual institutions that traditionally had little choice but to accumulate capital through retained earnings can use the MHC structure to sell minority stock interests.[3] The MHC structure can also be used as a vehicle to engage in activities under the holding company umbrella.

The guidance in this Section will help you assess the risks that the MHC structure poses. You must consider the combined risk profile, financial health and stability of the consolidated enterprise, the influence of minority shareholders and the degree of interdependence between the thrift, a mid-tier stock holding company (if one exists), and the MHC. You should base your examination conclusions on the current and prospective effect the structure has on the subsidiary thrift.

EXAMINATION COMPONENTS

The MHC form of organization may affect your examination steps. In addition to the standard examination procedures used for a stock holding company, you should evaluate the following unique areas of concern presented by an MHC.

Capital

As noted in Section 300, OTS does not have a standardized capital requirement that applies to all holding companies. Instead, capital is evaluated on a case-by-case basis determining the amount of capital necessary to support the risks within the structure.

Dividend Waivers

To allow more capital to remain at the thrift, thereby increasing the capital position of the thrift, an MHC may waive its right to receive a dividend. Needless to say, this has an impact not only on the thrift, but also on the level of capital at the MHC available to support its other activities. Prior notice must be provided to OTS.

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[1] A mid-tier stock holding company exists between the parent MHC and the thrift. The majority of shares in the mid-tier stock holding company must be issued to the MHC, and the mid-tier stock holding company must own 100 percent of the shares of the subsidiary thrift.

[2] An MHC may subsequently decide it wants to pursue a full conversion. This later action also requires OTS approval, and is referred to as a second step conversion.

[3] While mutual institutions may receive pledged deposits and issue mutual capital certificates and subordinated debentures, they rarely use these options.

Dividend waivers must not be detrimental to the safety and soundness of the subsidiary thrift. Dividend waivers also require a board resolution that the waiver by the MHC is consistent with the directors' fiduciary duty to the mutual members.

The waiver of dividends by the MHC allows for any dividend declared by the thrift to be distributed only to the minority shareholders. The potential for a conflict of interest exists when directors and officers are deciding whether or not to waive dividends. If the directors and officers also hold stock, the financial decisions they make may personally benefit them. You should determine if the waiver has unduly enriched the minority shareholders at the expense of the MHC members.

The waiver of dividends may also result in atypical per share results. Earnings per share calculations are made using all outstanding shares, both those held by the MHC and the minority shareholders. On the other hand, dividends per share calculations are typically made using only the number of shares that will receive dividend payments. If the MHC waives its right to a dividend, this will result in a calculation using only the number of outstanding minority shares. For example, assume net income of $20 million, dividends of $9 million on the 4 million shares owned by the minority shareholders, and dividends waived on the 6 million shares owned by the MHC. Earnings per share are $2.00 ($20 million /10 million shares). Dividends per share are $2.25 ($9 million /4 million shares). From these ratios, it might appear that dividends exceeded net income ($2.25 per share vs. $2.00 per share), when in fact dividends were only 45% of net income ($9 million/$20 million).

Organizational Structure

As discussed in Section 400, many thrift holding companies operate without activity restrictions. However, ***all MHCs and their subsidiaries are subject to activity restrictions***.[4] An MHC may engage in the same activities as a stock holding company subject to activity restrictions[5]. The permissible activities for holding companies subject to activity restrictions are outlined in Section 400.

Relationship

A unique aspect of the MHC structure is the ownership of the MHC by the members. This group may exhibit little interest in the activities that occur and may not realize their potential for involvement in the organization. The structure may operate with a small group of individuals exercising exclusive control over the entities within the structure.

Board Responsibilities

The existence of an MHC, and possibly a mid-tier stock holding company, adds complexity to the structure.

The boards of directors of the thrift, mid-tier holding company (if one exists) and MHC may be comprised of the same, or mostly the same members. However, you should ensure that the boards of directors of each entity in the structure operate independently. The boards of each organization have distinct responsibilities. Each entity must maintain a separate corporate identity and interrelationships among the companies should not be detrimental to the institution. MHCs and mid-tier boards may meet less frequently than thrift boards because they are typically shell entities. You should evaluate how effectively each Board operates in executing its duties and responsibilities. The interests of one entity in the structure should not be sacrificed for the benefit of another entity in the structure.

You should review board minutes to determine if adequate discussion and analysis of issues occurs at each level in the structure.

[4] 12 CFR § 1467a(o)(5).

[5] 12 CFR § 575.11.

Minority Shareholders

The addition of minority shareholders into a traditional mutual environment may result in change for the thrift. Minority shareholders, particularly those elected to the board of directors, may bring a fresh perspective from experiences in other organizations or industries. This additional perspective may help the organization to identify new ideas and enhance the thrift's potential for long-term growth. Minority shareholders may also create friction within the organization. A focus on dividends may result in unreasonable demands for increased earnings or dividends that may weaken the capital position of the subsidiary thrift.

Minority shareholders may call for activities that increase shareholder value through the sale or merger of the thrift with another institution. This may result in the board and management focusing on trying to appease shareholders rather than focusing on activities in the long-term best interest of the structure.

An option available to MHC's is a second step conversion. This enables the entity to convert to a stock structure. OTS requires a majority vote of minority shareholders to approve any second step conversion.

Earnings

The Earnings section of this handbook provides a number of useful ratios for analyzing the financial statements of each entity in the MHC structure.

Pure mutual organizations may have the goals of customer service as a priority over profit maximization. The shift to an MHC structure, with the resulting influence of shareholders, may create pressure for increased earnings.

Financial Statement Analysis

Financial statement analysis in an MHC structure will include evaluations of statements of each entity in the structure. Intercompany transactions should be evaluated closely. Your examination should determine that transactions that occur are properly authorized, recorded and reported, and assess the direct or indirect impact on the thrift. Transactions that may appear appropriate when only one entity is reviewed, may appear questionable when both sides of the transaction are reviewed together.

There should be a tax allocation agreement between the MHC, mid-tier and thrift. The allocation should ensure that the thrift does not assume a larger tax burden than it would if it filed independently.

The allocation of revenues and expenses between the savings association, affiliates, and holding companies should be based on a documented method that is systematic, rational, and consistent with sound principles of corporate governance. In the absence of an appropriate allocation, reported earnings could be significantly different from that which would have been the case had there not been the intercompany relationships. You should question the allocation if it does not track with the earnings activities of, or the economic benefits derived by, the separate entities. For example, the allocation of all legal costs incurred by, and for the benefit of, the savings association to an MHC, which has no significant operations of its own, is generally not appropriate. As a result, earnings of the MHC would be understated, while earnings of the savings association would be overstated. Where minority shareholders are present in the structure, they would benefit, to the detriment of the MHC. This is because the MHC would effectively bear more than its pro rata share (based on ownership) of the savings association's legal costs.

SUMMARY

The MHC structure expands the options available to mutual savings associations. The structure allows the organization to maintain many of the features of a mutual while providing access to capital markets.

Consistent with the general holding company philosophy and supervisory approach, the examination of an MHC structure should consider the direct and indirect impact on the thrift institu-

tion. Furthermore, since the MHC is the repository of the mutual members' economic and legal interests, you should insure that the directors and officers of the MHC are properly fulfilling their fiduciary responsibilities.

REFERENCES

United States Code (12 USC)

§1467a(o) Mutual Holding Companies

Code of Federal Regulations (12 CFR)

Part 575 Mutual Holding Companies

INTRODUCTION

Although commonly thought of as one industry, the insurance industry actually consists of several distinct industries. Each distinct industry is based on the type of insurance written, for example, property/casualty, life/health, health maintenance organizations, title, and disability[1]. Each functions in its own way, has distinct financial attributes and operates differently. OTS-chartered thrifts are owned by a variety of these different types of insurance entities.

The insurance industry is comprised of several different types of businesses:

- Insurance companies, also called insurance underwriters – those that take on insurance risk by underwriting and issuing policies to customers.
- Reinsurers – insurance companies that insure portions of the business underwritten by other insurance companies.
- Agents – sales staff, either employees or independent contractors that sell on behalf of the companies they represent.
- Brokers – sales staff that is independent of insurance companies, they bring together insurance buyers and sellers. They work on behalf of the buyer.

State insurance departments regulate each type of insurance business listed above in a different way and to a different extent[2].

As with any holding company, you need to start with the administrative program and then move onto the CORE program (or abbreviated program if applicable).

[1] Information about insurance industries is presented in Appendix A.

[2] Regulation by state insurance departments is discussed in Appendix B.

PROGRAM GUIDANCE

Capital

Information presented in Capital Section 300 is just as relevant to insurance entities as to other types of organizations. However, you should consider the information presented below before drawing firm conclusions about a holding company enterprise that is engaged in insurance activities within the structure.

Capital Sufficiency

Capital levels for insurance companies are typically relatively high. This is due to strong investment performance during the 1990's and significant investment regulation[3]. In addition, due to the risk of catastrophes and the long-term nature of life insurance policies, higher capital levels are typically held. Recent events may result in a reduction of capital for certain companies. However, the industry overall is expected to remain strong.

Risk-based capital (RBC) is the major tool used by insurance regulators to evaluate the adequacy of an insurance company's capital level on a statutory accounting basis.

Insurance companies are part of a highly regulated industry. This level of regulation may result in restrictions against providing capital to the thrift. Evaluate the existence and/or adequacy of holding company capital in support of the thrift. This evaluation of consolidated capital should exclude the capital related to regulated insurance companies and any other regulated entities such as state banks. The remaining amount of capital should then be evaluated for its adequacy in support of the subsidiary thrift.

An evaluation of capital would also include a determination of any existing capital restrictions by

[3] Capital regulation of the insurance industry is discussed further in Appendix A.

another regulator. For affiliates that are regulated by another state or federal agency, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (including capital contributions) to that entity. If such agreements or conditions exist, determine the extent to which they could ultimately have an adverse effect on the subsidiary thrift.

RBC is calculated at the individual insurance company, rather than enterprise level. Distinct RBC formulas are available for property/casualty, life and health maintenance organization companies.

The calculation involves applying risk factors to various asset, premium and reserve items. The factors are higher for items with greater underlying risk and lower for items with lower underlying risk.

As noted above, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital. Results of 200 percent or above typically indicate little concern. Results below 200 percent may result in insurance department actions.

OTS' approach to holding company supervision provides for the evaluation of capital on a case-by-case basis. Holding companies that underwrite insurance will prepare Statutory Accounting Statements either in addition to, or instead of GAAP statements. In those instances, SAP capital can be used as a measure of capital similar to tangible capital.

Risks

Capital Section 300 of the Handbook discusses various types of risk that organizations must address. The insurance industry also must deal with Underwriting Risk.

Insurance is a unique product in that the ultimate cost is sometimes not known until long after the product is sold. Underwriting risk is the risk that premiums will be inadequate to cover the cost of claims that occur during the policy periods. Insurance prices are established based on estimates of expected claim costs as well as estimates of the costs to issue and administer the policy. The estimates and assumptions used to develop policy pricing may prove to ultimately be inaccurate. This inaccuracy may result from poor assumptions, changing legal environments, increased longevity, higher than expected weather catastrophes and research breakthroughs as to the causes of disease[4]. The total cost of the policy may not be known until many years after the coverage has been provided. Factors that were unknown at the time the policy was issued may result in increased claims and claims costs.

Liquidity risk is typically less likely to be of concern in an insurance organization due to the extensive structure of investment regulation. Often 75 percent or more of an insurance company's assets are concentrated in the investment portfolio. Insurance investments are heavily weighted in bonds rather than stock.

Insurance company investments are typically structured to focus on providing for adequate diversification, liquidity and quality. The primary objective of an insurer's investment strategy is to preserve capital. Insurers invest largely in long-term bonds with fixed interest rates and predictable cash flows.

Life insurance companies present a unique aspect in evaluating capital. Variable life insurance and variable annuities are accounted for through the use of separate accounts. Policies accounted for in this way require no supporting capital. Capital calculations for companies with separate accounts

[4] Medical research may find the cause of a disease relates to a product thereby creating insurance claims outside of health insurance. For instance, several serious lung conditions have been traced to asbestos exposure resulting in large volumes of claims to manufacturers of asbestos. Lead paint has been linked to mental and physical impairment in children resulting in claims against paint manufacturers and landlords.

should be made excluding the amount recorded in that category[5].

Debt

Due to the strong capital levels and large investment portfolios most insurance organizations carry little debt. Procedures presented in Capital Section 300 related to debt may not be needed when evaluating many insurance holding companies.

Most insurance companies have negotiated terms for substantial letters of credit. These agreements are in place, available to activate in the event of a catastrophe. This type of agreement is not drawn on for operating funds or to finance growth, rather only for those infrequent, major events that require large amounts of immediate cash. The existence of these prenegotiated agreements provides the company the ability to obtain cash quickly without liquidating portions of the investment portfolio. The agreements help to minimize the impact that the sale of investments in a poor investment market would have on a company's operating results.

Dividend Policies

State insurance regulation typically includes restrictions on dividends from the underwriting company to the parent holding company. Dividends that do not require prior insurance department approval are limited to the current years earnings and ten percent of surplus as of the beginning of the year. Dividends in excess of that must receive prior insurance department approval.

As part of evaluating the financial condition of the holding company, the examiner should determine the impact reduced earnings (limiting dividends) would have on the cash flow needs of the holding company.

[5] Information about Separate Accounts is included in Appendix A.

Accounting Methods

You may find that companies that underwrite insurance may not have their financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP). Instead, companies that underwrite insurance must file their financial statements with state insurance departments using what is referred to as statutory accounting principles (SAP). Publicly traded insurance underwriting companies must file GAAP statements with the Securities and Exchange Commission in addition to the SAP statements filed with the state insurance departments. Mutual or closely held companies typically only prepare SAP statements.

When reviewing financial statements, you should determine if the company prepares both SAP and GAAP statements or if only SAP statements are prepared.

If the holding company itself is not engaged in insurance underwriting activities and only controls or has investments in insurance companies, financial statements would be prepared using GAAP, SAP would not be used.

Ratio results calculated using SAP numbers would appear less favorable than those prepared using GAAP numbers. You should not automatically evaluate this more conservative result harsher than a GAAP result.

Companies that underwrite insurance often have diverse affiliates and subsidiaries within the structure; therefore, the statements at the ultimate parent may be complex. Because of this complexity it is not practical to simply benchmark results. Rather, a thorough understanding of the company and its various components will provide a comfort level that examination procedures are adequate.

Organizational Structure and Relationship

As noted above, OTS has approved applications for thrift charters for several different types of insurance companies. The thrift has been used by these organizations as a means to fill product line gaps and cross sell related products to existing in-

surance clients. The types of products and services they offer reflect the overall organizations broader marketing strategy.

Several life insurance companies were granted thrift charters to provide trust services to consumers. The companies, whose insurance operations focus on life insurance and retirement and estate planning, use the thrift to provide trust services that complement these activities. Life insurance policies can be used to fund trusts. Retirement funds may be direct deposited into checking accounts. Certificates of deposit may be incorporated into asset diversification plans for retirement or estate planning purposes.

Several property/casualty insurance companies have applied for, and received full service retail charters. The products they offer, including home mortgages and auto loans, complement the auto and homeowners lines of insurance offered.

As the companies gain experience with the thrift and gain proficiency with the ability to cross sell thrift services to existing insurance clients, some have requested expanded authority. Several have acquired other thrifts or received approval to expand their authority to full service from trust only.

Approval of business plans for insurance industry thrifts often include restrictions or requirements. In many instances the insurance company plans for insurance agents to market thrift products. Agents' roles are largely marketing and information only; they are restricted from accepting deposits. In order to assure that this message is communicated effectively, agent training materials often require prior review by OTS before release.

Opportunities arise to cross sell thrift products to insurance clients. Likewise, opportunities exist to cross sell insurance products to thrift customers. Several existing thrifts have chosen to enter the insurance arena either through the creation or purchase of insurance agencies, marketing agreements with agents, or the creation of reinsurance companies.

Gramm-Leach-Bliley addressed concerns related to the sales of insurance products in a banking environment. The requirements of this law have been incorporated into OTS regulation through 12 CFR Chapter V Part 536 – Consumer Protection in Sales of Insurance.

The rule addresses anti-tying and disclosures to reduce customer confusion. A main focus of the rule is to make clear that the Federal Deposit Insurance Corporation does not insure insurance products sold on behalf of a bank or thrift. Compliance examiners review thrift activities for adherence to the rule.

Earnings

As recommended in the Earnings Section, you will consider ratings given by Moody's or Standards and Poor's. You should also review the ratings of A. M. Best for companies that underwrite insurance[6].

Although it is commonly thought that insurance companies make a profit only due to the difference between premium revenue and claim expenses, that if often not the case.

Insurance companies make a profit through their success at managing the funds available for investment. Insurance companies receive money from customers for premiums and management fees. The company has the funds available for investment, sometimes for many years, before claims are paid to policyholders and beneficiaries.

Ratio Analysis

Some of the ratios suggested in the Earnings Section use information from the cash flow statement. Typically, the cash flow statement is less informative for insurance companies than for other types of industries. The investment portfolio dominates assets and the management of it results in a significant volume of activity reported in the financing section of the cash flow statement. This leads to results that although typical for insurance may appear odd.

[6] Information about A. M. Best is included in Appendix C.

The current ratio cannot be used for most insurance organizations. The balance sheets for these entities are not usually segregated into current and long-term assets.

Operating cash flow is also of less importance for insurance companies again because of the significant impact of investing activities reflected in the financing section of the cash flow statement.

As mentioned previously many insurance entities have little to no debt resulting in either highly favorable or no result for the debt ratio.

Because of the high capital levels of many insurance companies, return on equity results are often lower for this industry than for other industries. Often investment analysts, due to their lack of understanding of the industry and their focus on maximizing return on equity for investors, shy away from these companies. Instead you should view the high capital level as a strength rather than a weakness.

Deferred Acquisition Costs

Deferred policy acquisition costs (DPAC) are referred to in the Earnings Section as an asset that does not generate cash. DPAC is comprised of the costs necessary to sell and issue a policy such as agent commissions and underwriters salaries and benefits. These expenses are paid early in the policy term. Under the GAAP matching concept items are expensed in the same period that the corresponding revenue is earned. DPAC is a prepaid expense (asset) that is amortized over the estimated life of the policy.

Property/casualty companies typically issue 6 month or 12 month policies. DPAC is expensed over the policy life. Given the short-term nature of property/casualty policies, DPAC does not typically represent a large portion of assets on the balance sheet.

Life insurance companies issue policies that are expected to remain in force for many years. DPAC is expensed over this estimated longer life of the policy and therefore is typically a larger percentage of assets.

SUMMARY

The insurance industry is comprised of a variety of different types of organizations. An understanding of these businesses and how they differ from thrifts will help you in determining the scope and methodology for conducting a holding company examination.

LIFE INSURANCE

The major distinguishing feature of the life insurance industry is its inherent long-term nature. The perspective of the long-term, collecting premium for many years and then paying a death benefit, impacts the approach to investing, revenue and expense recognition and regulation. The long-term nature of coverage combined with the increased risk of death as people age is distinct from the risks of other types of insurance.

Traditionally the life insurance industry focused on fixed life insurance products and fixed annuities. Products like term life and whole life are typical fixed products.

Over the past two decades, life insurance companies have focused on diversifying their revenue base by developing and selling retirement planning and asset management focused products. The inherent long-term nature of retirement planning and funding is a natural match for the industry.

The increase in stock market prices during the 1990's led to a significant shift in product sales from fixed life insurance and fixed annuities to variable life insurance and variable annuities. This shift has a material financial impact for the insurer. (Instability in the stock market that began during 2000 has resulted in a significant slowdown in sales of variable products and a renewed demand for fixed products.)

The insurer retains investment and interest rate risk for fixed products. Most variable products shift the substantial portion of investment and interest rate risk to the policyholder. Most variable products include rate guarantees set at very low levels.

In many ways, transferring risk benefits the company. However, during periods of high investment returns, the company's investment returns are less than for fixed products, where excess earnings are retained by the company.

Variable products also generate income differently than fixed products. Fixed products generate revenue through both insurance premiums and the portion of investment return that is above the fixed rate credited to the product. Variable products generate revenue through fees for insurance coverage and asset management fees for the portfolio of investments underlying the product. The shift to variable products can create a more stable revenue flow based on fee income rather than investment returns.

Typical Balance Sheet

The shift to variable products from fixed products has ramifications for financial statement presentation.

The largest asset category on the balance sheet for the typical life insurance company is cash and investments. Funds collected by insurers through the sales of fixed products fund the investment portfolio.

The majority of the general investment portfolio (about 70 percent) is invested in high quality bonds. About ten percent of the portfolio is typically invested in mortgage loans. The balance is split among common stock, real estate, cash and policy loans. States have strict investment laws limiting the percentages, and risk exposures of company investments.

Deferred policy acquisition costs consist of the expenses necessary to sell and issue a policy such as agent commissions and underwriters' salaries and benefits. These expenses are paid early in the policy term. Under the GAAP matching concept items are expensed in the same period the corresponding revenue is earned. Since these costs are paid early in the policy term a prepaid asset is recorded. The asset is expensed over the expected length of time the policy will be in force. Most types of life insurance policies remain in force for many years. Therefore, the prepaid expense (asset) is amortized over the actuarially estimated life, which may be many years. As a result DPAC

is often a material item on the balance sheet of life insurance companies.

Variable products, indexed products and some modified guaranteed products are accounted for through the use of 'separate accounts'. Separate accounts are separate line items in both the assets and liabilities sections of the balance sheet. The amounts should be comparable.

Separate accounts represent segregated portfolios of assets owned by a life insurance company. The accounts are segregated because investment experience is credited directly to the participating policies covered.

The corresponding liability recorded on the balance sheet represents the ownership interest in these funds by policyholders and beneficiaries.

Separate accounts are segregated from the balance of the investment portfolio because the assets and related investment gains and losses are insulated from the company's creditors and liquidation claims.

Due to customer interest in various sectors of the stock market, separate account investments are diverse. They are often of a higher level of risk than those in the general investment portfolio. State law allows separate account assets to be invested without the strict limitations imposed on the general investment account. Customers choose the types of investments that will be held based on their risk appetite. Separate account offerings can look similar to those of mutual funds. For example, separate accounts investments may be focused towards common stock or bonds, 'high-tech', small cap, international, growth or income focused investments.

Typically, cash, invested assets, separate accounts and deferred policy acquisition costs will account for the majority of total assets. The remaining amounts are spread among a variety of accounts depending on the types of business in which the company is involved.

The majority of liabilities are spread among a variety of accounts that represent reserves for current or expected future claims. These reserves are actuarially determined based upon estimates of mortality, morbidity and longevity. Reserves for life insurance policies begin to be accumulated once the policy is sold, and increase each year. As mentioned previously, separate accounts have both an asset and a corresponding liability.

A life insurance company's counterpart to retained earnings is called surplus. At the time of publication the industry is strongly capitalized with surplus supporting about seven percent of total assets.

Risk-Based Capital (RBC) Requirements

As noted in Section 930, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital.

The life and health insurance risk-based capital formula considers the four major risk categories of:

- Asset risk – the risk that an insurer's assets will default or decline in value.
- Insurance risk – the risk related to improper underwriting assumptions
- Interest rate risk – the risk of changing interest rates on assets and liabilities
- Business risk – other risks not included in the other three categories.

Risk-based capital results for life and health insurers are evaluated at various levels:

- 250% and above – adequate, no further action required.
- 200-249% – trend test level, a trend test is conducted to determine if an adverse trend exists. An adverse result requires the insurer to file an RBC corrective plan with the state. A favorable trend result requires no further action.

- 150-199% – Company action level, a corrective plan is required.
- 100-149% – Regulatory action level, appropriate examination procedures are required with corrective actions implemented.
- 70-99% – Authorized control level, a commissioner may take action against the company.
- Below 70% – Mandatory control level, the commissioner must seize the company unless there is a reasonable expectation that the condition will be resolved within 90 days.

Typical Income Statement

Under statutory accounting a life insurance company income statement is called a summary of operations. Given the more conservative nature of statutory accounting revenue tends to be recognized at the later of earned or received and expenses at the earlier of accrued or paid.

The statements shows various expensed amounts related to policy reserves. These are amounts recorded at actuarially determined periods throughout the life of the policy, not at the time of policy payment.

The life insurance industry does not have a counterpart to the combined ratio. However, for traditional fixed life insurance products and fixed annuities, the concept is similar although the time period may be even longer.

For fixed return products, the life insurance company receives the premium and invests the funds until policy benefits are paid to beneficiaries many years later. The company's success is measured by its ability to generate higher investment returns than the return guaranteed under the product.

The model is different for variable return life insurance and annuity products. Insurance companies charge a fee for the life insurance coverage provided by the product and in addition, charge a fee for the management of the underlying investment portfolio. This management fee makes up for the loss of the excess investment return earned on fixed products.

PROPERTY/CASUALTY INSURANCE

Property/casualty insurance companies are in the business of accepting the transfer of risk of financial loss from policyholders. Customers transfer the risk of loss, or decrease in value of automobiles, homes and other property as well as the risk of financial loss due to damages done to others (casualty losses).

A major factor impacting property/casualty companies is their exposure to catastrophe losses. Catastrophes are a single event that results in insured losses (to the industry) of $25 million or more. Most are weather related but they can result from other manmade events as well.

Although catastrophes are normal, expected events, they cannot be eliminated, controlled or accurately predicted with any large degree of reliability. For example, no one knows how many hurricanes, of what intensity and geographic course will occur in a season.

The exposure to catastrophe losses has significant repercussions in the way companies select, underwrite and price policies. It also impacts the degree of reinsurance needed to manage the business and the investment goals in managing the portfolio.

Catastrophes are easily understood to impact property insurance. Damage to homes, cars and commercial buildings by major weather events are often seen on the evening news. However, catastrophes also impact casualty insurance. For example, a hurricane that reaches an area during business hours may result in injuries to employees covered by workers' compensation insurance, customers of businesses covered by general liability insurance, and the general public injured by flying property and debris also covered by various types of liability insurance (both personal and business insurance).

Another major factor affecting property/casualty insurance is the short-tail or long-tail nature of the various types of insurance business. Short-tail lines of business are those where claims are paid within a short period of time after the loss occurs. Minor auto accidents that do not result in injuries are an example of this. Property insurance coverage is typically short-tail business.

Long-tail lines of business are those that take many years to resolve. Many casualty lines of business are long-tail lines of business. Medical malpractice insurance for pediatricians is a long-tail line of insurance. Laws allow claims to be brought by parents. However, the laws also allow the child to bring their own actions upon becoming an adult. The time between notice of a potential claim and final resolution may span decades in this type of insurance.

The potential time spans in resolving claims has serious ramifications in the company's investment strategy both in terms of risk and durations.

One of the ways in which property/casualty insurance differs from life insurance is in the duration of the policy.

Most property/casualty policies are written for a term of one year. Some companies still issue personal automobile insurance policies for 6 months. Life insurance policies are expected to span many years. This difference in term impacts financial statements.

Just as with life insurance companies, property/casualty companies are in the business of collecting premiums and fees, investing the funds and paying claims to policyholders and claimants.

For a claim to be covered by the policy it must occur during the policy period, regardless of when the insurance company is notified. The loss to the policyholder must also be from a cause of loss covered by the policy. It must also not have occurred as a result of an act of the policyholder intending to cause a loss.

Although a policy may be in force for 12 months, losses that occurred during the policy may be paid out over many years. For example, a person injured in an automobile accident may require medical treatment for many years. If a covered loss occurred during the policy term, expenses will be paid, many years later, up to the policy limit, even though the policy has long expired.

Typical Balance Sheet

As with life insurance companies, the largest asset category for property/casualty insurance companies is cash and investments. However, because property/casualty companies do not have separate accounts business a larger portion of total assets is in this category. Typically this category accounts for about 88 percent of total assets. Bonds are the largest portions of the portfolio. Typically bonds are about 65 percent of the total portfolio. Bonds are valued at amortized cost.

Common stock is the second largest component of the portfolio accounting for approximately about one quarter of the typical insurers investment portfolio.

The remaining 12 percent of total assets are spread among a variety of accounts including amounts due from agents for payment of policies and amounts due from reinsurers.

Property/casualty companies have built substantial amounts of retained earnings over the years. Property/casualty companies call retained earnings, capital stock and other amounts policyholders' surplus. Low catastrophe losses during the last half of the 1990's, strong investment results and judicious use of reinsurance have increased the level of surplus by the end of the decade. Recent events may result in decreased surplus for certain affected companies. The industry is expected to remain well capitalized.

The largest portion of liabilities is in accounts related to claim reserves. These accounts include reserves for the payment of claims as well as those for payment of expenses incurred in investigating and administering claims. Claim related reserves have decreased as a percent of assets over recent years not due to changes in loss patterns but due to strengthened surplus.

Risk-Based Capital Requirements

As noted in Section 930, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital.

The property/casualty risk-based capital formula considers the four major risk categories of:

- Investment risk – the risk that an insurer's assets will default or decline in value.
- Credit risk – the risk of default by agents, reinsurers and other types of creditors.
- Underwriting risk – considers the risk of adverse reserve development as well as the risk of inadequate rates.
- Off-balance sheet risk – the risks of excessive growth and contingent liabilities.

Risk-based capital results for property/casualty companies are evaluated based upon:

- 200% and above – Adequate level, no further action.
- 150-199% – Company action level, a corrective action plan is required.
- 100-149% – Regulatory action level, appropriate examination procedures and corrective action plan are required.
- 70-99% – Authorized control level, a commissioner may take action against the company.
- Below 70% – Mandatory control level, the commissioner must seize the company unless there is a reasonable expectation that the condition will be resolved within 90 days.

Typical Income Statement

A property/casualty company's financial success at underwriting insurance policies is measured through the combined ratio. This ratio measures the proportion of earned premium remaining after claim costs are incurred and the proportion of written premium remaining after the expenses of selling and issuing the policy. The industry typically has a combined ratio result slightly above 100. A combined ratio of 100 means that claims and expenses equal premium. In other words, underwriting results are at breakeven.

TITLE INSURANCE

Title insurance guarantees a clear title to real property. The policy is issued at the time of transfer or sale. Title insurance is a product that seeks to eliminate the risk of loss before the transaction by identifying any liens or judgments that would prohibit the transfer of a clear title. This differs from other types of insurance that reimburse for incurring a loss.

Title insurers, by researching the property history, identify potential problems thereby allowing a property purchaser to change the purchase decision or resolve the problem prior to purchase. It that way they seek to prevent claims from occurring. This differs from other types of insurance. For instance, a typical homeowners insurance policy does not prevent a fire from occurring, rather it reduces the potential financial impact to the homeowner should a fire occur.

Title insurance companies have a different business model than other types of insurance. Most insurers collect premium and incur the majority of their expenses (claims and claim adjustment) after the policy is effective. Title insurers historically have extremely low loss ratios (typically well below 20 percent) but incur the bulk of expenses prior to the effective date of the policy. Title insurers are in the business of risk elimination, not loss payment.

The effective date of the policy is typically the date of purchase. Prior to that time the title insurer engages in extensive and detailed investigation of the ownership history, filed liens and encumbrances on the property. The intent is to assure passage of a clear title. The difference in the business model results in some differences

in the types of items shown on the company's financial statements.

Typical Balance Sheet

The balance sheet reflects an asset "Title plants and other indexes" which reflects the accumulated value of all the properties researched over the years. The title plant is an asset whose value is based upon the ability to reuse that information and update it the next time the property is sold or transferred.

A title insurer will typically show the title plant as the third largest asset behind cash and investments. This long-term asset is not depreciated because the knowledge is not expected to decline in value over time.

Title insurance companies are not subject to risk-based capital requirements. Instead, each state requires that a minimum dollar amount of capital be held.

Typical Income Statement

Because title insurers focus on preventing claims, expenses related to payments under the policy terms are not the largest expense. Rather, administrative expenses to research titles, maintain the title plant and issue title policies account for the majority of expenses.

Claims do occur however, in spite of best efforts to prevent them. About 20 percent of premiums earned are eventually paid out in claims.

Title insurer profits can be more erratic than for other types of insurance. Title insurance is directly tied to the strength of the housing market. Increasing mortgage rates or recessions can slow home sales resulting in fewer title insurance policies being sold. Decreasing mortgages rates or economic recoveries can increase home sales and refinancing resulting in significant increases in title policies sold.

PRIVATE MORTGAGE INSURANCE

Lenders require private mortgage insurance (PMI) when the mortgage loan is for more than 80 percent of the appraised value of the home. The borrower pays for PMI but the lender is the policy beneficiary. Most borrowers obtain PMI coverage from the company offered by the lender although they have the option of obtaining it elsewhere.

Traditionally, the institution received a fee for each PMI client successfully referred to the PMI carrier. Over the last several years, thrift holding companies have established reinsurance subsidiaries to underwrite PMI reinsurance. The subsidiary typically provides PMI reinsurance only for a PMI carrier offered by the lender and for loans it originates.

Institutions and their holding companies have expanded their involvement into reinsurance for several reasons. Reinsurance premiums increase revenue. Lending also becomes more effective as the revenue generated from each loan increases. PMI also diversifies the sources of revenue generated within the structure by generating fee income rather than interest.

PMI companies have marketed this approach to institutions for several reasons. The participation of the institution in the risk of default is thought to strengthen the institutions risk selection process. The institution also shares in the risk of loss by providing reinsurer to the carrier.

PMI reinsurance is typically structured in one of two ways. The reinsurer may provide participating coverage of a certain percentage of each claim. A participating program results in the institution being financially responsible for a predetermined percentage of each claim.

More commonly, the reinsurer provides a set portion of excess coverage. Excess coverage is described in terms of 'layers' that stack on top of each other. Under excess coverage, the PMI carrier accepts the initial layer up to a predetermined dollar amount or percentage of covered loans. After that limit has been reached, the next layer of

coverage is activated. Claims in this layer are those usually covered by the reinsurer. Typically, the reinsured layer has both a floor and ceiling. The floor is the initial amount that must be paid by the PMI carrier before the reinsurance assumes any claims. The ceiling is the maximum amount covered by the reinsurance. Typically, after the ceiling has been met, the PMI carrier pays any additional claims.

Although the possibility of claims must exist for the program to be considered reinsurance, the expectation is for claims to rarely reach the layer of reinsurance coverage.

The PMI industry estimates claims rates at two percent to six percent of covered loan amounts. Actual results depend on economic factors and lending criteria. Reinsurance agreements are typically structured to begin at a percentage of loss greater than what would normally be expected from underlying loans.

INSURANCE AGENCIES AND BROKERS

Either agents or brokers can sell insurance. Agents work on behalf of the insurance companies they represent. They may be employees of the insurance company or they may be independent business people who choose to represent the insurance company.

Independent agents work on behalf of insurance companies but are independent businesses. They typically represent many different companies. Their competitive advantage is their ability to offer customers an array of products from various companies to meet their insurance needs. The insurance companies that they represent pay them commissions. Most companies also supplement agent compensation with bonuses based on growth and profitability.

Captive agents work on behalf of a single insurance company but are independent businesses. To the public they may appear to be employees of the insurance company. Their competitive advantage typically rests in the strong brand name and market presence of the insurance company they represent. Insurance companies that market through captive agents typically support the agents through strong training programs, advertising support and administrative programs. Captive agents are paid commissions often supplemented by growth and profitability bonuses.

Agents who are employees work for a single insurance company. They may work in a locations separate from the company offices. They are often paid a small base salary supplemented by commissions. Office administration, advertising, marketing, sales volumes and types are usually strictly controlled by the company.

Brokers represent customers rather than insurance companies. Their role is to bring together the buyer with appropriate insurance companies, analyze coverage needs and make recommendations. They are independent businesses. They are paid through commission. Some insurance companies do not pay growth and profitability bonuses to brokers, others do.

Agents and brokers must be licensed by each state in which they sell insurance. Most states require continuing education in order to renew licenses.

Historically, licensing requirements varied widely from state to state. Gramm-Leach-Bliley proposed the creation of the National Association of Registered Agents and Brokers (NARAB). Under this law NARAB would come into effect to create uniformity in agent and broker licensing unless a majority of the states enacted conforming legislation by November 12, 2002. A majority of states have passed laws that provide for reciprocity, a first step towards consistency.

Agents and brokers do not use SAP. Agents and brokers that are privately held may create cash basis or tax basis financial statements.

Agents and brokers are not required to file financial statements with the department of insurance. The department has the authority to request them at any time.

Sales of insurance products by thrifts, or on behalf of thrifts to consumers are regulated by 12

CFR Chapter V Part 536 Consumer Protection of Sales of Insurance. The rule became effective October 1, 2001. It implements requirements of Gramm-Leach-Bliley.

REINSURANCE

Reinsurance is insurance for insurance companies. Property/casualty companies use reinsurance more extensively than life insurance companies. An insurance company that sells its products to the public may also be a reinsurer for other insurance companies. There are also companies that only sell reinsurance.

Reinsurers are regulated less rigorously than insurance companies that deal with the public. Both parties in a reinsurance transaction are assumed to be knowledgeable in insurance and are therefore better prepared to protect their interests.

Reinsurance can be issued either for one policy (facultative) or for a group of many similar policies (treaty). Facultative reinsurance is used for large, complex, individualized policies. For instance, a large casino, horse racetrack and hotel complex with one owner would be more appropriately handled through facultative reinsurance.

Treaty reinsurance is typically used for types of business where many similar policies are issued. For instance, treaty reinsurance is very common for private passenger automobile insurance, homeowners insurance and small business insurance.

Insurance companies use reinsurance for several reasons. Property/casualty companies can use reinsurance to spread risk related to geographic concentrations. Companies with heavy concentrations of policyholders in locations exposed to weather catastrophes may choose to reinsure a potion of the business to reduce the risk of loss.

The purchase of reinsurance results in the receipt of a commission for producing the business. Reinsurance commissions flow into revenue thereby reimbursing a portion of the expenses incurred to generate sales. As discussed previously, under SAP, policy acquisition costs are immediately expensed. Reinsurance commissions offset a portion of these expenses.

Reinsurance can also be used to stabilize underwriting results by moving a portion of the risk to another insurer. Companies often reinsure particularly high-risk accounts, whether large, complex property/casualty accounts or large life insurance policies. Reinsuring the risk reduces the amount of the claim that will be incurred when an insured event occurs.

Companies also can obtain reinsurance when they would like to exit a line of business. A substantial reinsurance program can minimize the exposure of the company to the results of that business segment.

SUMMARY

Although part of the financial services industry, insurance operates differently than thrifts in many ways. A basic understanding of the industry can help you to identify potential problem areas and more effectively plan examination steps for insurance holding companies.

INTRODUCTION

Insurance regulation is conducted at an individual state level. Each insurance company has a domiciliary or home state. This is the state in which the company has its corporate charter. This state is the primary regulator of the company.

The mission of state insurance departments is to protect consumers and maintain a healthy industry. This mission is accomplished through a focus on financial solvency of companies and market conduct activities. (The term 'market conduct' is comparable to the OTS term 'compliance'.)

Insurance departments have authority to conduct examinations of any insurance company doing business in the state regardless of where the company is domiciled. Often states work together to conduct examinations of multi-state companies.

State insurance department reports are public information in many states. OTS has entered into information sharing agreements with many states to obtain access to examination reports. Your regional functional regulation coordinator can assist you in obtaining these reports.

Insurance department examination reports (both financial and market conduct) should be requested from the domiciliary state. You should evaluate these reports to determine any potential impact on the holding company or thrift.

STATE STRUCTURE

Companies must be licensed in each state in which they want to sell their products. Most large companies are licensed in each of the lower 48 states and the District of Columbia and often Alaska and Hawaii. (Because Alaska and Hawaii present unique geographic challenges some companies choose not to do business there.) Each state in which a company is licensed also has authority to regulate the company for activities within that state.

Most insurance holding companies own multiple insurance companies. They may all be domiciled in the same state or they may each be domiciled in a different state. In addition, each company may be licensed to do business in a variety of states.

In addition to chartering (domiciliary state) and licensing, states regulate other insurance activities as well. Policy forms, endorsements[1], riders[2] and rates (property/casualty insurance) are subject to regulation as well.

DEPARTMENT STRUCTURE

Most state insurance departments operate as a separate department within state government. In some states, regulation of all financial services has been centralized in one department. In those states the same department or agency regulates insurance, banking and securities with separate sections specializing in each. The departments in Vermont and New Jersey are two states that operate this way.

State insurance departments vary in size from less than 30 to over 1,000 employees. As a result, functions are handled differently from state to state. However, there are several common functions that are performed by all departments:

- Financial condition examinations
- Market conduct examinations
- Financial analysis
- Company licensing and admissions
- Consumer affairs
- Enforcement

[1] Endorsements are forms used to change a standard property/casualty policy to reflect the needs of the policyholder.

[2] Riders are forms used to change a standard life insurance policy to reflect the needs of the policyholder.

- Policy and forms analysis
- Rate filings
- Agent licensing
- Legal

In some smaller states, the same people may perform several functions, such as financial condition examinations and financial analysis. In other, larger states, employee responsibilities are more specialized.

Insurance companies receive the most structured and intensive regulation. In addition to financial and market conduct activity, policy forms, rates and advertising are subject to regulatory oversight.

Pure reinsurers receive significantly less oversight because they do not deal with the general public. These companies deal only with other insurance companies. Both the reinsurer and its insurance company customer are considered to be knowledgeable and less in need of protection.

Due to the large number of agents and brokers, regulation is handled in a different way. All states require licensing after successful completion of an examination. Most states also require continuing education in order to renew licenses.

Although state insurance departments have the authority to conduct financial and market conduct exams of agents at any time, they do not happen on a regular schedule. Most regulation for this group centers on the investigation of consumer complaints. A high frequency of serious complaints or severity of a given complaint may result in either a financial or market conduct examination.

Financial examinations occur every three to five years depending on state law. Most states do not have a specific requirement for the frequency of market conduct examinations. In small states, market conduct examinations are done through complaint investigation.

Insurance regulation historically varied greatly from state to state. During the last decade efforts have been made to strengthen and standardize insurance regulation and procedures from state to state. The passage of Gramm-Leach-Bliley in 1999 increased states efforts in these areas.

State insurance departments are funded in a variety of ways. Insurance department sources of revenues are premium taxes, audit fees, filing fees and licensing fees. In some states, the department receives revenues with the balance in excess of the budget forwarded to the state general fund. In other states, the state treasury receives insurance department revenue, with the department receiving its fund allocation. In general, less than ten percent of the revenue collected by the department is spent on insurance regulation.

GUARANTY FUNDS

Unlike thrifts, insurance companies failures are not covered by any government funded (either federal or state) insurance program.

Insurance companies failures are paid for by the other insurance companies selling business in the state. The mechanism to collect the funds and handle insolvencies is the state guaranty fund. Separate funds exist in each state, one each for property/casualty and life/health insurance.

Guaranty funds step in to make up state mandated shortfalls that may occur in company failures. Typically, policyholders are notified of the date coverage will terminate and their need to find coverage elsewhere. Claims are paid in full, up to a certain dollar amount, depending on the state and type of policy. Most states have maximum amounts per policy that are covered by the funds.

Guaranty funds are not prefunded. Once a state places a company into receivership the guaranty fund steps in. The fund works with the court appointed receiver to determine an estimated shortfall.

Insurance companies who write the same types of insurance in the state are subject to assessment for the failure. Each company is billed in relation to the amount of business it writes in the state. For instance, if an auto insurer is taken into receiver-

ship, the insurance company writing the most automobile insurance in the state will be assessed the largest amount. Receiverships can take many years to resolve.

The Federal Insurance Deposit Corporation (FDIC) advertises the insurance it provides to depositors. State guaranty funds do not. In many states agents are prohibited from discussing the existence of guaranty funds during the sales process. State regulators do not want to encourage consumers to rely on the existence of the fund instead of making informed purchase decisions.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

The NAIC, formed in 1871 is a voluntary organization of the chief insurance regulatory officials of the 50 states, the District of Columbia, American Samoa, Guam, Puerto Rico and the Virgin Islands. The purpose of the NAIC is to assist state insurance regulators in their mission of adequately regulating the insurance industry. The organization focuses on issues that protect consumers and help maintain the financial stability of the insurance industry.

The NAIC is comprised of insurance commissioners and their staff as well as a paid staff of NAIC employees. The organization develops model laws, financial analysis tools, statutory accounting principles, market conduct regulations and examination programs and practices.

The NAIC conducts its work through an elaborate system of committees, working groups and task forces. Groups can be disbanded once objectives are accomplished and new groups are created as issues arise in the industry. At any point in time the NAIC has over 150 different groups in place.

The groups conduct their work through conference calls and meetings. The NAIC meets formally on a quarterly basis to report on its progress and agenda. Most meetings are open to the public.

NAIC MODEL LAWS

The development of model laws is a key contribution of the NAIC. A model law is a draft bill that may be submitted to state legislature. States may modify model laws to meet their specific needs. Model laws typically include input from many states providing the benefit of diverse practices and real world experiences. States have the option of whether or not to use the model laws. State legislatures must pass the law in order to make it effective in the state.

NAIC DATABASE

The NAIC maintains the largest database of insurer financial information in the world. Companies required to file statutory financial statements by the state are usually also required to file the statements with the NAIC. The information becomes part of a database that is used as a basis for examination preparation and financial analysis.

NAIC SOLVENCY AND MARKET CONDUCT PRODUCTS

The NAIC also provides the states with standard financial examination, market conduct, financial analysis and other programs and handbooks, all supported by automated tools and training programs.

Smaller insurance departments are able to use the NAIC manuals and automated tools as a complete system for examinations and analysis. Larger departments often modify the products to meet specific state requirements and staffing needs.

In addition, NAIC staff is available to consult on unusual or complex topics that arise during the course of regulatory activities.

ACCREDITATION PROGRAM

In 1990, the NAIC implemented the Accreditation Program. This program includes the baseline

standards for solvency regulation by state insurance departments. The goal of the program is to improve the quality of regulation. The program includes a mandatory full on-site examination and re-accreditation of the department every five years with interim annual reviews to assure compliance with standards. Departments with inadequate regulations or procedures may lose accreditation. A map showing the current accreditation status of each state is available on the NAIC website (www.naic.org).

Accreditation standards require that insurance departments have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs. The program also evaluates the adequacy of staff, both in quantity and quality. In addition, the administrative, organizational and personnel practices are reviewed to determine that the department has the organizational ability to be effective.

Accreditation standards include required financial examination procedures and practices, personnel standards and the adoption of certain model laws by the state legislature.

STATUTORY ACCOUNTING PRINCIPLES

Statutory Accounting Principles (SAP) are the accounting rules and methods required by state insurance departments for insurance companies. SAP differs greatly from Generally Accepted Accounting Principles (GAAP).

Differences Between SAP and GAAP

SAP is balance sheet oriented with the emphasis on valuation of assets and liabilities on a liquidation basis. This is quite different than GAAP that has an income statement focus and assumes a going concern and the matching of income with related expense.

SAP is less concerned with matching income and expense time periods and instead recognizes expenses more aggressively and income more conservatively.

SAP is intentionally more conservative than GAAP. It values assets at amounts that could be realized quickly and liabilities at amounts required to satisfy them as though they were immediately due and payable. Because of this sense of immediacy, SAP statements do not use the traditional current and long-term categories often seen on GAAP statements.

An asset under SAP is only an asset if it has been specifically identified in SAP as an asset. Any GAAP asset that is not recognized by SAP is considered a nonadmitted asset. Because total GAAP assets are reduced by the value of nonadmitted assets to reach SAP assets, policyholders' surplus (owners' equity in GAAP) is also reduced by an equal amount.

A nonadmitted asset is an item that does not meet the strict requirements of liquidity for SAP. Examples are, company office buildings, furniture, fixtures, supplies, prepaid expenses and uncollected premiums more than 90 days old. These items are nonadmitted for SAP because it would be difficult to convert them into cash in a short period of time without a loss in value.

SAP also differs from GAAP in its more strict rules for the financial statement recognition of reinsurance, deferred taxes and premium deficiencies.

Because companies are regulated individually by states, SAP is focused on an individual insurance company presentation of results. Unlike GAAP, the concept of consolidated statements does not exist. Combined statements for a group of property/casualty insurance companies can be prepared but may not be all inclusive of all entities in the organization. Combined statements are not prepared for other types of insurers.

The NAIC's role in SAP

SAP is promulgated by the NAIC and is published in its Accounting Practices and Procedures Manual. This manual is for sale to the public. Changes to SAP are typically adopted as of January 1 of the year.

SAP stands separate and apart from GAAP. It has not received Other Comprehensive Basis of Accounting (OCBOA) standing from the American Institute of Certified Public Accountants (AICPA).

A standing committee of the NAIC is charged with reviewing changes to GAAP to determine the applicability and impact on SAP. This is done to address new developments in the world of financial reporting but is not done with the intent that SAP be changed to match GAAP.

SAP statements are prepared on NAIC standard forms called blanks. Statements are prepared for the first three quarters and at year-end. All companies report based upon calendar quarters and a December 31 year-end. The year-end blank is much more detailed than the quarterly blank.

Statutory Financial Statements

SAP statements include a balance sheet, income statement and cash flow statement. In addition, a number of schedules present detailed information regarding investments, claims and reinsurance.

Each major insurance industry has its own specific blanks version. Separate versions exist for property/casualty, life/health, health maintenance organization, dental plans, fraternal organizations and title insurance.

Prescribed and Permitted Practices

The NAIC prescribes SAP. State insurance departments, as the regulatory authority, continue to have the ability to grant companies permission to deviate from SAP. State approved deviations from SAP are considered permitted practices. Companies must include in the Notes to the Financial Statement permitted practices and their impact.

State insurance departments grant a permitted practice for an individual company when prescribed SAP would result in financial reporting that would be inappropriate or misleading for the situation.

SUMMARY

The insurance industry is regulated primarily at the state level. The insurance regulators of the 50 states, the District and the 4 territories developed methods of communicating and coordinating activities through the NAIC and informal channels of communication. This cooperation and communication has resulted in a regulatory system and structure that is consistent in many ways while still providing states the ability to address local concerns.

A. M. BEST

The A. M. Best (Best) Company is a widely recognized, and highly regarded firm that analyzes and rates insurance companies. Best has been publishing ratings of insurance companies since 1906.

Independent ratings are an important indicator of company solvency and financial condition. Best's ratings provide an independent opinion of an insurance company's ability to meet policyholder obligations (claim payments). Those evaluating a company or marketing relationship can use these ratings to identify concerns of a financial nature.

Best's information, consistent with state insurance regulation, is on an individual insurance company basis. The ratings do consider the impact of other companies in the structure, and the impact the holding company may have on the rated company.

Best ratings are available to the general public free of charge. The easiest way to obtain these ratings is through the Company's website www.ambest.com. Ratings can be obtained by entering the company name. Ratings for other companies in the group are also available.

There are 16 major letter ratings divided between the following two broad categories:

Secure – (strong ability to meet ongoing obligation to policyholders)

A++ and A+	Superior
A and A-	Excellent
B++ and B+	Very Good

Vulnerable – (good ability to meet ongoing obligations to policyholders)

B and B-	Fair
C++ and C+	Marginal
C and C-	Weak
D	Poor
E	Under Regulatory Supervision
F	In Liquidation

To obtain an alphabetical Best's rating, an insurance company must have a minimum of five consecutive years of operating results, be of a certain size, provide the required financial and operating information and pay a fee.

In addition to the letter rating, Best assigns a rating outlook to most companies. The outlook provides a sense of potential future direction for the company over the next 2 to 24 months. The indicators can be described as positive, negative or stable based upon expected business trends.

The process employed by Best is based on analysis of Statutory Accounting Principles (SAP) financial statements. This is supplemented with Generally Accepted Accounting Principles (GAAP) audited financial statements and SEC filings (where available), and other information. In order to receive a letter rating, Best must have the ability to conduct ongoing discussions with managements.

Best reviews and updates the ratings of each company at least annually. Reviews outside of the annual cycle are triggered by events that may materially impact the company. Examples of these events include: acquisitions, mergers and sales, major changes in reinsurance programs, demutualization, catastrophes, significant financial concerns regarding an affiliate, parent or subsidiary, significant changes in regulations or legislation, or unexpected changes in earnings.

OBTAINING INFORMATION

To facilitate your understanding of insurance enterprises with thrifts within the structure, you should review the Best rating. A review of the Best rating and the supporting analysis will aid you in identifying potential areas of concern in the examination process. It will also provide perspective on the current state of the insurance operation and its outlook in the near term.

Best ratings can be supplemented by obtaining a detailed company profile. These profiles contain a history and analysis of each company. Profiles can be ordered through the Best website. The profile is delivered to you through e-mail in a matter of minutes.

Individual company profiles cost $35 per company. Most insurance structures are comprised of several, sometimes, many, individual insurance companies. Requesting profiles for all the companies is typically not necessary and may be cost prohibitive.

In order to make the best use of funds, you may want to obtain profiles initially only for the largest companies in the structure. Going forward you should then consider obtaining profiles for any company in the enterprise with a rating in the vulnerable category or for any company with a significant rating decline.

OTS has established a prefunded account for staff to obtain these reports. The Manager of Information Services Branch in Washington administers the OTS account. Your region can forward the names of authorized users to Washington so that access can be established.

SUMMARY

Best’s has a long history and is highly regarded in its ability to evaluate insurance companies. Your use of Best information can help you in identifying areas of concern and in developing the scope of holding company examinations.

INTRODUCTION

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

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

This Section will provide you with a better understanding of the additional areas to consider within each CORE component when you examine a conglomerate. You should consider this guidance in connection with your examination and ongoing supervision of large and complex holding company enterprises that engage in multiple lines of business. This would typically include diversified holding companies, or holding companies that control numerous different legal entities engaged in lines of business that cross traditional sectors. A joint decision will be made by senior management in DC and the region as to whether a holding company enterprise is: 1) a conglomerate subject to the guidance contained in this Section; and 2) a conglomerate subject to a directive issued by the European Parliament and the Council of the European Union (see Appendix A).

ONGOING SUPERVISION AND USE OF SUPERVISORY PLANS

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

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

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

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

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

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

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

- An organizational chart or similar summary of the major entities in the conglomerate that also identifies other regulators and their point of contact. This step will facilitate communication between interested regulators, as well as give other regulators the opportunity to verify the accuracy of your assessment of the major entities in the conglomerate.
- A list of major shareholders and managers that exercise significant influence in the conglomerate.
- The strategic policies of the conglomerate. This will allow each interested regulator to assess the impact of the conglomerate's policies on their relevant regulated entity.
- Your conclusions about the financial condition and capital adequacy of the conglomerate.
- Any significant risk concentrations or intra-group transactions that may raise supervisory concern.
- Assessment of the capability and effectiveness of management.
- Your assessment of the adequacy of risk management and internal control systems of the conglomerate.
- Any developments with major entities in the conglomerate (including the thrift) that may adversely impact other entities in the enterprise.
- Much of this information will be contained in the holding company examination report. You may share your supervisory findings with other supervisors. These conclusions should be presented to the other regulators using the Conglomerate Supervisory Review format. You will draw much of the information needed to complete the Review from the holding company examination report. Examination conclusions should be summarized in the review.

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

CAPITAL

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

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

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

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

A conglomerate's capital adequacy is based on the five principles discussed below. While your capital adequacy analysis will need to be based on these principles, also consider the discussion of leveraging, earnings, and cash flow analysis described in the other sections of this Handbook.

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

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

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

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

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

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

By simply aggregating the available capital of the three entities ($1,500 + $900 + $500 = $2,900), it would appear that on a combined basis the group-wide available capital easily exceeds the capital required of $2,000. However, as $500 of the parent's available capital was downstreamed into the second-tier bank and counted by the bank as available capital, that capital is double-geared. Further, the bank's investment of $250 of its available capital in its securities company represents an instance of multiple gearing because the same funds are now being counted by three different entities as available capital. Removing the double and triple counting of capital by deducting the insurance company's $500 investment in the bank, and the bank's $250 investment in the securities company, $750 in total, the entire conglomerate maintains a group-wide capital surplus of only $150. Also note that the parent's capital surplus is reduced from $700 to $200 and the bank's capital surplus of $100 becomes a capital deficit of $150. As the example shows, the capital adequacy of conglomerates may appear significantly better before double and multiple-gearing is recognized and removed from group-wide capital.

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

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

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

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

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

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

4. Identify the risks being accepted by unregulated entities.

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

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

Unregulated Parent Holding Company	
Investment in Bank Subsidiary	$700
Investment in Insurance Subsidiary	200
Investment in Leasing Subsidiary	100
Equity Capital	300
Capital Required	0

100% Owned Bank Subsidiary	
Equity Capital	$700
General Reserves	100
Available Capital[3]	800
Capital Required	-100
Capital Surplus / - Deficit	700

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

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

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

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

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

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

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

In those instances where parent companies control less than 100 percent of one or more subsidiaries, you will need to carefully assess each interest. You will need to determine if your assessment of capital adequacy is more representative of the associated risks by fully aggregating the interests or excluding them by pro rating the interests. In situations where the conglomerate maintains a majority ownership interest, in excess of 50 percent but less than 100 percent, full consolidation is typically required. However, full consolidation is likely to overstate capital adequacy when capital surpluses exist. If you fully aggregate the surplus capital of subsidiaries where the parent holds less than a 100 percent interest, you may overstate capital adequacy, as compared to pro rating the capital surplus based on the parent's ownership interest. Pro rating the capital surplus recognizes the minority interest holders' right to their proportionate share of the surplus capital. It is expected that you would generally pro rate surplus capital if the conglomerate's interest in an entity is less than 100 percent. Additional discussion of the prudent treatment of majority and minority interests is detailed in Appendix C.

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

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

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

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

CAPITAL MEASUREMENT METHODS

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

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

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

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

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

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

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

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

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

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

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

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

Prior to undertaking your capital analysis, you will need to understand the conglomerate's organizational structure. Only by understanding the legal structure of each significant entity, can you begin to consider the capital implications.

ORGANIZATIONAL STRUCTURE

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

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

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

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

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

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

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

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

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

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

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

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

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

- How the conglomerate manages its foreign exchange risk?
- What type of foreign exchange risk is the conglomerate exposed to, such as direct lending in other currencies, capital market transactions in other currencies, or overseas operations that are funded in other currencies?
- How large is the conglomerate's foreign exchange risk relative to earnings and capital?
- Do the conglomerate's policies and procedures directly address authorizations for conducting such transactions and exposure limits by types of transactions and by country?
- Does the conglomerate maintain specific foreign exchange counterparty and settlement limits by entity? Are the limits monitored on a regular basis with exceptions identified?
- Does the conglomerate hedge its foreign exchange risk? If so, what policies, procedures, controls, and reporting have been established?

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

RELATIONSHIP

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- What information is available on the range of intra-group and related entity transactions and exposures? What types of management information reports are produced and how frequently?
- What is the conglomerate's overall strategy with respect to intra-group transactions and exposures? What types of intra-group/related entity transactions or other arrangements are used (for example, servicing agreements, loans)?
- How are intra-group and related entity exposures and transactions monitored?
- What is the volume of intra-group/related entity transactions and level of finance exposures? Does the conglomerate have internal limits or thresholds on such transactions or exposures? Are there internal or external limits or thresholds on such transactions or exposures (such as regulatory, borrowing, or board set limits)?
- What is the level of financial exposure to entities that are not wholly owned? Are there limits or thresholds for transactions and exposures to such entities?

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

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

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

the conglomerate's financial statements and risk management activities.

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

EARNINGS

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

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

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

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

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

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

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

When conducting your analysis, you will need to consider:

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

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

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

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

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

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

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

SUMMARY

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

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

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

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

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

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

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

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

An interest in a financial sector is considered significant if:

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

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

[2] http://www.bis.org/publ/joint02.pdf

[3] http://europa.eu.int/eurlex/pri/en/oj/dat/2003/l_035/l_03520030211en00010027.pdf

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

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

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

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

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

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

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

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

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

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

Accounting Consolidation Method:

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

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

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

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

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

Accounting Consolidation Capital Assessment Using Full Consolidation					
	Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned	Group-Wide Totals
Equity Capital	$63	$10	$20	$5	**$98**
General Reserves	4	2	2	2	**10**
Available Capital	67	12	22	7	**108**
Deduct Investment In Subsidiaries	-27	0	0	0	**-27**
Capital Required / Proxy [3]	-32	-10	-17	-10	**-69**
Capital Surplus / - Deficit	$8	$2	$5	-$3	**$12**

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

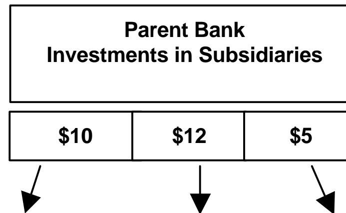
[3] In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate's group wide totals. In this example you would need to deduct the unregulated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

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

Deduction and Aggregation Method:

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

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



	Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Pro Rated Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned	Group-Wide Totals
Available Capital [5]	$67	$12	$13.2	$7	**$99.2**
Capital Required / Proxy [6]	-32	-10	-10.2	-10	**-62.2**
Inv. in Subsidiaries	-27				**-27.0**
Capital Surplus / - Deficit	$8	$2	$3.0	-$3	**$10.0**

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

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

Book Value / Requirement Deduction Method:

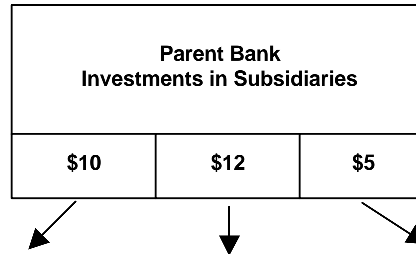
- Uses unconsolidated statements.
- Performs analysis from parent company perspective.
- Predicated on pro rata consolidation of subsidiaries.
- Focuses on capital surplus or deficit of each dependent (subsidiary) and the transferability of available capital to the parent or elsewhere in the group.

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

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

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

Book Value / Requirement Deduction Method (Continued):



	Unconsolidated Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned
Available Capital [7]	$67	$12	$13.2	$7
Capital Required / Proxy [8]	32	10	10.2	10
Surplus/ (Deficit)	$35	$2	$3.0	-$3

Parent's Available Capital ($63 Equity Capital plus $4 General Reserves)		$67
Sum:		
Parent's Capital Required	$32	
Calculate the higher of the book value of the parent's investment in each individual entity or sector or these entities' capital requirements:		
Insurance Subsidiary	10	
Securities Subsidiary	12	
Unregulated Finance Subsidiary	10	
Total Capital Required		64
Group-Wide Capital Surplus / - Deficit		**$3**

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

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

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

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.