

SOUTH AFRICAN RESERVE BANK  
Prudential Authority

# **Statement of the need for, expected impact and intended operation of the proposed prudential standards on the regulation and supervision of financial conglomerates**

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## List of acronyms

<b>BCBS</b>	Basel Committee on Banking Supervision
<b>FSAP</b>	Financial Sector Assessment Program
<b>FSB</b>	Financial Stability Board
<b>G20</b>	Group of Twenty
<b>SIFIs</b>	Systemically Important Financial Institutions
<b>IAIS</b>	International Association of Insurance Supervisors
<b>IMF</b>	International Monetary Fund
<b>IOSCO</b>	International Organization of Securities Commissions
<b>MI</b>	Market Infrastructure
<b>PA</b>	Prudential Authority
<b>QIS</b>	Quantitative Impact Study
<b>SARB</b>	South African Reserve Bank

## 1. Introduction

- 1.1. The mandate of the Prudential Authority (PA) is to promote and enhance the safety, and soundness of regulated financial institutions and market infrastructures. In addition, the PA has a responsibility to assist the South African Reserve Bank (SARB) in maintaining financial stability.
- 1.2. The PA currently supervises financial institutions (particularly banks insurers) and market infrastructures on a solo (level 1) and/or consolidated/group supervision basis (level 2). The promulgation and commencement of the Financial Sector Regulation Act 9 of 2017 (FSR Act) created the framework for financial conglomerate<sup>1</sup> regulation and supervision. This is one of the fundamental areas of financial sector regulatory reforms introduced by the FSR Act.
- 1.3. Sections 105 and 164 of the FSR Act empower the PA to issue prudential standards<sup>2</sup> (Standards) with which financial conglomerates designated in terms of section 160 of the FSR Act must comply.
- 1.4. In accordance with the provisions under the FSR Act, the PA is putting in place a regulatory and supervisory framework for large and complex financial groups (financial conglomerates)<sup>3</sup> at the conglomerate level (level 3 supervision). Together with this Statement, the PA has published four sets of draft Standards on the regulation and supervision of financial conglomerates, as follows:
  - Prudential Standard FC02–Intragroup transaction and exposures;
  - Prudential Standard FC03–Auditor requirements for holding companies of financial conglomerates;
  - Prudential Standard FC04–Governance and risk management for financial conglomerates; and
  - Prudential Standard FC05–Risk concentrations for financial conglomerates
- 1.5. The FSR Act requires the PA to publish the following documents before making a prudential standard (regulatory instrument): a draft of the regulatory instrument; a statement explaining the need for and the intended operation of the regulatory

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<sup>1</sup> The FSRA defines a financial conglomerate as a group of companies designated as a financial conglomerate in terms of section 160 of the FSRA.

<sup>2</sup> These may include requirements with respect to intra-group exposures, governance, reporting as well as risk management.

<sup>3</sup> Must include both an eligible financial institution (this can be a bank, insurer or market infrastructure) and a holding company of the eligible financial institution.

instrument; a notice inviting submissions to the regulatory instrument, stating where, how and by when submissions are to be made; and a statement of the expected impact of the regulatory instrument.

- 1.6. In line with the above-mentioned legislative requirements for making regulatory instruments, the PA prepared this 'Statement of the need for, intended operation and expected impact (Statement or Report) of the proposed prudential standards on the regulation and supervision of financial conglomerates' highlighted in paragraph 1.4 above.
- 1.7. The Statement articulates the need for, expected impact and intended operation of the proposed prudential standards on the regulation and supervision of financial conglomerates. It also sets out the approach that has been undertaken by the PA to implement the financial conglomerate regulatory and supervisory framework in South Africa.
- 1.8. This report has been prepared having collated and analysed the responses<sup>1</sup> received to a questionnaire that was circulated to the industry by the PA during the informal consultation process, to solicit industry inputs on the expected impact of implementing the proposed prudential standards.

## **2. Background**

- 2.1. In 2008, the Group of Twenty (G20) leaders requested that the standard-setting bodies review the scope of financial regulation, with particular focus on unregulated institutions, instruments and markets. This call also sought to ensure that all systemically-important financial institutions (SIFIs) are appropriately regulated.
- 2.2. In response to this call by the G20 leaders, the Financial Stability Board (FSB), in collaboration with the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), tasked the Joint Forum to address the request by the G20.

2.3. In 2010, the Joint Forum<sup>4</sup> finalised its assigned task and compiled a report<sup>5</sup> to help identify potential areas where systemic risks may not have been fully captured in the regulatory framework and to make recommendations accordingly.

2.4. The Joint Forum sought to shed light on some of the major sources of systemic risks that emerged from the 2008 global financial crisis. The regulation and supervision of financial groups is one of the areas that were scrutinised and key observations by the Joint Forum were as follows:

- Different jurisdictions applied different treatments to unregulated entities when calculating group capital adequacy;
- differences observed in the treatment of inter-group exposures, including exposures related to unregulated entities;
- treatment of unregulated parent companies, particularly non-operating holding companies of regulated entities was different across jurisdictions; and
- challenges in obtaining information on unregulated entities that are subsidiaries of parent companies of regulated entities.

2.5. In response to the weaknesses identified through the review process and to improve the regulation and supervision of financial conglomerates, the Joint Forum made the following proposals:

- The principles in the 1999 framework for the regulation and supervision of financial conglomerates (1999 Principles) dealing with capital adequacy, risk concentration, and intra-group exposure needed to be updated to reflect industry developments and provide greater focus on special purpose vehicles and holding companies of financial conglomerates;
- the “Fit and Proper Principles” needed to be updated and expanded to incorporate the broader areas of governance; and
- all groups particularly those that are active across borders needed to be subjected to regulation and supervision that captures the full spectrum of their group-wide activities and risks, including all risks from entities within the group, whether

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<sup>4</sup> Composed of the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO).

<sup>5</sup> The Joint Forum: Review of the Differentiated Nature and Scope of Financial Regulation- Keys issues and recommendations, 2010

regulated or unregulated that may pose a significant impact on the financial position of the group.

2.6. In 2012, the Joint Forum published an updated set of Principles for the Supervision of Financial Conglomerates<sup>6</sup> (the updated principles) aimed at ensuring that the financial conglomerate supervisory framework assists with:

- detection and correction of multiple uses of capital to deal with the issue of double or multiple gearing;
- assessment of group risks to address contagion, concentration, management complexity and conflicts of interest; and
- the minimisation of regulatory arbitrage.

2.7. The updated principles were put in place as part of G20's financial reform agenda aimed at strengthening the global financial system through more effective oversight and supervision. The set of the updated principles replaces the compendium of principles developed in 1999 and published in 2001 by the Joint Forum.

2.8. The updated principles are broader and more consolidated and provide guidance on regulation and supervision of financial conglomerates, with particular focus on the governance, capital, liquidity and risk management frameworks of financial conglomerates.

2.9. The principles expand and supplement the 1999 principles and are organised into five sections as follows:

- Supervisory powers and authority;
- Supervisory responsibility;
- Corporate governance;
- Capital adequacy and liquidity; and
- Risk management

2.10. The principles do not replace the Core Principles for Effective Banking Supervision, the Insurance Core Principles nor the Objectives and Principles of Securities Regulation but are intended to address issues that are not covered in the sectoral rules.

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<sup>6</sup> <https://www.bis.org/publ/joint29.pdf>: The Joint Forum: Principles for the supervision of financial conglomerates, September 2012

2.11. South Africa created an enabling framework for the regulation and supervision of financial conglomerates through the FSR Act which came into effect on 1 April 2018. The framework allows for the PA to designate members of a group of companies as a financial conglomerate. The PA has embarked on the process of making the prudential standards on financial conglomerates which are now being published for the public consultation process.

2.12. It is envisaged that the financial conglomerate regulatory and supervisory framework will come into effect on 1 January 2022.

### **3. Statement of the need – Context and definition of the policy problem**

3.1. Before the 2008 global financial crisis, certain international financial groups exploited gaps in cross-sectoral supervision by taking excessive risks within their non-regulated entities. This had contagion risk on the regulated financial institutions. It became evident during the global financial crisis that financial groups had become more complex in size, operations and organisational and corporate structures.

3.2. The economic influence of large and complex financial groups, and the combination of regulated and unregulated entities (such as special purpose entities and unregulated holding companies) operating across sectoral boundaries within financial conglomerates, presents challenges for sector-specific supervisory oversight.

3.3. The Joint Forum principles on financial conglomerates emphasise the importance of recognising structural complexity and the potential risks posed by such complex structures, including risks arising from all entities that affect the overall risk profile and financial position of the financial conglomerate and the individual entities within the group.

3.4. Internationally, the need to supervise financial conglomerates on a group-wide basis and to supplement the sectoral legislation on banking, investment and insurance has been identified based on the following:

- The global financial crisis has highlighted just how embedded groups are within financial and economic systems;

- The globalisation of financial markets that created a catalyst for the development of internationally active financial groups, which have increased in number, complexity and size — providing a range of financial products and services;
- Recent failures in the supervision of financial groups have highlighted the deficiencies in traditional supervisory frameworks, where oversight was restricted; and
- Financial conglomerate supervision has emerged as a critical tool to help ensure that financial groups are effectively regulated.

3.5. A report by the Tripartite Group of Bank, Securities and Insurance Regulators, published in 1995<sup>7</sup> identified some issues relating to the supervision of financial conglomerates. The issues are still relevant today.

3.6. As the report stated, the issues that were identified underscore the need for an effective regulatory and supervisory framework for financial conglomerates which includes:

- developing a group-wide supervisory framework that regulates the legal entities within the group and also assesses the group as a whole;
- mitigating group interlinkages and contagion effects which can prompt potential insolvency or contravene regulatory requirements in relevant jurisdictions;
- identifying risk concentration and intra-group transactions, which present substantial credit risk;
- determining group capital adequacy;
- determining the fitness and propriety of the group's Board of Directors, shareholders and senior management;
- ensuring that the group has appropriate risk management and internal controls suited to its nature, size and complexity;
- accessing prudential information on the group to effectively supervise the legal entities and the group as a whole; and
- eliminating supervisory arbitrage.

3.7. In the context of South Africa, the need to supervise financial conglomerates on a group-wide basis and to supplement the sectoral legislation on banking, investment and insurance has been identified based on the following 3 key areas:

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<sup>7</sup> <https://www.bis.org/publ/bcbs20.pdf>



*(i) Need to address risks emanating from the structure of the SA financial system*

- 3.8. The SA financial system is dominated by a few, large and interconnected financial institutions that predominantly have combined banking, insurance and securities businesses.
- 3.9. According to the Financial System Stability Assessment Report<sup>8</sup> compiled by the International Monetary Fund (IMF) during the 2014 Financial Sector Assessment Program (FSAP), seven financial groups dominated the SA financial services sector. The financial groups highlighted above accounted for a significant market share in the banking, insurance and asset management business (see Table 1). This has been updated using the latest information and this is shown in Table 2.

*Table 1: Market share of largest financial groups in percent as at 2014*

<b>Financial Group</b>	<b>Banking Assets (%)</b>	<b>Assets in Life Insurance (%)</b>	<b>Premiums in general insurance (%)</b>	<b>Assets under management (%)</b>
Standard Bank	25.5	11.9	-	31.7
Absa	20.2	0.7	2.8	21.3
Old Mutual	17.2	22.4	8.6	11.3
FirstRand Bank	20.4	-	-	0.4
Investec	7.1	4.3	-	11.4
MMI Holdings	-	15.5	5.6	0.6
Sanlam Life	-	14.7	17.2	1.1
<b>Total Share</b>	<b>90.5</b>	<b>69.5</b>	<b>34.2</b>	<b>77.8</b>

Source: South Africa Financial System Stability Assessment Report, IMF, December 2014

- 3.10. Five banks accounted for 90% of the total banking assets while six insurers controlled 70% of the life insurance assets. Seven financial groups had 78% of total assets under management.

*Table 2: Market share of largest financial groups in percent, as at 2020*

<b>Financial Group</b>	<b>Banking Assets (%)</b>	<b>Assets in Life Insurance (%)</b>	<b>Premiums in general insurance (%)</b>
Standard Bank	24.0	-	-
Absa	19.5	0.8	1.9
Old Mutual	-	21.9	8.4
Nedbank	17.2	0.8	0.8
FirstRand Bank	21.7	0.2	0.2
Investec	7.6	5.6	-
MMI Holdings	-	12.5	0.6
Sanlam Life	-	18.4	18.9
<b>Total Share</b>	<b>90.1</b>	<b>60.2</b>	<b>30.7</b>

Source: Prudential Authority, 2020

<sup>8</sup> <https://www.imf.org/external/pubs/ft/scr/2014/cr14340.pdf> - Financial System Stability Assessment Report is the main document that concludes a Financial Sector Assessment Program (FSAP) for an individual country by the International Monetary Fund.

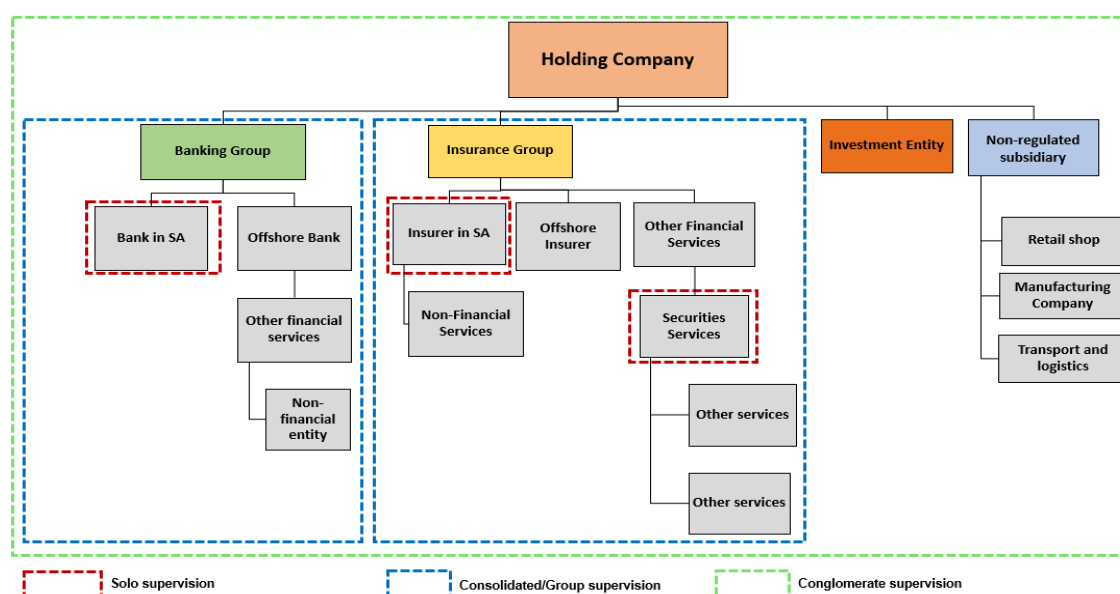
- 3.11. The structure of the SA financial system which is dominated by a few large interconnected financial groups poses some risks to the financial system as well as the general financial stability. One of such risks is contagion risk which results when financial difficulties in one of the entities within a large financial group could spill over to other entities.
- 3.12. Stress in a non-prudentially regulated entity of the group can be transmitted through the prudentially regulated entity and consequently the financial system, potentially causing the risk of collapse of the entire financial system.
- 3.13. Reputational risk is inherent in large and complex financial groups due to common branding, funding and sometimes management. Adverse information on an entity belonging to a group can result in loss of confidence and financial damage to other entities in the group.
- 3.14. The structure of the SA financial sector also poses a challenge of *'too-big-to-fail'*. Given the size and level of interconnectedness, some entities in a group may take on excessive risks on the assumption they will be bailed out by other entities within the group or even the government.
- 3.15. Size and complexity could also mean increased operational risk (associated with people and systems) and if such risk is not properly supervised and managed may threaten the stability of the entire group, including the prudentially regulated entities of the group. Poor governance arrangements in the wider group due to complicated legal and managerial structures may also pose risks to the prudentially regulated financial institution.
- 3.16. Currently, the PA supervises banks and insurance companies on a solo and/or consolidated/group basis. However, consolidated/group supervision is limited to the entities in the banking and/or insurance groups which pose gaps in the assessment of risks posed by other entities that fall under the same holding company but are not captured under consolidated/group supervision.
- 3.17. Individualised supervisory approaches may hide potential conflicts of interests, risks of contagion, and misguide the overall measurement of aggregated risks that very often arise in large, diverse and complex financial conglomerates.

3.18. Given the structure of the South African financial system, a more comprehensive supervisory approach for financial conglomerates is needed, including enhanced powers for the PA and suite of prudential standards and as well as a supervisory approach that better capture specific risks posed by financial conglomerates.

3.19. The risks discussed above that may emanate from the unregulated entities of large financial groups have the potential to compromise the safety and soundness of the prudentially regulated entities and threaten the interest of financial customers and the financial system at large. The fact that such risks can emanate from non-prudentially regulated entities presents a rationale for conglomerate supervision that seeks to ensure that the PA effectively supervises these risks on a group-wide basis in addition to existing consolidated/group supervision.

3.20. The scope of solo, consolidated/group supervision as well as conglomerate supervision are illustrated in Figure 1.

*Figure 1: Illustration of solo, consolidated/group and conglomerate supervision*



*(ii) Need to address the FSAP findings*

3.21. The 2014 FSAP identified as a key risk factor to SA's financial stability, the possibility of stress in certain financial institutions spilling over to others in the financial system. This was as a result of the high levels of the interconnectedness of the SA financial sector where all major banks belong to a large financial group that own banks and non-bank financial institutions or own shares in non-bank financial institutions. The

IMF identified the lack of a robust group-wide supervisory approach to conglomerate supervision as a factor that could lead to the accumulation of the risk.

3.22. The IMF recommended that the microprudential supervision of financial conglomerates needed to be specifically addressed in law. According to the IMF, microprudential supervision of financial conglomerates would enable the supervisor to detect, monitor and assess risks of the entire financial system as well as that of financial conglomerates.

3.23. The FSR Act empowers the PA to regulate financial conglomerates and the proposed Standards will provide a regulatory framework for their regulation.

*(iii) Need to address weaknesses identified from the global financial crisis*

3.24. Due to their economic reach and their use of regulated and unregulated entities across sectoral boundaries, financial conglomerates present a challenge for sector-specific supervisory oversight. In hindsight, the crisis exposed situations in which regulatory requirements and oversight did not fully capture all of the activities of financial conglomerates or fully consider the impact and cost that these activities may pose to the financial system. A stronger supervisory framework for financial conglomerates was necessary to fill these gaps<sup>9</sup>.

3.25. Financial conglomerates were at the epicentre of the global financial crisis and many suffered huge losses as a result of the crisis. Governments and central banks particularly in the USA and Europe provided financial support to large financial institutions to avoid the collapse of the global financial system. The support was in the form of emergence liquidity assistance, capital injections, asset purchase programmes and guarantees.

3.26. The need to ensure that SA has an adequate regulatory and supervisory framework for financial conglomerates also emanates from SA's commitments as a member of the G20.

3.27. While SA weathered the global financial crisis relatively well compared to other jurisdictions, the structure of the SA financial sector, as well as the lessons from the global financial crisis, present an opportunity to strengthen the regulatory and

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<sup>9</sup> International Monetary Fund. 2013. *Belgium: Technical Note on Financial Conglomerate Supervision*. IMF Country Report No. 13/138

supervisory framework for regulation and supervision of large and complex financial groups that dominate the SA financial system.

3.28. The current solo and/or consolidated/group supervision framework does not adequately address risks associated with financial conglomerates hence the PA is proposing to issue a set of Standards to strengthen and supplement the current level 1 and/or 2 supervisory frameworks.

3.29. It has become important that supervisors consider risks arising from the activities of unregulated entities, and paying particular attention to those that are not directly prudentially regulated. Unregulated entities may pose different risks to a financial conglomerate and each may require separate consideration and treatment.

#### **4. Approach taken by the PA on proposed Standards**

4.1. The PA considers that the existing solo and consolidated/group supervisory framework does not adequately provide the PA with a holistic view of all risks that the regulated entities within large and complex financial groups (which may also include non-prudentially regulated entities) to ensure that they are adequately regulated and supervised. A narrow view of the risks posed to the PA-regulated entities from the wider group could lead to the under-capitalisation of the regulated entities.

4.2. To address the shortfalls in solo and/or consolidated/group supervision, the PA has proposed a set of standards for the regulation supervision of financial conglomerates to supplement the existing solo supervision and consolidated/group supervision. The proposed Standards will ensure that the prudential regulatory framework fully captures all the activities and risks posed by entities (prudentially regulated and non-prudentially regulated<sup>10</sup>) belonging to the same group (financial conglomerate).

4.3. The proposed Standards are closely aligned to the internationally agreed principles and best practices for the regulation and supervision of financial conglomerates and other jurisdictions that have implemented a similar regulatory approach. The Principles use the flexibility of the non-prescriptive approach coupled with the use of national discretion to the regulation and supervision of financial conglomerates.

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<sup>10</sup> This refers to entities within the financial conglomerate (or the wider group to which the financial conglomerate belongs) that are prudentially regulated or are lightly regulated.

4.4. The twenty-nine Joint Forum Principles for the supervision of financial conglomerates are grouped into five broad categories as follows:

- *Supervisory powers and authority*: The Principles under this category require the regulatory framework to provide the regulators with the necessary powers, authority and resources to supervise financial conglomerates. There should also be sufficient coordinating mechanisms with other regulators to ensure comprehensive group-wide supervision of financial conglomerates.
- *Supervisory responsibility*: Under this set of principles, the regulators should be able to impose, monitor and supervise minimum prudential requirements as well as take corrective action to ensure compliance.
- *Corporate governance*: Financial conglomerates are required to have a comprehensive and consistent governance framework across the group (including the unregulated entities). Furthermore, financial conglomerates are required to have transparent organisational and managerial structures, appoint 'fit and proper' board members and senior managers.
- *Capital adequacy and liquidity*: Financial conglomerates need to ensure that they have adequate capital that takes into account the full spectrum of risks, including the risk emanating from the unregulated entities. The financial conglomerates are also required to develop capital management processes as well as ensure that they adequately measure and manage liquidity risk.
- *Risk management*: This requires financial conglomerates to have a comprehensive risk management framework to manage and report group-wide risk concentrations and intra-group transactions and exposures.

4.5. In line with the abovementioned Joint Principles, the PA is proposing to issue four Standards dealing with:

- Intragroup transaction and exposures;
- Auditor requirements for holding companies of financial conglomerates;
- Governance and risk management for financial conglomerates; and
- Risk concentrations for financial conglomerates.

4.6. During the informal public consultation process, two sets of capital standards were circulated for industry inputs — principle-based and technical capital standard.

However, the PA has postponed the implementation of the Prudential Standard for capital requirements for financial conglomerates.

- 4.7. The PA will refine the draft capital Standard to ensure a better understanding of the requirements by the industry. The proposed Standard will be tested from January 2022, with the designated holding companies and refined further before final implementation. Since the last Statement the PA has designated some groups as financial conglomerates.
- 4.8. The holding companies of financial conglomerates will be required to calculate capital in terms of the technical specifications of the capital Standard as well as report such calculations in terms of the reporting templates that will be developed by the PA but will not be required to hold the resultant capital. Any additional risks posed to the eligible financial institution(s) that will be identified at the conglomerate level will need to be addressed at level 1 or level 2 supervision until the capital Standard is finalised.
- 4.9. The PA envisages that the process of finalising an appropriate capital Standard for financial conglomerates will take between 2-3 years. Once this process has been finalised, the PA will conduct a quantitative impact assessment (QIS) of the proposed capital Standard to assess the capital implications of the proposed Standard on financial conglomerates. It is also hoped that during the testing period, there will be an enhanced understanding of the proposed capital Standards which will also feed into further refinements to the proposed capital Standard.
- 4.10. The PA took into consideration the Joint Forum principles and approaches that have been adopted for financial conglomerate supervision in other jurisdictions in drafting the proposed Standards.
- 4.11. With regards to the scope of financial conglomerate coverage, the Joint Forum does not include Market Infrastructures (MIs) under the scope of financial conglomerates. It only recognises a holding company of a group that has activities in at least two different financial sectors that are banking, securities, or insurance. Market infrastructures are not included.
- 4.12. Initially, the MIs will not be scoped into financial conglomerate supervision given that the PA is still developing a supervisory framework for the regulation and supervision

of MIs. In the future, once the supervisory framework is in place, they will be scoped into financial conglomerate supervision.

## **5. Objectives of proposed Standards**

- 5.1. The primary objective of the proposed Standards for financial conglomerate regulation and supervision is to strengthen prudential oversight of financial institutions (i.e. banks, insurers, or securities service providers) and capture risks that may not be adequately addressed under the current level 1 and level 2 supervision.
- 5.2. It is not the intention of the PA to impose onerous and ineffective requirements on the holding company of a financial conglomerate. Standards and requirements deemed necessary for the PA to exercise its powers and meet its mandate will be introduced. The proposed Standards and requirements aim to enhance the safety and soundness of an eligible financial institution as well as to assist with the overall resilience of the financial system to shocks by addressing concerns around governance and risk management, intragroup transactions and exposures, auditor requirements as well as risk concentrations for financial conglomerates.
- 5.3. At a high level, some salient objectives of the different Standards are highlighted as follows:
- *Prudential Standard FC02 – Intra-group transactions and exposures:* The draft Standard requires that all material intra-group transactions and exposures are reported to the PA on a semi-annual basis, including the nature of the transaction regarded as significant and the counterparties involved.
  - *Prudential Standard FC03 – Auditor requirements for financial conglomerates:* The draft standard prescribes the PA's requirements in terms of auditors of a financial conglomerate and sets down the requirements for approval to be an auditor of a financial conglomerate. The Standard also provides for the ability of the PA to require joint auditors for a financial conglomerate based on the nature, scale and complexity of the financial conglomerate;
  - *Prudential Standard FC04 – Governance and risk management requirements for financial conglomerates:* The Standard prescribes the PA's requirements and principles on governance and risk management for a financial conglomerate including requirements and principles concerning board composition, board



committees, roles and responsibilities of the board and key persons, board performance, delegations, risk strategy, etc.

- *Prudential Standard FC05 – Risk concentration requirements for financial conglomerates*: The Standard requires the financial conglomerate to have an internal policy to identify, measure and monitor the risk concentration as well as imposing a reporting requirement on the conglomerate for each significant<sup>11</sup> institution.

## **6. Statement of expected impact – Costs and benefits of proposed Standards**

### ***Scope and sample of the impact study***

- 6.1. A total of 27 groups or organisations with operations in the financial services such as banking, insurance, and securities services, participated in the impact study conducted by the PA. Out of the 27 respondents, only 1 respondent indicated that they did not consider their operations to be mainly in the financial services sector.

### ***Methodology***

- 6.2. To gather the necessary qualitative and quantitative information required to assess the expected impact of the proposed Standards, the PA solicited industry inputs, through a questionnaire. Specific questions on all the four proposed Standards were posed and the industry's responses were analysed, consolidated and incorporated into this Report.

### ***Some observations from the industry responses***

- 6.3. Based on their assessment of the provisions in Chapter 12 of the FSR Act and the draft designation criteria that was circulated by the PA, 8 out of the 27 respondents considered their groups or organisations to be financial conglomerates or members of a financial conglomerate.
- 6.4. Out of the 27 respondents, 12 were involved in at least two industries/sectors i.e. banking, insurance, securities services and market infrastructure.

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<sup>11</sup> An institution within the financial conglomerate which assets contribute to at least 10% of the total assets of the financial conglomerate

- 6.5. Only 3 out of the 27 respondents indicated that their groups had non-regulated entities that perform material activities not subject to the current level 2 (group/consolidated supervision) framework.

***Analysis of expected impact from industry responses***

- 6.6. The respondents to the PA's questionnaire indicated the difficulty, at this stage, to quantify the costs.
- 6.7. Though the additional costs to the regulated entities over and above the current level 1 and level 2 supervision are expected to be minimal, the respondents identified some major cost drivers that might contribute towards some additional costs to the industry. These cost drivers are discussed as follows:

***Human resources***

- 6.8. From the responses received, broadly speaking costs will likely emanate from additional human resources required and investment in training/up-skilling of staff to deal with, for example, the increased compliance and reporting requirements.

***Risk management system and reporting***

- 6.9. In light of the regulatory returns that span across different entities across different sectors in a diversified financial conglomerate, system incompatibilities and other structural and architectural differences will require some initial cost in building these systems and capabilities. Furthermore, a group-wide risk management system will potentially require additional resourcing. However, for those groups that already have well-established risk management and reporting systems at a group level, the additional investment required in systems improvement would be minimal given that this would be dependent on the nature, scale and complexity of the business. In addition, some respondents do not anticipate that the proposed Standards will introduce additional costs to their groups.

***Governance and policies***

- 6.10. In some cases, groups that will be designated as financial conglomerates will need to dedicate more resources to give effect to the enhanced oversight as well as additional monitoring and reporting. Where the cost of maintaining governance and other structures, could be a duplication of existing structures, this will result in unnecessary additional costs and the PA has taken a position to ensure that on

application, full exemption or partial exemption from level 3 regulation, supervision and/or reporting requirements to any financial conglomerate can be granted.

#### Audit fees

- 6.11. From the information gathered from the survey, a potential increase in audit fees is anticipated due to the requirement on audits to provide assurance to the PA that the financial conglomerate complies with the requirements of the financial conglomerate regulatory framework. Also, a requirement for multiple audit firms, in particular, will result in additional costs, however, given that some of the groups already have joint audits in place, the proposed Standards will not result in material additional costs on audit fees.

#### ***Mitigations around costs***

- 6.12. To mitigate the cost implications of the proposed Standards on financial groups that will be designated as financial conglomerates, the PA will consider exemptions from certain requirements in the proposed Standards in cases or circumstances where the existing requirements might be sufficient and there will be no need to impose additional requirements to the regulated entity.
- 6.13. In terms of the designation criteria, the PA may, on application, grant full exemption or partial exemption from level 3 regulation, supervision and/or reporting requirements to any financial conglomerate identified. This is if in the opinion of the PA, the current sectoral regulation and supervision of such a financial conglomerate at level 2 are adequate and no further supervisory insight will be created by level 3 supervision and/or reporting; or the involvement of the financial conglomerate in the other regulated and unregulated sectors is immaterial and no further supervisory insight will be added by level 3 supervision and/or reporting.
- 6.14. The exemptions that will be granted by the PA will be subject to certain conditions that will be specified by the PA. The fact that the PA can exempt certain financial groups from level 3 regulation and supervision will mitigate the set-up costs that may be required, particularly in respect of the groups where the additional costs will not be justifiable given that there will be no additional benefits in imposing additional level 3 requirements. Exemptions will eliminate duplications that may lead to increased costs.

6.15. While in the short term, some costs will be incurred in developing policies and rolling them out, once the systems are developed and are running, it becomes business and usual. However, these costs are not anticipated to be material.

### ***Benefits of the Proposed Standards***

6.16. The proposed Standards are expected to yield the following benefits:

- Enhanced and coherent governance processes, and heightened focus on the role of the board in providing a holistic view of the financial conglomerate that will lead to improved understanding of the various risks and interdependencies within the financial conglomerate as well as increased ability to proactively manage the identified risks;
- Greater financial stability and improved consumer protection would be achieved if large institutions which are inherently complex would be subjected to a regulatory framework that ensures greater oversight e.g. avoidance of double gearing;
- Integrated risk management and governance practices that will allow the board of more complex organisations to appropriately and adequately aggregate, manage and oversee the financial conglomerates;
- A more formalised approach ensures improved oversight of intra-group transactions and exposures and that appropriate risk management considerations are taken into account which will in turn help in mitigating contagion risk that might result from interconnectedness with unregulated entities within the conglomerate itself; and
- The framework will ensure increased visibility of risk concentration which might also encourage conglomerates to address the interaction between risk types and between entities on common risk factors that when aggregated may provide a more complete picture of the wider group's level of actual concentration to a customer, sector, product, country, collateral type, etc.

6.17. Based on the responses that were received to the questionnaire that the PA circulated to the industry during the informal consultation period, it can be concluded that the benefits for implementing the proposed Standards on financial conglomerate supervision outweigh the marginal costs that are anticipated with the implementation of the proposed Standards.

## **7. Policy options considered by the PA**

7.1. The PA could have maintained the status quo and not implemented the proposed framework for regulation and supervision of financial conglomerates. However, maintaining the status quo was not considered to be a viable option based on the following:

- The solo and consolidated/group supervisory framework does not adequately provide the PA with a holistic view of all risks posed to the regulated entities within large and complex financial groups (which may also include non-prudentially regulated entities);
- The 2014 FSAP identified the lack of a robust group-wide supervisory approach to conglomerate supervision as a factor that could lead to the accumulation of the risk and according to the IMF, microprudential supervision of financial conglomerates would enable the supervisor to detect, monitor and assess risks of financial conglomerates; and
- Implementation of the regulatory and supervisory framework for conglomerate supervision will ensure that SA complies with its G20 commitments. A framework for financial conglomerates supervision will improve the safety and soundness of financial institutions regulated by the PA by ensuring that the PA effectively supervises risks posed to the PA-regulated entities from the wider group.

## **8. Consultation**

8.1. To assist in the process of developing the proposed Standards, the PA took a collaborative approach and established a Financial Conglomerate Supervision Working Group (FCS Working Group) which comprised representatives from the industry. Five sub-working groups reporting to the FCS Working Group were also formed and focused on capital requirements, risk concentrations, intragroup transactions and exposures, corporate governance and risk management, and auditing and reporting requirements.

8.2. The PA has been working very closely with the industry in developing the proposed designation criteria and Standards. In July 2018, the PA conducted an informal consultation process for six weeks as a precursor to another round of informal consultation.

- 8.3. The informal consultation processes were meant to ensure that the proposed Standards and reporting templates adequately and correctly capture the views of industry bodies that were represented in the FSC Working Group.
- 8.4. Comments received during the informal consultation process were considered by the PA and used to refine the draft Standards and reporting templates before the formal consultation process.
- 8.5. Through the formal consultation process, the regulated sector as well as any other interested parties had another opportunity to provide comments on the proposed approach for the regulation and supervision of financial conglomerates.

## **9. Statement of intended operation – Implementation and evaluation**

- 9.1. The FSR Act creates a framework that allows the PA to designate members of a group of companies as a financial conglomerate, in addition to the regulation and supervision of individual entities or sub-groups within a financial group in terms of the sectoral laws.
- 9.2. The FSR Act stipulates<sup>12</sup> that a financial conglomerate must include an eligible financial institution and a holding company of the eligible financial institution, but need not include all the members of a group of companies.
- 9.3. The PA will designate members of a group of companies as a financial conglomerate, following a set designation process, per the designation criteria. A financial institution that is designated as a financial conglomerate may be licensed by the PA and will be required to comply with the Standards for financial conglomerates. The proposed Standards are envisaged to commence on 1 January 2022. Since the last Statement some groups were designated as conglomerates.
- 9.4. Once the Standards have been implemented, the PA will assess and evaluate the effect of the Standards on a continuous basis as part of the regulators' supervisory responsibility to ensure that any unintended consequences of the Standards on the industry are adequately addressed.

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<sup>12</sup> Section 160(2) of the FSR Act.

## **10. Conclusion**

- 10.1. The proposed Standards and this Statement are prepared in terms of section 98(1) of the FSR Act and were published for public consultation in terms of section 98(2) of the FSR Act. Following the public consultation process, the PA made the necessary changes to the proposed Standards and this Statement, taking into account all submissions that were received. A revised set of Standards and updated Statement together with other documents required in terms of the FSR Act were submitted to Parliament for 30 days while Parliament is in session.
- 10.2. While this Statement takes into account all the responses that were received through the questionnaire that was circulated to the industry, the assessment of the expected impact that the PA has conducted does not take into consideration any assumptions about the industry's behavioural responses to the regulatory framework, such as management actions to the impending regulatory frameworks.