THE BERMUDA MONETARY AUTHORITY

BANKS AND DEPOSIT COMPANIES ACT 1999:

The Approach to Consolidated Supervision

May 2007

Introduction

1. This paper revises and replaces the existing policy guidance set out in 'The Approach to Consolidated Supervision', published in January 2000. It has been the subject of consultation with the banking industry based on proposals set out in a consultation paper published in December 2006.

2. The Bermuda Monetary Authority ('the Authority') is committed to considering carefully, in relation to each institution for which it has lead supervisory responsibility, whether there is a need to conduct consolidated supervision in addition to supervision of the individual licensed entity. Where the result will be a more accurate assessment of the risks to which a licensed institution may be exposed, avoiding the dangers caused by material unregulated operations within financial groups, the Authority conducts such consolidated supervision, liaising with other relevant supervisors as necessary.

3. Consolidated supervision involves an overall evaluation of the strength of a group to which a licensed entity belongs, in order to assess the potential impact of other group companies on the licensed institution. Consolidated supervision may be conducted on either a qualitative or a quantitative basis, or including elements of both. Generally, the Authority expects that the policies and procedures judged prudent for the licensed entity are also applied and enforced, mutatis mutandis, throughout the consolidated group to which it belongs. Quantitative consolidated supervision is based on consolidated financial returns, reflecting an accounting consolidation of the licensed entity with parts or the whole of the group to which it belongs, together with the direct application of consolidated capital adequacy and other prudential requirements. In certain cases, however, accounting consolidation is not meaningful, because of the nature of particular assets and activities conducted in other parts of a group (e.g. where an industrial company is involved, or an entity underwriting insurance risks). In such cases, the Authority undertakes a qualitative consolidated supervision of the group as a whole, focussing on the group's general business and the environment in which it operates, as well as its controls, organisation and management in order to evaluate material risks to the reputation or financial soundness of licensed institutions.

4. The Authority sees consolidated supervision as a complement to, not a substitute for, solo supervision. When conducting quantitative consolidated supervision, therefore, it sets specific capital ratios at both the solo and consolidated levels, against which the institution and group are monitored. Where relevant, large exposures are also monitored and controlled on both a solo and consolidated basis. However, the prime focus of the Authority's supervision remains at all times the licensed institution. The purpose of consolidated supervision is **not** to supervise all the companies within a group, but rather to ensure that the licensed entity is supervised as a part of its group.

5. The Authority maintains through regular review, the overall activities of groups subject to consolidated supervision in order to ensure that it can properly evaluate the risks posed to the licensed institution. Where particular foreign operations conducted within the consolidated group involve a higher risk profile or are conducted under supervisory regimes that differ materially from those in Bermuda, the Authority needs to be satisfied that the institution is able to maintain particularly close oversight and control. Where the Authority has concerns about the risks within an entity within the consolidated group, it is likely to seek to limit the exposure of the licensed institution to that entity or to require additional capital at group level. Where there may be concerns as to the institution's ability to obtain access to the information and data necessary for it to exercise proper oversight and control (eg as a result of local secrecy requirements), the Authority considers whether the minimum licensing criteria may no longer be met as a result of the position of the entity in question. In the most extreme case, the Authority may require the sale or closure of particular overseas operations.

Scope of Accounting Consolidation

6. Broadly, the Authority requires prudential returns reflecting consolidated financial statements for a licensed entity together with all relevant financial companies within the group. Financial companies comprise those entities whose main business significantly involves: ancillary banking services (including owning/managing group properties and real estate); lending; financial leasing; money transmission services; issuing and administering means of payment; issuing guarantees and commitments; trading for own account or account of customers in money market instruments, foreign exchange, financial futures, options, exchange and interest rate instruments and transferable securities; participation in securities issues and related services; merchant banking advice; money broking; portfolio management and advice; and safekeeping and administration of securities. Companies whose activities involve primarily insurance business, insurance broking and commercial/domestic real estate services do not constitute financial companies for this test.

Companies to be Consolidated

7. Consolidation extends to all relevant financial companies within the structure including parents, subsidiaries, sisters and companies or other entities in which group companies have a participation (i.e. ownership of 20% or more of the voting rights or capital).

8. The scope of consolidated returns and, in particular, any exceptions to the standard rules for accounting consolidation must be agreed individually with the Authority beforehand.

Exceptions

9. The Authority may exceptionally agree to permit the exclusion from an institution's consolidated returns of subsidiaries or participations which otherwise meet the criteria for consolidation where:
   i. it believes that consolidation would be inappropriate or misleading;
   ii. the assets in question total less than 1% of the total of the on and off balance sheet assets of the remainder of the consolidated group and can be excluded on the grounds that they are clearly non-material;
   iii. there are legal impediments to the transfer of the full information required for accounting consolidation. (Unless the activities are clearly non-material, such a legal impediment to the proper flow of information is unlikely to be regarded as acceptable other than on a purely short term basis).

10. Where any such exclusions are agreed, the investment concerned is deducted from consolidated capital, and the assets are not included in group weighted risk assets.

Techniques of Accounting Consolidation

11. The Authority normally requires full line by line consolidation of all entities within the group, covering all the assets and liabilities of the companies being consolidated, according to conventional accounting rules including the netting of balances between companies.

12. Exceptionally, however, pro rata consolidation may be permitted in the case of certain participations. This will generally be the case only where the Authority is satisfied that there are other significant shareholders who have the means and the will to provide equivalent parental support to that provided by the licensed institution or its group. In particular, this may be the case where another licensed or regulated institution is involved.

Qualitative Consolidated Supervision

13. In cases where the Authority agrees that it would be inappropriate to implement an accounting consolidation of a licensed institution with the remainder of the group to which it belongs, it requires the institution to ensure that the Authority is provided with such data and information as it considers necessary for the purpose of its qualitative supervision of the licensed institution within its group.

Off-Site and On-Site Supervision

14. In the course of its supervision of licensed institutions within consolidated groups, the Authority maintains under close review the scope of on-site and off-site supervision that is appropriate in relation to overseas operations. Where necessary, additional routine reporting requirements may be put in place. On-site examinations of material overseas operations are also conducted, as part of the Authority's risk-based review schedule.

Home-Host Relationships

15. The Authority establishes and maintains appropriate arrangements with other prudential regulators of licensed institutions and entities within their consolidated groups for the sharing, on a confidential basis, of information on financial condition, performance and compliance of the institutions or entities concerned. Where appropriate, formal cooperation arrangements are put in place eg through suitable memoranda of understanding. In such cases, the scope and nature of the arrangements (but not the detail of the information exchanges themselves) are made known to the institutions affected.