

To: All prospective and registered: Co-operative financial institutions and co-operative banks

Guidance Note 2/2020 issued in terms of section 45(e) of the Co-operative Banks Act, 2007 (Act No. 40 of 2007)

Guidelines in relation to the common bond requirement

Executive Summary

Prudential standard – TCFI-01 – Transitional arrangements for co-operative financial institutions specifies the requirements for registration of a co-operative financial institution with the Prudential Authority in terms of the provisions of the Co-operative Banks Act, 2007 (Act No. 40 of 2007).

This Guidance Note is issued to assist prospective and registered co-operative financial institutions by providing guidance on the common bond requirement, as per Form 001 as well as dealing with the common bond in the finalisation of the constitution of a co-operative financial institution.

This Guidance Note is also applicable to prospective and registered co-operative banks.

1. Interpretation and definitions

- 1.1 This guidance note should be read in conjunction with the following legislative frameworks:
 - 1.1.1 The Co-operatives Act, 2005 (Act No. 14 of 2005) (Co-operatives Act);
 - 1.1.2 The Co-operative Banks Act, 2007 (Act No. 40 of 2007) (Co-operative Banks Act);
 - 1.1.3 the Regulations issued under the Co-operative Banks Act as well as the Supervisors' Rules;
 - 1.1.4 The Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act);
 - 1.1.5 Prudential Standard – TCFI-01 – Transitional arrangements for co-operative financial institutions (Prudential Standard - TCFI-01);
 - 1.1.6 Guidance Note 1 of 2019;
 - 1.1.7 Guidance Note 2 of 2019; and
 - 1.1.8 Guidance Note 1 of 2020.

- 1.2 All terms used in this guidance note have the same meaning as defined in the above-mentioned legislative frameworks, unless the context indicates otherwise.

2. Introduction

- 2.1 Co-operative financial institutions (CFIs) and co-operative banks in South Africa are restricted from taking deposits from the general public due to licence limitations that only permit them to serve a membership that is characterised by a 'common bond', which is founded on a pre-existing social connection, such as belonging to a particular community, industrial or geographic group. The common bond is considered an explicit characteristic which distinguishes the co-operative banking model from other financial institutions.
- 2.2 Specifically, section 1 of the Co-operatives Banks Act defines a "co-operative bank" as a co-operative or a co-operative financial institution registered as a co-operative bank in terms of the Co-operative Banks Act whose members-
- (a) are employed by a common employer or who are employed within the same business district; or
 - (b) have common membership in an association or organisation, including a religious, social, co-operative, labour or educational group; or
 - (c) reside within the same defined community or geographical area.
- 2.3 The objective of this Guidance Note 2/2020 (Guidance Note) is to provide guidance on the common bond to assist prospective and registered CFIs and co-operative banks in meeting and continue meeting the requirements for registration. An extensive discussion of the common bond was published by the Co-operative Banks Development Agency (CBDA) in 2013. The document can be found on the website of the CBDA by following the link below: <http://www.treasury.gov.za/coopbank/supervisory%20CFIs/guidancenotes/Briefing%20note%20on%20common%20bond.pdf>
- 2.4 '*TCFI-01 Form 001 Application for registration*' requires that an applicant provide the Prudential Authority (PA) with the common bond description.
- 2.5 Prospective and registered CFIs and co-operative banks are also required to provide a description of their common bond adopted by its members, in their constitutions.

3. Diversity of types of bonds

- 3.1 There are several distinct types of bonds, corresponding to the types of financial co-operatives. Some international examples include **parish-based bonds**, **community-based**, **employee-based**, **out-growers** (farmers), being a member of a **bona fide organisation** or being otherwise associated with other members of the society for a purpose **other than that of forming a society to be registered as a credit union**.

- 3.2 Although the common bond has not been restricted to any specific type of bond, this requirement has been an integral feature of virtually all financial co-operatives since their earliest recorded examples.
- 3.3 It is clear from the preceding description that the common bond is usually associational, occupational or residential.
- 3.4 The requirement to belong to a common bond is seen as a cornerstone in the success of financial co-operatives, as the social pressure that is created by the members knowing each other, lessens the risk of default, especially in its start-up phase. From a prudential regulation perspective the common-bond is critical to assessing the risk profile of the CFI and the co-operative bank and applying proportional regulation and supervision. If a common bond did not exist, the prudential regulation and supervision will be heightened through increased supervisory interventions and higher capital and operational requirements.
- 3.5 The PA recognises that the industry may be reluctant to make any change to their basic structure to satisfy the requirement for a common bond or may be of the view that the common bond is a constraint to their growth, and encourages the sector to engage with the PA on how to apply for the common bond to be reviewed as CFIs and co-operative banks gain traction in the sector and grow.
- 3.6 It must be noted from a risk management perspective that a common bond for the purposes of an application to the PA cannot extend over borders and large geographical areas (rendering the common bond irrelevant) as such physical distance between members makes it more difficult to apply social pressure which potentially increases the risk profile of the CFI or co-operative bank.

4. Assessment of common bond by the Prudential Authority

- 4.1 A prospective CFI and co-operative bank will need to demonstrate to the PA that it has:
- 4.1.1 adequately engaged with the potential members of its chosen common bond in order to ascertain that the common bond is indeed established;
 - 4.1.2 it is from the identified common bond that the CFI or co-operative bank will be drawing its membership; and
 - 4.1.3 the common bond makes for a compelling business case for the establishment of a viable and sustainable entity.
- 4.2 The following table provides examples of acceptable common bonds for each of the common bonds types mentioned in paragraphs 2 and 3 and examples of the expected level of engagement with prospective members.

Type	Description	Engagement
Common employer or employed within the same district	<ul style="list-style-type: none"> - employees of the “Name” company Pty Ltd and “Name 2” company Pty Ltd. Adding additional common employer(s) should be read in conjunction with paragraph 5 below. - employees working in the “Name” business district, town centre or an (singular) industrial area of a town or city. 	A prospective CFI or co-operative bank should at a minimum be able to provide to the Prudential Authority the comfort that it engaged the common employer company and the employees and has adequate employee commitment to establish a viable and sustainable CFI or co-operative bank.
Common membership in an association or organisation, including a religious, social, co-operative, labour or educational group	<ul style="list-style-type: none"> - members of the “Name” trade union, “Name” parish, employees and students of the “Name” FET¹ or university, members of the “Name” co-operative or staff and volunteers of the “Name” society. <p>The associations must be registered with an appropriate body and within itself be reflective of a defined membership with a common interest that can be verified by the Prudential Authority.</p>	The applicant CFIs or co-operative bank should at a minimum be able to provide to the Prudential Authority the comfort that it engaged the host association and its members and has members’ commitment to establish a viable and sustainable CFI or co-operative bank.
Persons residing within the same defined community or geographical area	<ul style="list-style-type: none"> - all residents who live and work in the “Name” village; and - all the residents of the “Name” suburb/township. <p>The Prudential Authority’s interpretation of persons residing within the same defined community or geographical area requires that applicants include the specific (defined) district community, which could be either rural or urban. The Prudential Authority will not focus on the geographical boundaries classified by provincial or</p>	An applicant CFI or co-operative bank should at a minimum be able to provide to the Prudential Authority the comfort that it engaged and consulted the community or geographical area in which it proposes to operate. Evidence should be provided from community members, leaders and / or officials that shows commitment to establish a viable and sustainable CFI or co-operative bank.

¹ FET – Further Education and Training Institutions

	<p>national legislation per se, but on what attributes define the proposed community and the bond amongst residents.</p> <p>Metropolis and cities are not considered communities nor are residential districts as they are amalgamations and mergers of municipalities and districts.</p>	
--	---	--

5. Applications to extend common bonds

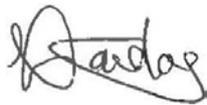
- 5.1 CFIs or co-operative banks must apply to the PA to extend their common bonds as they become saturated or seek to extend the membership of their initial common bond.
- 5.2 In such cases CFIs or co-operative banks must apply to “open” their bonds of association. Typically this would initially be to allow family members to join, thereafter expand into a geographic area, or alternatively to allow additional employer or associational groups to join/merge with an existing CFI or co-operative bank.
- 5.3 The regulatory effect of an open bond may attract higher capital and prudential requirements. This is as a result of increased risk as the CFI’s or co-operative bank’s reliance on the mutuality relationship predominant in ‘closed bond’ CFIs or co-operative bank is replaced by a need for skills in credit and other risk appraisals. In other words, common bond restrictions are assumed to reduce the cost of gathering credit information, thereby minimizing exposure of individual CFIs or co-operative bank to bad debt losses.
- 5.4 In considering whether to approve the opening of a common bond, the PA will assess the potential increase in risk, and the necessary features that need to be put in place to mitigate such risk.
- 5.5 The PA may also require additional capital to be held by the CFI based on its risk assessment.

6. Contact

- 6.1 A prospective or registered CFI or co-operative bank requiring assistance with their common bond may contact:
- 6.1.1 The CBDA by sending an e-mail to: CBDA@treasury.co.za; or
- 6.1.2 The PA by sending an e-mail to SARB-PA@resbank.co.za with the subject line: CFI/Co-op Bank – Registration Assistance.

7. Acknowledgement of receipt

- 7.1 Kindly ensure that a copy of this guidance note is made available to your institution's board of directors, and where applicable, external auditor. The attached acknowledgement of receipt, duly completed and signed by at least two directors, should be returned to the PA at the earliest convenience of the aforementioned signatories.



Kuben Naidoo
Deputy Governor and CEO: Prudential Authority

Date: 25 June 2020

The previous guidance note issued was Guidance Note 1/2020, dated 2 March 2020.