



SOUTH AFRICAN RESERVE BANK
Prudential Authority

DRAFT FOR FORMAL CONSULTATION– OCTOBER 2020

Statement¹ of the need for, expected impact and intended operation of a regulatory instrument:

Prudential Standard on Governance and Risk Management requirements for Mutual Banks

October 2020

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¹ This statement is prepared and published in accordance with and in fulfilment of the requirements under section 98(1)(a)(ii) and (ii) of the Financial Sector Regulation Act, No. 9 of 2017

1 Introduction

- 1.1 The proposed prudential standard on governance and risk management for mutual banks seeks to articulate the Prudential Authority's (PA, or the Authority) expectations in relation to the minimum standard of governance and risk management for mutual banks registered in South Africa.
- 1.2 The recent failure of a long standing institution such as VBS Mutual Bank highlighted the importance of having an effective governance framework in the bank, and that takes cognisance of the risk management structures. The findings of the forensic investigation² initiated by the Chief Executive Officer of the PA in April 2018 emphasised the role of the board of directors of the bank which contributed directly in the institution found to be conducting its business in a fraudulent manner, and consequently led to its failure, resulting in adverse outcomes for depositors.
- 1.3 Proper governance is an integral part of the risk management and internal controls of the mutual bank, and it is the responsibility of the board of directors to ensure the prudent management and oversight of the activities of the mutual bank. However lessons learnt from the recent bank failure, coupled with the evolving business models of modern mutual banks, have highlighted shortcomings in the regulatory framework that inhibit and limit the ability of the PA to apply an appropriate level of supervisory intensity and intervention that takes account of the evolving nature of the business and activities of the financial institutions which contribute to their increased risk profile.
- 1.4 The primary objective of the PA is to ensure that financial institutions are safe and sound and that they are able to meet their obligations to financial customers³. To achieve its objective, the PA must take into account the need for a primarily pre-emptive, outcomes focused and risk-based approach to regulation and supervision. The proposed standard will assist the Authority in achieving its regulatory objective.
- 1.5 Section 105 of the FSRA empowers the PA to make prudential standards on matters in respect of financial institutions that provide financial products and key persons of

² Motau, T., (2018) *VBS Mutual Bank – The Great Bank Heist: Investigator's Report to the Prudential Authority*, Available: https://www.resbank.co.za/Lists/News_and_Publications/Attachments/8830/VBS_Mutual_Bank_-_The_Great_Bank_Heist.pdf

³ This objective is set out in section 33 of the Financial Sector Regulation Act (FSRA)

such financial institution which it has the power to make. In addition, standards may be made on matters specified in section 108, which include:

- 1.5.1 fit and proper person requirements;
 - 1.5.2 corporate governance, and matters related to the roles and responsibilities of governing bodies;
 - 1.5.3 the appointment, duties, responsibilities, remuneration, reward, incentive schemes of members of governing bodies and key persons;
 - 1.5.4 the suspension and dismissal of members of governing bodies and key persons; and
 - 1.5.5 risk management and internal control functions.
- 1.6 The board of directors of the mutual bank must put in place a corporate governance framework, supported by the board-approved risk management framework, that documents clear lines of responsibility and accountability within the financial institution, and enable the monitoring of risks to ensure that the mutual bank effectively delivers on its obligations to stakeholders. These requirements are designed to ensure that there is continuous monitoring of the bank's activities so that it does not undermine the prudent management of the business.

2 Statement of need

- 2.1 Good governance and risk management are fundamental aspects of operating a mutual bank. The proposed standard is therefore intending to set out the minimum governance requirements expected to be complied with by mutual banks, particularly the with regard to culture, the roles and responsibilities of the board of directors and board committees, the appointment of the members of the board of directors, the conduct of directors and executive officers, fitness and propriety of directors and executive officers, internal controls, control functions, outsourcing, remuneration, managing conflicts of interest, related party transactions and required disclosures. These requirements are aimed at enhancing governance and risk management by the mutual bank, and include requiring the board to establish a directors' affairs committee to assist the board in determining and evaluating the adequacy and efficiency of the corporate governance structure at the mutual bank,

as well as establishing appropriate remuneration policies and practices that are aligned with the bank's culture, strategies, risk appetite and long term interests.

- 2.2 The board of directors must furthermore develop and implement a code of conduct for its directors, senior managements and employees that uphold the highest standards of honesty and ethical conduct. The board and management of the mutual bank by law stand in a fiduciary relationship to the bank and must act honestly and in good faith, in the best interest of the institution, its members (the shareholders) and depositors, and must entrench an ethical culture within the organisation.
- 2.3 The board is responsible for ensuring that the mutual bank complies with all the requirements and principles of good governance, and must exercise oversight on the affairs of the bank. This requires the board to understand the risks associated with the business activities of the bank, and the impact on the integrity and the safety and soundness of the institution. Among its responsibilities, the board must ensure that key areas of governance are effectively managed. These include ensuring that the mutual bank has a clear strategic plan to ensure the sustainable creation, protection and return of value for members. The board retains ultimate responsibility for managing the mutual bank's risks, and must develop and implement a risk management framework that enables the recognition, identification and evaluation of risks involved in the mutual bank's business operations.
- 2.4 In terms of section 98 of the Financial Sector Regulation Act (FSRA), a financial sector regulator must not make a regulatory instrument⁴ unless it has published the following documents:
- 2.4.1 a draft of the regulatory instrument;
 - 2.4.2 a statement explaining the need for and the intended operation of the regulatory instrument;
 - 2.4.3 a statement of the expected impact of the regulatory instrument; and
 - 2.4.4 a notice inviting submissions in relation to the regulatory instrument, stating where, how and by when submissions are to be made.

⁴ For the purpose of this Statement, this refers to a prudential standard

- 2.5 In fulfilment of the above-mentioned requirements, the statement of the need for, intended operation and expected impact of the draft prudential standard on governance for mutual banks is intended to communicate to all relevant stakeholders the intended application of the standard, to assist regulated institutions in interpreting and complying with the requirements contained in the standard, and to gauge the expected benefits and costs to the institutions in relation to the compliance with the standard.

3 Statement of expected impact

Cost and expected benefit implications of the standard

- 3.1 The standard will apply to all mutual banks. It is expected that the standard will place an administrative burden on mutual banks, and may potentially result in increased ongoing compliance costs. However the standard is necessary and is expected to yield enhanced efficiency, oversight and governance of mutual banks.

4 Consultation

- 4.1 The Prudential Authority is releasing the draft '*Prudential Standard on Governance and Risk Management for Mutual Banks*' for public comment, together with a questionnaire to solicit for industry input on the expected impact of the draft prudential standard.
- 4.2 The Authority is requesting industry feedback on the questionnaire, on the expected impact of the governance and risk management requirements that are to be implemented in the standard. Written submissions on the questionnaire in accordance with the Notice of Invitation, may be sent on or before **25 November 2020** via e-mail to PA-Standards@resbank.co.za for the attention of Ms Petula Sihlali.