Intra-Group Transactions and Exposures Principles

THE JOINT FORUM

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Purpose

1. To provide banking, securities and insurance supervisors principles for ensuring through the regulatory and supervisory process the prudent management and control of intragroup transactions and exposures by financial conglomerates.

2. Intra-group transactions and exposures (ITEs) can facilitate the synergies within different parts of the conglomerate and thereby lead to healthy cost efficiencies and profit maximisation, improvements to risk management, and more effective control of capital and funding. Often achieving these benefits is a major goal of the organisational structures that give rise to ITEs. At the same time, material ITEs represent avenues of contagion within the conglomerate and potentially complicate the resolution of failures. Achieving the appropriate balance between the benefits and risks of ITEs is an important objective for conglomerates and for supervisors, and the appropriate balance may vary across activities and types of ITEs.

Definition and Types of intra-group transactions and exposures

3. For purposes of this paper, a financial conglomerate is defined as a conglomerate whose primary business is financial and whose regulated entities engage to a significant extent in at least two of the banking, securities and insurance sectors. Each supervisory discipline has developed a perspective on ITEs in its respective industry, and this paper draws on those perspectives in considering the supervisory oversight of ITEs in a financial conglomerate.

4. ITEs take the form of direct and indirect claims between entities within financial conglomerates. ITEs can originate in a variety of ways, for example, through:

(a) cross shareholdings;

(b) trading operations whereby one group company deals with, or on behalf of, another group company;

(c) central management of short-term liquidity within the conglomerate;

(d) guarantees, loans and commitments provided to, or received from, other companies in the group;

(e) the provision of management and other service arrangements, e.g. pension arrangements or back office services;

(f) exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees);

(g) exposures arising through the placement of client assets with other group companies;

(h) purchases or sales of assets with other group companies;

transfer of risk through reinsurance; and

(j) transactions to shift third party-related risk exposures between entities within the conglomerate.

Principles

I. **Supervisors should take steps, directly or through regulated entities, to provide that conglomerates have adequate risk management processes in place, including those pertaining to ITEs, for the conglomerate as a whole. Where necessary the supervisors should consider appropriate measures, such as reinforcing these processes with supervisory limits.**

II. **Supervisors should monitor material ITEs of the regulated financial entities on a timely basis, as needed, through regular reporting or by other means to help form a clear understanding of the ITEs of the financial conglomerate.**

III. **Supervisors should encourage public disclosure of ITEs.**

IV. **Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate any supervisory action relative to ITEs within the group.**

V. **Supervisors should deal effectively and appropriately with material ITEs that are considered to have a detrimental effect on the regulated entities, either directly or through an overall detrimental effect on the group.**

The work of the Study Group

5. The Study Group on Intra-Group Transactions and Exposures and Risk Concentrations conducted fact-finding work on the risk management of ITEs by way of two questionnaires: one dealing with supervisory practices and another with conglomerate practices. The results of these questionnaires are summarised below. The study group surveyed ten financial conglomerates on their management practices with respect to ITEs. These included six bank-led conglomerates with activities in securities and/or insurance business, two insurance-led conglomerates with banking or securities business, one securities-led conglomerate with banking activities and one mixed conglomerate involved in banking and insurance.

Review of supervisory practices

6. The scope of regulation of ITEs is influenced by a jurisdiction's supervisory framework. Some supervisory regimes exclude from ITE regulation transactions between subsidiaries and a regulated parent, between subsidiaries with a common regulated parent, and between sister institutions subject to the same or similar regulation in the same country. In general, ITE regulation is directed at transactions between the regulated entity and entities "outside" the immediate regulatory regime. As a result, ITEs between a regulated entity in one sector with a regulated entity in another sector would generally be subject to limitations imposed by ITE regulations, possibly in both sectors. ITE regulations virtually always apply to transactions between a regulated entity and unregulated affiliates and holding companies.

7. Most supervisory regimes are designed to prohibit detrimental ITEs before they can occur. Supervisory efforts have been directed at those ITEs which could be avenues to weakening the financial condition of the regulated entity. Regulatory tools include prohibiting movements of capital or income outright, requiring collateralisation, limiting transfers, requiring prior approval by supervisors, and restricting specific types of transfers. In addition, most supervisory regimes require that ITEs, when they occur, be done at arm's length terms, or at least on terms that are not disadvantageous to the regulated entity. Certain supervisors require statutory reporting of ITEs or public disclosure in notes to financial statements. Others require entities to submit both consolidated income and balance sheet information and consolidating statements from all major subsidiaries in order for the supervisor to analyse ITEs.

Financial conglomerates' practices

8. Within the group of ten conglomerates surveyed, some conglomerates only monitor compliance with regulatory requirements and otherwise give little attention to ITEs. Moreover, management of these conglomerates often consider monitoring unnecessary because of the knowledge level and unified control over the two sides of the transaction. Some conglomerates also view a focus on ITEs as inconsistent with the firm's strategy to manage by business lines rather than by legal entities.

9. Certain conglomerates, however, closely monitor ITEs or impose conditions on their use, such as requiring collateral for any exposures. The Study Group was interested in the reasons behind the greater attention to ITEs at those conglomerates. For some firms, management of ITEs is an important element of corporate governance and internal control. Given the size, complexity and number of legal entities within a large, internationally active financial conglomerate, control over capital, funding, and other risk- and income-transferring mechanisms presents a means to limit or draw to senior management attention unusual or excessive activity in individual locations or legal entities. Another related motive is to ensure accurate cost accounting and profit attribution and thus the effectiveness of the management incentive systems in the conglomerate. These reasons, whilst substantially different from the concerns of

supervisors described in the next section, nonetheless appear to both provide sound management of ITEs and produce the information systems and management reporting mechanisms that would allow supervisors to monitor ITEs and their management.

Analysis of Issues in the Supervision of Financial Conglomerates

10. The mere presence of ITEs is not a matter of supervisory concern. They should be seen as a means to an end which can be either beneficial or harmful to regulated entities in a conglomerate.

11. Conglomerates centralise key activities and enter into intragroup transactions and exposures (ITEs) to facilitate risk management, seek efficiencies, and manage capital and funding. The emergence of financial conglomerates and the complexities of their operations have resulted in a broad range of ITEs. Newly important types of ITEs, including derivatives and service and fee-for-service arrangements, reflect changing organisation structures and the evolution of management and control by business lines, as documented by the work of the Joint Forum in the *Framework for Supervisory Information Sharing Paper.*

12. The importance and changing structure of ITEs within financial conglomerates increase the supervisory challenges in assessing ITEs to ensure that they are not disadvantageous to the regulated entities or to its customers. In general, supervisory concerns arise when ITEs:

- result in capital or income being inappropriately transferred from the regulated entity;
- are on terms or under circumstances which parties operating at arm's length would not allow and may be disadvantageous to a regulated entity;
- can adversely affect the solvency, the liquidity and the profitability of individual entities within a group;
- are used as a means of supervisory arbitrage, thereby evading capital or other regulatory requirements altogether.

13. ITEs can take the form of service and fee-for-service arrangements and represent ongoing obligations rather than single point-in-time transfers. Supervisors and conglomerates need to consider the value of these transactions and ascertain whether they are done at other-than-market prices or on terms that may prove to be disadvantageous to the regulated entity or to its customers. At the same time, these ITEs do not lend themselves easily to traditional forms of regulation. For these transactions, supervisors will generally hold the regulated entity accountable to manage and monitor intra-group relationships.

14. The expansion of ITEs and the change in their composition open more avenues for contagion to regulated entities in the conglomerate, and can potentially complicate the resolution of the regulated entities within a troubled or failing conglomerate. The latter concern is especially important for internationally active financial conglomerates where the insolvency regimes may vary across country and regulatory jurisdiction. In this respect, ITEs can be large enough to be a type of sectoral or group-wide concentration that may not be monitored well by many conglomerates or supervisors.

15. Resources flowing from a regulated entity to an unregulated parent or other unregulated entities in the group, via the purchase of shares or other means which results in a migration of capital from the regulated entity, can be of particular supervisory concern, although not all such transfers are detrimental. Drains on capital and double or multiple gearing in particular are addressed in the Joint Forum's *Capital Adequacy Principles paper*. The risks associated with ITEs involving unregulated entities also will be influenced by whether these entities transact solely with the conglomerate or with outside parties, since those outside parties can introduce new risks to the conglomerate. The level of concern about ITEs with unregulated entities is influenced by the effectiveness of measures available to the supervisor to obtain information from the unregulated entity or influence its behavior either directly or indirectly through regulated entities.

16. In developing supervisory policy toward ITEs, individual supervisors need to balance the supervisory concerns against the improvements to risk management, more effective control of capital and funding and cost efficiencies which are the goals of many conglomerates extensively using ITEs. The need to strike an appropriate balance points to the importance of supervisors understanding the role of ITEs in individual conglomerates and the need for supervisory monitoring. While monitoring can take different forms across supervisory regimes, from reporting to on-site examination, effective monitoring is essential.

17. Because of the bilateral nature of ITEs, regulation and other supervisory oversight at the sector level is the principal means to address supervisory concerns about ITEs. The level of supervisory oversight of ITEs in part depends on the other elements – capital regulation, examination, financial reporting, etc. – relied upon in each supervisory regime. Because these elements differ across regimes, supervisors tailor their approaches to ITEs at the sectoral level anywhere along a continuum from restrictive to relatively free, but in all approaches incorporate some element of monitoring. When consolidated supervision encompasses all or a significant portion of a conglomerate, the overview provided to the consolidated supervisor through review of consolidating financial statements or regulatory reporting of ITEs may be seen as sufficient to permit a fairly free flow of ITEs, as is the case in many jurisdictions. Such an approach should not override rules imposed by the sectoral supervisors.

18. The efficiency of conglomerate supervision may be reduced if the supervisory regimes with respect to ITEs conflict in a significant way. This may be especially true in the presence of unregulated entities. Thus, one element in shaping a sectoral strategy for ITEs is to understand thoroughly the supervisory environment of the two intra-group

entities, and the specifics of ITE regulation and supervisory oversight in key jurisdictions. For each transaction, is each of the intra-group entities subject to a close degree of regulation and supervision or are there few restrictions on ITEs? The combination of the degree of regulation in these two environments will influence the level and nature of supervisory risk that may be associated with ITEs.

19. Supervisors will therefore have a strong interest in understanding the overall risk profile of the conglomerate in order to determine how ITEs affect the regulated entity. Cooperation and communication among supervisors can contribute toward that understanding.

20. The nature of supervisory concerns makes it imperative that the regulated entities within conglomerates have in place a process for measuring, monitoring and managing material ITEs, as part of their broader risk management system. Well-managed conglomerates appear to place emphasis on managing ITEs, largely for internal control and corporate governance reasons. While supervisory attention to ITEs generally arises because of concerns about contagion or weakening of the regulated entity, effective internal control and corporate governance frameworks are recognised as important tools in managing ITEs. Where the conglomerate establishes controls over ITEs, the conglomerate's monitoring systems are likely to provide the types of information about ITEs that the supervisor would like to receive in order to monitor them.

21. In addition to internal control by conglomerates and oversight by supervisors, public disclosure can contribute to sound management of ITEs by enhancing market discipline. Public disclosure by the conglomerate of its ITEs can serve two purposes. First, it can enhance market discipline by allowing other market participants to differentiate between organisations that understand and manage their ITEs effectively and those that do not, thereby assisting supervisors in promoting the adoption of sound risk management practices. Through disclosure, creditors can understand better how developments in other legal entities of the conglomerate could affect repayment of their claims, which are on individual legal entities. Second, disclosure can be helpful to supervisors in understanding material ITEs in the conglomerate. While supervisors often find that disclosures are just the starting point for further questions and discussion, such disclosures may reduce the burden faced by a financial conglomerate in dealing with a number of supervisory authorities.

22. Market discipline can only be effective if disclosures are timely, reliable, relevant and sufficient. Based on a review of published financial statements by a small sample of financial conglomerates, disclosures of ITEs are minimal and could be considerably enhanced, especially in annual reports. The expanded range of ITEs within conglomerates, however, has the potential to produce a burdensome volume of information. In this respect, prompt, detailed information on principal relationships among the legal entities within the conglomerate outside the normal financial cycle is seen as an effective and constructive supplement to annual or other periodic disclosures. In addition, qualitative information about the management of ITEs remains essential to make quantitative information meaningful.

Guiding Principles

23. Supervisory strategy with respect to ITEs in a conglomerate necessarily reflects the powers that supervisors have to induce financial institutions to control problematic or excessive ITEs and non-arm's length transactions. In some cases, supervisors will have ample authority to supervise risk management throughout the conglomerate. In many cases, they will not. In all cases, supervisors should have sufficient authority to gather and safeguard information to enable them to monitor material ITEs across sectors and to observe how ITE-related risks are managed. Supervisors also should have the power to deal with ITEs that are manipulative or abusive, through preventive regulation, such as limits, or remedial actions, as necessary. Where supervisors lack sufficient powers, they should seek the additional authority they need.

I. Supervisors should take steps, directly or through regulated entities, to provide that conglomerates have adequate risk management processes in place, including those pertaining to ITEs. Where necessary the supervisors should consider appropriate measures, such as reinforcing these processes with supervisory limits.

24. Many of the supervisory concerns emerging from ITEs, in particular contagion effects, can be mitigated by good internal control policies within the conglomerate. Supervisors expect that financial conglomerates will have a framework in place to measure, monitor and manage ITEs. Supervisors should expect that regulated entities will monitor and control ITEs in such a manner that the financial integrity of each regulated entity is protected. Supervisors should take steps directly or through regulated entities to provide that financial conglomerates have controls in place to manage their ITEs. For example, where the supervisor does not consider the controls adequate, or there is evidence of abusive or manipulative activity, supervisors should consider imposing supervisory limits or other measures.

25. A sound risk management process for ITEs begins with policies and procedures approved by the board of directors or other appropriate body[1] and active oversight by both the board and senior management of each regulated entity. The process should include a unified framework for the measurement and monitoring of material ITEs, so that both sides of bilateral transactions can be analysed at the individual regulated entity level, as well as at the conglomerate level. Management information and reporting

[1] Corporate governance with respect to financial institutions varies from jurisdiction to jurisdiction. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the financial institution.

systems are essential to a sound risk management approach. Finally, sufficient attention should be given to non-quantifiable, as well as quantifiable, risks.

26. As financial institutions from different sectors merge and financial conglomerates evolve, the potential size, volume and complexity of ITEs could increase. When evaluating proposed mergers or expansions, supervisors should take into account management plans to manage material ITEs at a group-wide level .

II. Supervisors should monitor material ITEs of the regulated financial entities on a timely basis, as needed through regular reporting or by other means to help form a clear understanding of the ITEs of the financial conglomerate.

27. Supervisors may be able to tailor their monitoring of material ITEs based on the nature and scope of the conglomerate's corporate governance and internal control mechanisms. Supervisors should have access to information or should be informed on a regular basis on ITEs, on both a solo and consolidated basis, that exceed a set standard rule. This implies that supervisors need to refer to both consolidated and unconsolidated financial statements to properly detect ITEs.

28. There may be financial conglomerates where there are few supervisory concerns because all material entities are regulated and business lines and other activities follow legal entity lines. In other instances, however, particularly where the conglomerate contains significant unregulated entities or has an organisational structure very different from its legal entity structure, sound management of ITEs by the regulated entities of the financial conglomerate, and possibly by the financial conglomerate as a whole, will be an important concern. Supervisors should monitor carefully both the extent of material ITEs and their management.

29. Different approaches to capital regulation and accounting rules in different financial sectors may increase the opportunities for regulatory arbitrage. Supervisors should be especially vigilant in identifying ITEs throughout the financial conglomerate that facilitate such arbitrage.

30. As ITEs evolve, reporting of these transactions must also evolve and take into account new benefits and risks that may be associated with these new structures.

III. Supervisors should encourage public disclosure of ITEs.

31. Public disclosure of ITEs can promote market discipline, in the case of ITEs, by providing insight into the relationships among the various entities in the conglomerate. Effective public disclosures allow market participants to reward conglomerates that manage the risk associated with ITEs effectively and to penalise those which do not, thus reinforcing the messages provided by the supervisor. For market discipline to be effective, disclosures need to be timely, reliable, relevant and sufficient. Given the variety of possible ITEs in a financial conglomerate, public disclosure should not simply

highlight the volume of ITEs but help the reader of financial statements to gain a greater understanding of the operations of the conglomerate. This no doubt means enhancing disclosures by expanding both the qualitative information, such as the scope, significance and management of the conglomerate's major ITEs, as well as quantitative information. In addition, public disclosure can facilitate supervisory monitoring and risk assessment and lead supervisors to explore further material issues.

32. It is not intended that disclosure of ITEs be done in a way that would involve the disclosure of proprietary information or information about customers that would unreasonably violate their privacy.

IV. Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate any supervisory action relative to ITEs within the group.

33. A better understanding of supervisory methods dealing with ITEs and their rationale will facilitate a group-wide assessment of the difficulties that may be encountered by conglomerates as a result of ITEs. Thus, information sharing and liaison among supervisors are important. Supervisory concerns associated with cross-jurisdiction and cross-sector ITEs may be mitigated by communication among supervisors.

34. Generally, channels to permit the exchange of information within sectors have been established. The Joint Forum has set out principles for sharing information across sectors, *inter alia,* in the documents entitled *Principles for Supervisory Information Sharing Paper* and in *The Coordinator Paper*. These documents, along with others in the Joint Forum package, provide principles and techniques to assist supervisors to liaise more closely and effectively with one another in the supervision of financial conglomerates.

35. One of the key considerations influencing the supervisory approach to the regulation of ITEs is the legal structure of the conglomerate and the legal framework in each jurisdiction and country in which the conglomerate has operations. In deteriorating financial scenarios, the liquidation and bankruptcy regimes of each separate legal entity will determine at what point the regulated entity is endangered and will be moved into liquidation or resolution. Supervisors need to be aware that differences in the bankruptcy/liquidation regimes exist so that they can anticipate the impact of such regimes on the regulated entities within a troubled conglomerate and coordinate as necessary and where possible with other supervisors.

V. Supervisors should deal effectively and appropriately with material ITEs that are considered to have a detrimental effect on the regulated entities, either directly or through an overall detrimental effect on the group.

36. Most supervisory regimes are designed to prohibit detrimental ITEs. If prohibited transactions occur or if a financial conglomerate is exposed to ITEs that may

affect its financial stability, supervisors should take appropriate measures with respect to the regulated entities. Examples of supervisory actions include requiring that prohibited transactions be nullified or cease to continue, that the use of ITEs be modified going forward or that they be subject to other prudential measures. Supervisors may also have to use moral suasion in instances where their powers are lacking to deal with ITEs. Where ITEs cut across the regulated entities of the firm, cooperation among the relevant supervisors (as well as with the primary supervisor[2]) is important.

[2] For purposes of this document, the term "primary supervisor" 'is generally considered to be the supervisor of the parent or the dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements.' *Supervision of Financial Conglomerates,* Papers prepared by the Joint Forum on Financial Conglomerates, February 1999, page 101.