



SOUTH AFRICAN RESERVE BANK  
Prudential Authority

## **DRAFT FOR FORMAL CONSULTATION – OCTOBER 2020**

### **Prudential Standard FC05**

#### **Risk concentration requirements for financial conglomerates**

##### ***Objectives and key requirements of Prudential Standard FC05***

*This Standard is made in terms of section 164 read with sections 105 and 108 of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) and requires the holding company to operate within the principles and comply with the requirements relating to risk concentrations for financial conglomerates.*

*It is the responsibility of the board of directors (board) of the holding company to ensure that the financial conglomerate meets the requirements on risk concentration on a continuous basis.*

*This Standard highlights the Prudential Authority's requirements in terms of the identification and management of risk concentration within the financial conglomerate and sets down the reporting requirements for exposure to single counterparties or groups of connected counterparties.*

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## 1. Commencement

- 1.1 This Standard commences on 1 January 2022 (proposed).

Version number	Commencement date
1	1 January 2022 (proposed)

## 2. Legislative Authority

- 2.1 This Standard is made under section 164 read with sections 105 and 108 of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act).

## 3. Application

- 3.1 This Standard applies to the holding company of a financial conglomerate as designated by the Prudential Authority in terms of section 160(1) read with section 160(2) of the FSR Act.
- 3.2 Where a responsibility is placed on the holding company in terms of this Standard, it must be discharged by the board of the holding company and in respect of all the entities within the financial conglomerate.
- 3.3 This Standard applies in addition to the financial sector laws applicable to specific financial institutions within the financial conglomerate. The requirements in this Standard do not derogate from any existing concentration risk requirements contained in other financial sector laws applicable to a financial institution within the financial conglomerate and must therefore be read with such other financial sector laws which impose requirements on monitoring and measuring risk concentration.

## 4. Definitions and interpretation

- 4.1 The terms used in this Standard, unless indicated otherwise, are defined in the FSR Act and the financial sector laws, and have the same meaning in this Standard.

**‘auditor’** means a registered auditor as defined in the Auditing Profession Act, 2005 (Act No. 26 of 2005);

**‘board’** means the board of directors of the holding company;

**‘holding company’** means the holding company of the financial conglomerate as designated by the Prudential Authority in terms of section 160(1) read with section 160(2) of the FSR Act;

**‘member of the financial conglomerate’** refers to a company that has been scoped into the financial conglomerate but excludes the holding company;

**‘significant institution’** is any institution within the financial conglomerate which assets contribute to at least 10 per cent of the total assets of the financial conglomerate; and

Two or more natural or juristic persons are deemed to be **‘a group of connected counterparties’**, if at least one of the following criteria is satisfied:

- (a) Control relationship: One of the counterparties, directly or indirectly, has control over the other(s); or
- (b) Economic interdependence: If one of the counterparties were to experience financial difficulties, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter similar difficulties.

- 4.2 The ‘Objectives and key requirements of Prudential Standard FC05’ that are italicised in the preamble of this Standard must not be used in the interpretation of any paragraph of this Standard.

## **5. Roles and responsibilities**

- 5.1. The board is ultimately responsible for ensuring that the financial conglomerate complies with the principles and requirements of this Standard.
- 5.2. Where a financial conglomerate’s control functions are required to perform certain functions in terms of this Standard, the board must ensure that the control functions regularly review and report to the board on the financial conglomerate’s compliance with this Standard.
- 5.3. If requested to do so, the board and/or auditor of the financial conglomerate must provide assurance to the Prudential Authority that the financial conglomerate complies with the requirements of this Standard.

## **6. Principles underlying risk concentration**

- 6.1. For the purpose of this Standard, risk concentration arises from activities of the financial conglomerate that has the potential to result in material losses which may threaten the safety and soundness of eligible financial institutions and consequently results in the inability to meet its obligations.
- 6.2. Risk concentrations can arise from a financial conglomerate’s assets, liabilities or off-balance sheet commitments, through the execution or processing of transactions (either financial product or service), or through a combination of exposures across these broad categories. Risk concentrations can therefore take many forms, and may include, but are not limited to:
  - (a) exposures to individual or single counterparties;
  - (b) exposures to group of connected counterparties;
  - (c) exposures to counterparties in the same industry, economic sector or geographic region;
  - (d) exposures to counterparties where the financial performance of these counterparties are dependent on the same activity or commodity;
  - (e) exposures arising from risk mitigation activities;
  - (f) liquidity risk;
  - (g) funding sources;

- (h) exposures arising from trading activities;
- (i) equity exposures;
- (j) specific assets or instruments such as structured products;
- (k) off-balance sheet commitments, such as guarantees and liquidity lines;
- (l) operational risk, such as service providers and outsourcing;
- (m) natural disasters or catastrophes; and/or
- (n) correlation between any of the aforesaid risks, counterparties, instruments, assets, liabilities and/or commitments.

6.3. The combination of different activities of members of the financial conglomerate may give rise to new risk concentrations at the financial conglomerate level. Therefore, the financial conglomerate should, where appropriate, give due consideration to scenario analysis and conducting stress testing on risk concentration exposures to assess the impact of these risks on the financial conglomerate.

## **7. Requirements underlying risk concentration policy**

7.1 A financial conglomerate must have a risk concentration policy in place that gives consideration to the identification, measurement, management and monitoring of, and reporting on, risk concentration exposures associated with all material risks to which the financial conglomerate is exposed.

7.2 The board or a board committee established for such a purpose, is responsible for, at a minimum:

- (a) approving the risk concentration policy;
- (b) reviewing the risk concentration policy at least annually;
- (c) ensuring that adequate systems and controls are in place to identify, measure, monitor, report, and mitigate the types of risk concentration the financial conglomerate is exposed to, which must form part of the financial conglomerate's broader risk management framework<sup>1</sup>, including scenario analysis and stress testing;
- (d) continuously monitoring risk concentration, which must include receiving an aggregated view of the risk concentration. Reports on the aggregated view of the risk concentration must be made available to the Prudential Authority on request; and
- (e) ensuring that the financial conglomerate complies with the risk concentration policy.

7.3 The risk concentration policy of a financial conglomerate must, at a minimum:

- (a) be conceptually sound and transparent as well as subjected to review by internal audit or auditors of the financial conglomerate;
- (b) be consistently implemented across the financial conglomerate to ensure that all members of the financial conglomerate are taken into consideration;
- (c) include a description of the procedures for identifying, measuring, monitoring, reporting, and mitigating the types of risk concentrations to

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<sup>1</sup> Reference should be made to the Governance and Risk Management Prudential Standard (FC04).

which the financial conglomerate is exposed. This must at a minimum, include:

- (i) a clear statement of the respective responsibilities and compliance obligations of the board, board committees and senior management of the financial conglomerate in relation to the monitoring and management of risk concentrations;
  - (ii) procedures for reporting on and authorising risk concentration policy and internal limit breaches;
  - (iii) the frequency of reporting to the board on the aggregate view of risk concentration within the financial conglomerate;
- (d) capture all types of risk concentration as specified in paragraph 6.2 to which the financial conglomerate is exposed; and
- (e) where appropriate, specify internal limits for specific types of risk concentrations, where the limits are commensurate with the financial conglomerate's business operations, structure, risk appetite and tolerance as well as the size, nature and complexity; and include a description of the process relating to formulating scenarios and conducting stress testing on risk concentration exposures to assess the impact on the core operations of the financial conglomerate.

## **8. Reporting requirements for exposures to single counterparties or groups of connected counterparties**

- 8.1. A financial conglomerate must report its largest exposures to single counterparties or groups of connected counterparties to the Prudential Authority on a semi-annual basis.
- 8.2. The exposure amount to single counterparties or groups of connected counterparties must include both on- and off-balance sheet exposures as well as any equity exposures. The exposure amount shall be calculated as follows:
- (a) for an eligible financial institution within the financial conglomerate which is licensed as a bank or a controlling company in terms of the Banks Act, 1990 (Act No. 94 of 1990), the exposure amount (bank<sub>i</sub>) should be based on the large exposure framework as prescribed by the Regulations relating to Banks, where the exposure amount would be the gross exposure amount.
  - (b) for an eligible financial institution within the financial conglomerate which is licensed as an insurer or an insurance group in terms of the Insurance Act, 2017 (Act No. 18 of 2017), the exposure amount (insurer<sub>i</sub>) should be based on the Prudential Standards made in terms of the Insurance Act, insofar as it relates to concentration risk. The exposure amount should also be considered before any risk adjustments are made.
  - (c) for any other member of the financial conglomerate or the holding company, other than eligible financial institutions specified in subparagraphs (a) and (b) above, the exposure amount (other<sub>i</sub>) would be the sum of the amount outstanding and other off-balance sheet commitments made.
- 8.3. For each significant institution within the financial conglomerate the holding company must determine:

- (a) the 10 largest exposures to a single counterparty or group of connected counterparties, where the exposure amount must be calculated as specified in 8.2 above; and
  - (b) whether any members of the financial conglomerate (whether significant or not) also have an exposure to any of the 10 largest single counterparties or group of connected counterparties as determined by paragraph 8.3.(a) above.
- 8.4. To determine the aggregate exposure of the financial conglomerate to the single counterparty or group of connected counterparties ( $E_i$ ), the exposure to the single counterparty or group of connected counterparties must be aggregated across the members of the financial conglomerate as well as the holding company that is:

$$E_i = \Sigma (\text{Bank}_i; \text{Insurer}_i; \text{Other}_i)$$

- 8.5 Instead of, or in addition to, the requirements in paragraphs 8.1 to 8.3, the holding company may be required to report on exposures to single counterparties or groups of connected counterparties exceeding a threshold as may be determined by the Prudential Authority.
- 8.6 The form and manner of regulatory reporting returns will be determined by the Prudential Authority and published on its website.

## **9. Matters related to exempt exposures**

- 9.1 The following exposures will be exempted from the reporting requirements, defined in paragraph 8:
- (a) any intragroup transactions or exposures that is subject to the requirements specified in Prudential Standard FC02; or
  - (b) any other exposure specified in writing by the Prudential Authority.

## **10. Regulatory action**

- 10.1 If in the view of the Prudential Authority, the financial conglomerate has not complied with the principles and requirements of this Standard, the Prudential Authority may take appropriate regulatory action.