

The Joint Forum

Intra-Group Transactions and Exposures and Risk Concentrations Principles

The Joint Forum, as part of its initial mandate to work towards the development of principles for the future supervision of financial conglomerates, has drafted principles to address supervisory approaches to risk concentrations (RC) and intra-group transactions and exposures (ITE). These principles, if adopted by the Joint Forum's parent organisations after consultation with industry and supervisors, would complement the Joint Forum's already published *Supervision of Financial Conglomerates*, issued in February 1999.

With respect to the form of the documents, the attached Intra-Group Transactions and Exposures and Risk Concentrations principles are being issued as two separate documents. The organisation of the discussion and the principles suggested in the two documents are largely the same. The parallel structure, especially of the principles, reflects that sound risk management practices at conglomerates, complemented by effective supervisory oversight, are necessary to ensure that both ITEs and RCs are properly controlled. Although the parallel structure creates some overlap between the two papers, it should both facilitate comparison and contrast between the principles and allow each document to be used independently.

Since financial conglomerates manage RCs and ITEs as part of the overall risk management process, the Joint Forum has sought to develop principles that reflect the rapid pace of evolution in risk management practices by identifying and drawing on progressive risk management practices. While the proposed principles can be applied by supervisors in the near term, as a practical matter, many financial conglomerates are still developing group-wide risk management approaches that would meet the expectations set out in these documents.

The work of the Joint Forum identified significant differences in the supervisory issues associated with ITEs and RCs, which supervisors may find helpful in evaluating or designing supervisory approaches. Many important differences arise because ITEs represent risk

exposures between legal entities within a conglomerate while RCs represent risk exposures across the conglomerate's legal entities. That is, ITEs constitute a series of bilateral relationships within the conglomerate which to a significant extent can be monitored and controlled at the legal entity level. RCs reflect the combination and interaction of risk exposures across the conglomerate, making a groupwide approach to RCs essential.

The work of the Joint Forum also found that the risks of RCs were more widely understood and monitored by conglomerates and supervisors than the risks of ITEs. All the conglomerates interviewed for this study had risk management processes to identify RCs at the banking, securities and insurance sector levels, and some had developed approaches at the conglomerate level. By contrast, many conglomerates interviewed monitored ITEs only to the extent required by regulators, although a few had developed comprehensive approaches to managing and monitoring ITEs throughout the conglomerate. An important observation of this study is that those conglomerates that developed comprehensive approaches to ITEs did so as part of their overall process of corporate governance and internal control.

For ITEs, the principal supervisory concern involves the transactions and risk exposures of regulated entities with other entities in the conglomerate. Supervisory frameworks are intended to protect regulated entities from ITEs that can weaken the entities' financial condition. Most frameworks are designed to prevent harmful ITEs before they can occur, by having in place various restrictions on movements of capital, funding and assets and requirements for regulatory approval. Regulatory reporting and on-site or off-site supervisory review are other important elements of the framework. While some types of ITEs, such as risk management transactions and servicing agreements, have become more important in financial conglomerates, the issues they present are largely the same as those associated with transfers of capital, funding and assets. A key finding of the work on ITEs, therefore, is that supervisory approaches in place in the banking, securities and insurance sector should be expected to remain largely effective in a conglomerate context when augmented by supervisory cooperation.

The principal concern for RCs is that concentrations can emerge at the conglomerate level, which can affect the financial condition of regulated entities. These concentrations can take

the form of large aggregate exposures across the firm's legal entities. However, increasingly conglomerates and supervisors are focusing on more analytically complex concentrations that reflect the interaction of risk factors or the presence of common risk factors in seemingly unrelated portions of business. Most supervisory frameworks at the sector level effectively limit certain types of large exposures, but virtually all expect firms to have sound risk management processes to manage and monitor concentrations. The study found that effective risk management of concentrations within conglomerates requires a group-wide risk management process with clearly assigned responsibility for monitoring concentrations at the group level. Similarly, supervisors need to conduct a group-wide assessment of concentrations. Such assessment should highlight supervisors' information needs about concentrations at the conglomerate level, which can be developed through information provided by the conglomerate or through supervisory cooperation and information sharing.