COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES

BS/79/30e revised

The treatment of minority participations in the consolidation of banks' balance sheets

In October 1978 the Committee on Banking Regulations and Supervisory Practices submitted a report to the Governors of the Group of Ten countries and Switzerland on the consolidation of banks' balance sheets as a method of supervising bank solvency (BS/77/52, 3rd revision). While concluding that the capital adequacy and risk exposure of banks and their affiliates can most satisfactorily be monitored on the basis of consolidation of risk assets, the paper mentioned (page 4) a number of operational difficulties in stipulating which interests should be consolidated and in what proportion. Attention was drawn to the treatment of less than wholly-owned interests and it was stated that the question was on the future agenda of the Committee. The purpose of this note is to summarise the points of agreement that emerged from the subsequent discussion as well as those areas where there are differences of opinion.

The first point to be noted in this connection is that the Committee does not consider that those of their banks' minority interests which are not at present consolidated or supervised to some degree constitute a significant leakage in the supervisory system as a whole. Such minority interests can, however, be important for an individual bank.

As regards the treatment of minority interests (i.e. those up to and including 50 per cent. of the share capital) in any consolidation procedure, the Committee is agreed on certain principles. The first of these is that consolidation is only appropriate in the case of financial interests, i.e. those with a gearing capability (as demonstrated in Appendix 1 of BS/77/52). Secondly, it is agreed that there is no advantage to be gained by requiring very small interests to be consolidated and that their exemption would reduce the banks' reporting burden. There are, nevertheless, different opinions over what the appropriate threshold should be or whether it is even necessary for a common threshold to be applied universally (in practice, the Netherlands sets the threshold at 10 per cent. and Canada and Japan at 20 per cent.). There might also be a case for relating such a threshold to the national equity accounting threshold above which an investing bank is entitled to absorb the proportionate share of a subsidiary's earnings, and not just its dividend alone (this threshold is currently 20 per cent. in the United Kingdom and the United States). One factor which deserves consideration in the choice of a minimum threshold is that joint ventures, which can quite often represent a substantial investment for an individual bank, commonly have six or seven equal shareholders. Thirdly, the Committee agrees that consolidation should be a reflection of responsibility. In other words, the extent to which a subsidiary's balance sheet is merged into that of the parent bank should be dependent on the potential liability which may arise, bearing in mind that this can substantially exceed the book value of its investment. Finally, the Committee is agreed that by one means or another the capital of a bank with an investment in a financial company should be adjusted to reflect the risk associated with the investment and that where these interests are not consolidated one possible course would be to deduct the book value of such an investment from the parent bank's capital.

On the practical handling of minority interests in a bank's consolidation procedures, there are two schools of thought in the Committee. One view is that no uniform rules for the treatment of such participations should be applied, but that the supervisor should take into account the individual features of each minority interest on a case-by-case basis in his assessment of the parent bank. The supporters of this view point to the following considerations which in their opinion make it impractical to consider minority interests in a rule-of-thumb way:

- the nature of the investment itself, i.e. whether it is an interest where the involvement is essentially passive, or whether it is inherently linked to the parent bank's active business and therefore of an "operational" nature. The question of voting rights may be relevant in this context.
- the importance of the subsidiary interest to the investing bank. Whatever the size of a participation, the shareholder bank is likely to be in principle disposed to inject additional funds rather than to risk damage to its own reputation.

- the financial strength of the other shareholders and whether they are also banks (who would presumably be equally concerned about their reputation). In this respect, any contract or understanding between the shareholders about relative responsibilities would be relevant.
- in the case of establishments abroad, the nature of the supervision system under which the venture operates and whether the capital requirements there are considered adequate.

An alternative view is held by members in whose countries consolidation of minority interests is undertaken on a pro-rata basis, where it fits into the framework of their system of solvency ratios. These members accept the validity of the points mentioned in the previous paragraph, but are of the opinion that it may be very difficult in practice to decide the exact weight to be given to particular characteristics, e.g. the nature of the investment or the measurement of potential exposure. For this reason, they advocate pro-rata consolidation as a first indicator of a bank's responsibility. This does not, they point out, preclude a degree of assessment being exercised on an ad hoc basis in individual cases; indeed certain of these countries do this as a matter of course where the minority holding is not insignificant.

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