Consolidated supervision of institutions authorised under the Banking Act 1979

Notice to recognised banks and licensed deposit-takers issued by the Bank's Banking Supervision Division on 25 March 1986

1 In a discussion paper published in May 1985, the Bank of England ('the Bank') described its proposed approach to the consolidated supervision of institutions authorised under the Banking Act 1979 (banks and licensed deposit-takers, which are hereafter referred to as 'banks'). Following consultations with the banking community and other interested parties, the Bank is now issuing this statement of its policy. The policy has been agreed with HM Treasury and its implementation will fulfil, *inter alia*, the United Kingdom's obligation to comply with the European Communities' Consolidated Supervision Directive.(1) (The supervision of financial conglomerates raises broader issues which are not addressed in this paper; the principles to be followed were set out in the answer to a Parliamentary Question on 21 January.)

Introduction

2 The Bank is committed to the principle that the supervision of institutions authorised under the Banking Act 1979 should be conducted on a consolidated basis and indeed the Bank has been carrying this out wherever banks are members of a wider group, although the particular approach adopted has inevitably depended on the nature of each group. The Bank has reviewed the way in which it conducts consolidated supervision of banks in the light of the European Communities' Consolidated Supervision Directive, the revised Basle Concordat,(2) and developments in the financial system.

3 The terms 'consolidated supervision' and 'supervision on a consolidated basis' must be distinguished from the term 'consolidation'. 'Consolidated supervision' essentially involves an assessment of the overall strength of a banking group together with an assessment of the impact on a bank of the operations of other parts of the group to which it belongs. 'Consolidation' is used in this paper to mean the preparation of consolidated statistical returns covering a group, or part of a group. Consolidated supervision will often, but not always, require consolidated financial statements to be provided to the Bank.

4 The European Communities' Consolidated Supervision Directive was adopted in 1983 following consultations with the banking community. Although the Bank's previous practice was already in line with the requirements of the Directive, there were areas where the Bank considered its procedures still needed to be developed further. The Directive itself is generally worded and only relates to subsidiaries of credit institutions which are themselves credit or financial institutions. However, the Bank believes that consolidated supervision, to be effective, needs to go somewhat further than the requirements of the Directive to include not only companies within a group which have assets carrying a banking type risk but also, in particular cases, other companies.

5 In order to minimise duplication and possibly conflicting supervisory requirements the banking supervisors will have regard to the supervision carried out by other UK supervisory authorities. These include the Department of Trade and Industry, and a Designated Agency or a Self-Regulating Organisation under the proposals contained in the Financial Services Bill. The presumption must be that the supervisor of, for example, a securities company is the best judge of the adequacy of its capital. The Bank will not generally expect to have to make an independent quantitative assessment of the capital adequacy of group companies which are subject to detailed supervision by other UK supervisory authorities. The Bank's approach will, however, depend on the overall nature of the business of a company which is authorised to do investment or insurance business and the systems of supervision adopted by other UK supervisory authorities.

6 The Bank will not, therefore, normally require group companies undertaking an investment or insurance business and supervised by another UK supervisory body to be included within banks' consolidated statistical returns (except in relation to the country exposure return, Form C1, and large exposures). Nevertheless, all such companies will be included within the Bank's consolidated supervision of banking groups. To this end the Bank will wish to discuss with group management, *inter alia*, the organisational structure of the group as a whole and its plans for individual group companies, especially those which might have a significant impact on the financial position of the bank in the group. In addition, the Bank will maintain close relations with the

(1) Council Directive of 13 June 1983 on the supervision of credit institutions on a consolidated basis (83/350/EEC).
(2) Committee on Banking Regulations and Supervisory Practices. *Principles for the supervision of banks' foreign establishments.* Basle, May 1983.

supervisory bodies concerned so as to ensure that both they and the Bank are aware of significant developments in the group which may affect the companies for which they have responsibility.

7 Consolidated supervision of banks does not replace supervision on an unconsolidated basis, but is complementary to it. In some cases steps may have been taken to isolate the bank from the remainder of the group so that developments elsewhere in the group will have little, if any, effect upon it. In such a situation consolidated supervision may not serve any useful purpose.

Objective

8 The Bank will seek to examine the capital adequacy and risk concentration of banks on a consolidated basis where this is appropriate. This will include large exposures to individual borrowers, countries and other sectoral risks. At this stage the measurement of liquidity and foreign exchange exposure on a consolidated basis for all banks is not contemplated. The assessment of interest rate risk on a consolidated basis is not covered in this paper: the general subject of interest rate risk raises some complex questions which are under study. This paper sets out principles of general applicability which will govern the extent and manner in which consolidated supervision will be applied.

Scope of consolidation

9 There are two main considerations in deciding which parts of a group should be included in consolidated statistical returns:

(i) the nature of the activities being undertaken; and

(ii) the position of each company within the overall structure of the group.

In respect of those group companies which are not included in consolidated returns, the Bank will wish to obtain information separately about such individual companies which could have a significant impact on the health of the bank or banks within the group.

Activities

10 In principle, for the purposes of supervision, figures for all companies which undertake financial business within a group or sub-group headed by a bank should be included in consolidated returns. Financial companies are easier to recognise than to capture within a straightforward definition. The European Communities' Consolidated Supervision Directive defines a financial institution as 'an undertaking, not being a credit institution, whose principal activity is to grant credit facilities (including guarantees), to acquire participations or to make investments'.[1] However, some other businesses not covered by this definition are financial in nature and these, and possibly others, should be included within the scope of a bank's consolidated returns. The annex to this paper lists the principal activities currently undertaken within banking groups. These may be divided into two groups:

(a) those which should generally be included in consolidated returns unless there are special circumstances where it can be demonstrated that to do so would be undesirable or misleading; or

(b) where inclusion in the consolidated returns will depend on the particular circumstances of the institution concerned.

Activities not included in the annex will need to be considered case by case.

Group structures

11 The most important factors to consider before deciding whether inclusion of a particular company in consolidated returns is appropriate are:

(i) the management structure;

(ii) the size of the company in relation to the bank;

(iii) the extent of any funding provided by the bank;

(iv) potential calls on, or other adverse consequences for, the bank which may arise from the activities of the company.

Any one of these factors may be sufficient on its own to justify consolidation.

12 A key factor in any approach to consolidated supervision is the nature of the management control of the various companies in a group. Accordingly, the Bank will normally accept for the purposes of consolidated statistical returns, and of consolidated supervision more generally, the coverage of banks' existing management and/or financial accounts, unless it has strong grounds for doing otherwise. The additional burden of consolidated supervision in terms of additional coverage and collection of statistics will therefore generally be rather limited.

13 If the companies whose activities the Bank wishes to capture in consolidated returns are all effectively managed from a particular company within a group, its approach will go with the grain of the group's own management control. Thus, if the Bank seeks consolidated statistics on this basis, the group's own management will probably also already require similar information.

14 If the Bank's approach to consolidated returns does not match the group's own management structure, the Bank will wish to discuss with the relevant group management whether the existing group control arrangements represent an acceptable basis on which to build the Bank's consolidated supervision or what mutually acceptable modifications can be devised.

(1) A credit institution is defined as 'an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account'.

15 As a general rule, all credit and financial companies owned by a bank, either directly or through intermediate holding companies, will be included in the consolidation. Sister companies owned by an ultimate non-bank parent and the ultimate parent itself will only be captured in the consolidation if there are particular reasons for doing so. The appropriate treatment in particular cases will be discussed with the management of the individual group.

16 The Bank accepts that practical considerations should determine the inclusion or exclusion of subsidiaries which do not have a significant effect on the overall picture. In some cases, banks will undoubtedly find it easier to consolidate all the companies in a group or sub-group. It is recognised that some of the companies to be consolidated will add little to the size of the balance sheet, but could have a significant impact on the profit and loss account and the reserves.

17 In some instances consolidation of a subsidiary's assets with those of its parent may not be meaningful because of significant differences in the nature of the assets and/or activities of the two institutions. In this case the companies will need to be considered separately. Although it is normally neither desirable nor appropriate to consolidate non-financial companies, the potential impact of such companies on the viability of a bank within the same group needs to be considered. The Bank will not seek to extend its supervision to such companies, but it must be recognised that a major difficulty elsewhere in a widely diversified group may have some impact on the fortunes of a bank and the Bank must take account of this.

18 In conducting supervision on a consolidated basis, the Bank expects to have regular discussions with those members of the group's management who are familiar with, and have responsibility for, the overall group position. These discussions will be complementary to those held with the management of individual banks. The Bank will also need to have discussions with the supervisors of companies within the group which are subject to separate supervision (for example, in respect of investment and insurance businesses).

19 Where the ultimate parent in a group is itself a bank, it is reasonable to assume that the management control starts with that company and can encompass all the subsidiaries which the Bank will wish to include within its consolidated supervision. The only issue to be considered in these circumstances is whether there are any sub-groups, incorporating a separately authorised institution, which might be looked at separately as well as being incorporated in the overall consolidated supervision.

20 Where the ultimate parent is an overseas bank, the normal approach will be to include in the consolidated supervision only subsidiaries of the United Kingdom bank. There may, however, be circumstances where supervision on such a basis is of little real value and, subject to the terms of the European Communities' Consolidated Supervision Directive,[1] need not be undertaken because of the nature of the supervision of the parent. On the other hand, there may be circumstances in which the Bank might wish to consider wider consolidation.

Type of consolidation

21 The Bank's basic approach is to require *full consolidation for all majority shareholdings* in credit or financial institutions. Full consolidation of minority holdings may also be carried out where any one of the following applies:

(a) the management is provided by the bank concerned;

(b) the name of the bank is used and/or the bank is strongly identified with the institution;

(c) there are no other substantial shareholders;

(d) the associate is substantially funded by the bank.

Consolidation of a minority holding will not normally be required unless the holding is a material one in a company of significance. This will be determined on a case-by-case basis.

22 Even in cases where (a) to (d) above do not apply, the full consolidation of minority holdings in banks may still need to be considered. This is because even a relatively small shareholding in another bank may be seen to carry responsibilities which go beyond the capital invested. It is, therefore, necessary to capture this additional risk in assessing the position of a banking group. In other cases, namely where there is a good reason for the responsibilities, and therefore risks, to be limited to the shareholding, pro rata consolidation may be justified.

Distribution of capital resources within a group

23 In determining the level of the risk asset ratio for each bank and each banking group, the Bank takes into account a range of factors which cannot be incorporated within the simple structure of risk weightings applied to assets in the calculation of risk asset ratios. These factors include, for example, the general nature of the business of a bank or banking group including the degree of diversification and the experience of management. An additional factor is the amount of capital held elsewhere in the group to which a bank belongs. The Bank also has regard to the implications of particular group structures for banks' consolidated capital ratios.

24 In determining the balance between ratios calculated on a consolidated and unconsolidated basis for a group including a bank or banks , the following broad principles will govern the Bank's approach:

(1) The European Communities' Directive allows supervisory authorities to forego supervision on a consolidated basis where the parent is subject to supervision on a consolidated basis by the supervisory authority of a Member State. It also provides for bilateral agreements to be reached with the authorities in non-member countries.

(a) Consolidated risk asset and gearing ratios will be calculated to assess the capital adequacy of the group as a whole.

(b) In assessing the adequacy, or otherwise, of consolidated capital ratios it will be necessary to examine the location of capital within the group to ensure that reliance is not being placed on surplus capital which is locked into particular countries, or indeed companies, and therefore which is not available to support the group more widely. Tax considerations are relevant, and the Bank may wish to make a notional deduction for the tax which might be payable if funds were to be transferred to another company within the group.

(c) Adequate capital ratios are required in each bank but, to avoid double counting, loans to group companies which are incorporated in the United Kingdom, and are separately authorised under the Banking Act, will be ignored. These funds will only be weighted in the company which lends them to a borrower which is not another UK-incorporated group bank. (Similarly, intra-group contingent liabilities will also be excluded from the ratio calculations.)

(d) The Bank expects bank members of a group to maintain capital ratios in line with those expected of entirely independent banks undertaking the same range and scale of business. However, certain amendments to the calculation of the ratios, described in paragraphs 24(c) and 26, will be made: namely removing the double counting of certain intra-group lending and allowing non-bank subsidiaries which are effectively divisions of the parent to be included when calculating 'solo' (ie unconsolidated) ratios.

25 As a matter of principle, the Bank will therefore assess and ensure capital adequacy both on a consolidated and unconsolidated basis. The Banking Act requires banks to maintain net assets which, together with other available financial resources, are considered appropriate by the Bank. However, this does not rule out the possibility that a bank may hold some of its capital other than on its own balance sheet, particularly downstream where it is under the bank's control.

26 The Bank is prepared to consolidate certain subsidiaries in computing the 'solo' ratios, specifically where *all* of the following apply:

(i) the subsidiary is at least 75% owned—to ensure complete control (and tax grouping) in most circumstances;

(ii) the management is undertaken by the parent company's own staff;

(iii) it is clear that there are no potential obstacles to the payment of surplus capital up to the bank, in particular taking account of overseas exchange controls, potential legal problems and taxation;

(iv) there is sufficient capital in the bank to fund the fixed assets in its own balance sheet and its investment in its own subsidiaries (this is to ensure that such assets are not funded by deposits);

(v) the subsidiary is wholly funded by the bank itself.

Large exposures

27 The Bank believes that individual exposures should be monitored and controlled both at the group and the individual bank level. In a consultative paper[1] setting out proposals for its policy towards large exposures undertaken by banks, the Bank proposed a limit of 25% of capital base.[2] This limit would apply, except in the most exceptional circumstances, for exposures to individual borrowers and groups of closely related borrowers which are undertaken either by a bank or a bank group. The paper also proposed that banks which are subsidiaries of other banks may be allowed to undertake exposures of up to 50% of capital base provided that, for groups headed by a UK-incorporated bank, the exposure to the borrower remains overall within the 25% of capital base limits for the group and the parent bank.

28 Following consultations with the banking industry and other interested parties, the Bank will issue a paper setting out its detailed policies (including the definition of an exposure) for the monitoring and control of large exposures. These will be applied both to the solo and consolidated positions of a bank.

Foreign exchange exposure

29 In principle it is necessary to supervise the foreign exchange exposure of a group on a consolidated basis in addition to the exposure of an individual bank. The Bank's principal objective initially is to take account of the consolidated foreign exchange exposure in computing consolidated capital ratios rather than to monitor on a day to day basis the consolidated dealing position of a group. The Bank recognises, however, that it is often difficult to obtain all the necessary statistics to carry out a full consolidation. For the present, therefore, it will concentrate on identifying all foreign exchange exposures—trading and structural—throughout a group, but will not require these to be regularly reported in the form of consolidated returns.

Liquidity

30 The Bank recognises that group operations may be carried out in a number of markets which can differ in their legal, regulatory and institutional characteristics, in the stability of deposits and in the range of marketable instruments available to form a stock of liquid assets. A number of these markets may overlap to varying degrees, but the distinctive characteristics of each market mean

(1) *Large exposures undertaken by institutions authorised under the Banking Act 1979.* July 1985.
(2) Adjusted capital base as defined in *The measurement of capital.* 1980.

that they cannot simply be aggregated. Neither a fully centralised nor a fully decentralised approach to the monitoring of liquidity is adequate for all purposes.

31 The Bank believes that the supervision of group liquidity should start from an assessment of the adequacy of liquidity by reference to each market in which a group operates, and with particular regard to the way in which management operates. Once an assessment of each market has been made, an overview can be taken on the extent to which surplus liquidity in some markets can cover possible problems in others, and on the capacity of the central reserve (if any) to provide a breathing space in a crisis. The Bank will wish to discuss with each bank during the course of prudential interviews its liquidity position and policies on a consolidated basis. It is not intended at present to collect consolidated statistical returns for liquidity.

Statistical issues

Risk asset weightings

32 The weightings applied by the Bank to a bank's assets for the purpose of the risk asset ratio are set out in the Bank's paper *The measurement of capital.* These weightings make little distinction between overseas assets of different kinds, for example, claims on governments or the private sector. Such an approach is less justifiable when considering the consolidated position of a group, a substantial part of whose capital and assets is held abroad.

33 In assessing the adequacy of capital on such a basis, therefore, differences in the risks associated with the assets held locally by each subsidiary need to be considered from the point of view of that institution rather than that of the parent company. A distinction between local and non-local assets needs to be applied to the existing weightings in calculating the risk assets of overseas subsidiaries. Accordingly, claims for example on the government of a country held by a subsidiary which is located in that country will be weighted in the same way as are claims on the United Kingdom government by a United Kingdom bank.

Reporting requirements

34 Institutions will be required to provide consolidated data half-yearly. The consolidated returns will be additional to the unconsolidated returns already collected from banks on a monthly and quarterly basis.

35 Initially, the reporting arrangements for most institutions will require the completion of two forms—a new consolidated balance sheet (form CBS), and the existing Q7 form, which was designed for completion on either a consolidated or unconsolidated basis. At this stage, the provision of data regarding foreign exchange exposure or the maturity structure of assets and liabilities will not be required on a consolidated basis.

36 The preparation of consolidated returns raises numerous technical problems of an accounting nature as the choice between alternative accounting practices, such as the valuation rules for assets and liabilities denominated in foreign currencies, can have a significant effect on the assessment of group capital. The accounting problems associated with the consolidation of overseas subsidiaries and associates may be especially acute. The Bank will, therefore, wish to discuss with a bank the accounting policies adopted where these could substantially affect its consolidated returns.

Annex
Activities within banking groups

A Activities which will normally be included in consolidated returns:

bullion trading
business expansion funds management(1)
cheque and voucher trading
commodity broking and trading(2)
provision of executor/trustee services(1)
factoring and invoice discounting
financial/investment advice(1)(2)
hire purchase lending
house mortgage lending
insurance broking(1)(2)
investment/fund management(1)(2)
lease management(1)
leasing
money broking(1)
provision of pension services(1)(2)
securities trading(2)
securities underwriting(2)
trade finance
unit trust management(1)(2)
provision of venture/development capital

[Premises beneficially owned and occupied by a bank but held in a subsidiary company should also be brought within the consolidation, as should subsidiaries whose only activity is to hold accrued profits, usually off-shore.]

B Activities where inclusion in the consolidated returns will depend on the circumstances of the institution concerned:(3)

provision of computer services
diamond dealing/broking
estate agency
general insurance(2)
life assurance(2)
management services
plant hire services
property development/management
shipping agency services
travel agency services

(1) It will only be appropriate to consolidate the balance sheet and profit and loss account of the management company, not the activities or funds managed.

(2) Banks' investment and insurance activities which are carried on through non-bank UK-supervised subsidiaries will not normally be included in consolidated returns but will be taken into account, qualitatively, during the course of consolidated supervision.

(3) These and other non-financial activities will generally only be included in consolidated returns if they are very small in relation to the balance sheet and business of the parent bank and it would be inconvenient to exclude them.