

**DRAFT FOR INFORMAL CONSULTATION – MARCH 2020**

**Prudential Standard FC05**

**Risk concentrations for financial conglomerates**

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

*This Standard is made in terms of sections 105 and 164 of the Financial Sector Regulation Act 9 of 2017 and requires the holding company of a financial conglomerate to operate within the principles and comply with the requirements relating to large exposures and risk concentrations.*

*It is the responsibility of the board of directors (board) of the holding company of a financial conglomerate 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 concentration risk and sets down the responsibilities of the board of the holding company of the financial conglomerate, the minimum requirements for a risk concentration policy, requirements relating to the identification of internal limits as well as the reporting and approval requirements.*

**Contents**

|  |   |
|--|---|
| 1. Commencement.....   | 2 |
| 2. Legislative Authority .....   | 2 |
| 3. Application.....  | 2 |
| 4. Definitions and interpretation .....  | 2 |
| 5. Roles and responsibilities .....  | 3 |
| 6. Principles underlying risk concentration.....   | 3 |
| 7. Reporting and approval requirements for concentration risk relating to a large exposure ..... | 4 |
| 8. Matters related to exempt exposures.....  | 5 |
| 9. Regulatory action .....   | 5 |

## **1. Commencement**

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

| <b>Version number</b> | <b>Commencement date</b>  |
|-----------------------|---------------------------|
| 1                     | 1 January 2022 (proposed) |

## **2. Legislative Authority**

- 2.1 This Standard is made under section 164(1) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017)(FSR Act).

## **3. Application**

- 3.1 This Standard applies to financial conglomerates as designated by the Prudential Authority in terms of section 160 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 directors (board) of the holding company and in respect of all the entities within the financial conglomerate.

## **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.
- 4.2 Risk concentration arises from exposures to individual counterparties, a group of related individual counterparties, a group of counterparties with similar characteristics (e.g. in specific geographical locations or industry sectors) or to particular asset classes (e.g. property holdings or other investments) where the exposures have the potential to result in material losses for the financial conglomerate or an individual prudentially regulated institution within the group. When determining the risk concentration exposures, both on- and off-balance sheet exposures should be included.
- 4.3 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); and/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.
- 4.4 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 of the holding company of a financial conglomerate 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 of the holding company of the financial conglomerate and/or auditor 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 A financial conglomerate must have a risk concentration policy that gives consideration to the identification, measurement, management and monitoring of, and reporting on, risk concentration exposures associated with all risk types to which the financial conglomerate will be exposed.
- 6.2 The board of the holding company of the financial conglomerate or a board sub-committee established for such a purpose, is responsible for, but not limited to:
  - 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 to which the financial conglomerate is exposed;
  - d. ensuring compliance of the financial conglomerate with the risk concentration policy;
  - e. continuously monitoring risk concentration, which includes receiving an aggregated view of the risk concentration of the financial conglomerate;
  - f. approving a large exposure as defined in paragraph 7.1 of this Standard.
- 6.3 The risk concentration policy for a financial conglomerate must, among other things:
  - a. be conceptually sound and transparent as well as be subject to independent review;
  - b. be consistently implemented across the financial conglomerate which ensures that institutions within the financial conglomerate are also taken into consideration;
  - c. capture all material risk concentration exposure as specified in paragraph 6.4;
  - d. specify internal limits on acceptable levels of risk concentration per risk type;
  - e. include a description of the procedures for identifying, measuring, monitoring, reporting, and mitigating the types of risk concentration to which the financial conglomerate is exposed. This must, among other things, include:

- i. a clear statement of the respective responsibilities and compliance obligations of the board of the holding company of the financial conglomerate, and its board committees and senior management of the financial conglomerate in relation to the monitoring and management of risk concentrations; and
- ii. procedures for authorising and reporting on risk concentration policy breaches.

6.4 The internal limits identified for risk concentration under paragraph 6.3(d) should include, where appropriate, concentration exposures relating to or arising from but limited to the following:

- a. an individual or single counterparty, borrower or person;
- b. a group of related or connected counterparties, borrowers or persons;
- c. exposures in respect of counterparties or persons in the same industry, economic sector or geographic region;
- d. exposures to counterparties or persons, the financial performance of which is dependent on the same activity or commodity;
- e. exposures arising from risk mitigation activities;
- f. liquidity risk;
- g. funding sources;
- h. trading exposures;
- i. equity positions;
- j. specific assets or instruments such as structured products;
- k. off-balance sheet exposures, including guarantees, liquidity lines or other commitments;
- l. operational risk exposures, relating to:
  - i. service providers;
  - ii. outsourcing; and
  - iii. any other operational risks;
- m. correlation between any of the aforesaid risks, counterparties, instruments, assets, liabilities or commitments.

## **7. Reporting and approval requirements for concentration risk relating to a large exposure**

- 7.1 An exposure of a financial conglomerate to a counterparty or to a group of connected counterparties, as defined in paragraph 4, will be regarded as a large exposure if the aggregate exposure to the counterparty or to the group of connected counterparties is in excess of 10% of the financial conglomerate's eligible capital base as defined in Prudential Standard FC01: Capital requirements for financial conglomerates - Technical.
- 7.2 A financial conglomerate must report any large exposure to the Prudential Authority on a semi-annual basis.
- 7.3 The financial conglomerate must obtain prior written approval from the Prudential Authority should the large exposure exceed 25% of the financial conglomerate's eligible capital base as defined in Prudential Standard FC01: Capital requirements for financial conglomerates - Technical.

- 7.4 To determine the aggregate exposure ( $E_i$ ) to a counterparty or group of connected counterparties, the exposure to the counterparty or group of connected counterparties for each institution within the financial conglomerate will be aggregated, that is:

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

Where:

$\text{Bank}_i$  is the gross exposure for the counterparty<sub>i</sub> or connected counterparty<sub>i</sub> of a financial institution licensed as a bank in terms of the Banks Act, 1990 within the financial conglomerate where the gross exposure should be based on the large exposure framework issued under the Regulations relating to Banks.

$\text{Insurer}_i$  is the gross exposure for the counterparty<sub>i</sub> or connected counterparty<sub>i</sub> of a financial institution licensed as an insurer in terms of the Insurance Act, 2017 within the financial conglomerate where the gross exposure should be based on the Prudential Standards made in terms of the Insurance Act, 2017 insofar as it relates to concentration risk. The gross exposure amount will be before any risk adjustments are made.

$\text{Other}_i$  is the gross exposure for the counterparty<sub>i</sub> or connected counterparty<sub>i</sub> to an institution other than a bank or an insurer within the financial conglomerate. The gross exposure amount will be before any risk adjustments are made.

- 7.5 Should any additional risks result in large financial losses, these additional risks should be measured and added. A financial conglomerate must take care to ensure that risk exposures are not double-counted.

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

- 8.1 The following counterparties will be exempted from the large exposure approval, defined in paragraph 7.3:
- any exposure to a sovereign or central bank including any portion of an exposure guaranteed or secured by a financial instrument issued by a sovereign or central bank;
  - subject to such conditions as may be specified in writing by the Prudential Authority, any exposure to a qualifying central counterparty related to clearing activities;
  - any intraday interbank exposure; and
  - any other exposure specified in writing by the Prudential Authority.

## **9. Regulatory action**

- 9.1 If in the view of the Prudential Authority, risk concentration exposures are not adequately covered or taken into account by the financial conglomerate, the Prudential Authority may take any regulatory action including requiring the financial conglomerate to maintain additional capital.