South African Reserve Bank

Prudential Authority

DRAFT

Discussion Document:

Financial Conglomerate Supervision Framework

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1. PURPOSE OF THIS DOCUMENT

The purpose of this document is to set out the proposed approach on how the Prudential Authority (PA) intends to regulate and supervise financial conglomerates to best achieve its objectives as set out in the Financial Sector Regulation Bill (FSR Bill):

a) To promote and enhance the safety and soundness of financial institutions that provides financial products and services.
b) To promote and enhance the safety and soundness of financial markets infrastructures.
c) To protect customers of financial institutions against the risk that those financial institutions may fail to meet their obligations.
d) To assist in maintaining financial stability.

This discussion document will also form the basis for further engagement with industry on the on the proposed approach and to invite further feedback from industry on the proposals set out below.

Regulatory and supervisory regimes must respond to changes in the structure and business operations of regulated financial firms. The emergence of financial conglomerates is a key feature of the evolution of financial systems and the increased functional integration between the business of banking, insurance and securities services. The proposals outlined in this document, once final, will be given effect to through Prudential Standards, or Join Standards where applicable, to be issued and consulted on in terms of the FSR Bill.

2. INTRODUCTION

The South African Financial system is dominated by a small number of large financial institutions. This resulted in a highly concentrated market with a high level of interconnectedness which increased contagion risk in the financial system. The South African financial sector is also fragmented. Different sectorial laws apply to different regulatory authorities who oversee these financial institutions which increased the risk of regulatory arbitrage.

The South African financial system proved its resilience during the most recent global financial crisis. Failures in regulation and supervision internationally have, however, highlighted deficiencies in traditional regulatory and supervisory frameworks. These failures identified financial conglomerate supervision as a supervisory tool to ensure more effective regulation and supervision of these financial groups.

The FSR Bill supports a more consistent and complete regulation and supervision of financial institutions by introducing financial conglomerate supervision as the third level of supervision within the supervisory hierarchy.

The Joint Forum Principles for the Supervision of Financial Conglomerates[1] (2012 Joint Forum Principles) point out that global financial crisis that began in 2007 highlighted the significant role that financial groups, including financial conglomerates, play in the stability of global and local economies. The economic reach of financial conglomerates, and the mix 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. Thus, from an international perspective, the need has been identified to supervise financial conglomerates on a group-wide basis and to supplement the sectoral legislation on banking, investment and insurance[2] based on the following:

a) The globalisation of financial markets created a catalyst for the development of internationally active financial groups, which have increased in number, complexity and size. These groups provide a range of financial products and services, including insurance, banking and investment services.

b) Recent failures in the supervision of financial groups have highlighted the deficiencies in traditional supervisory frameworks, where oversight was restricted. This is particularly important for groups that operate in multiple jurisdictions and conduct cross-sector activities.

c) The global financial crisis has highlighted just how embedded groups are within financial and economic systems. Governments and central banks in a number of jurisdictions had to implement emergency crisis resolution measures to stabilise and mitigate the potentially damaging effects of the failure of large financial groups on their respective economies.

d) The implementation of financial conglomerate supervision has emerged as a critical tool to help ensure that financial groups are effectively regulated and that they conduct their operations in both a prudent and financially sound manner.

e) It is important to note that the Tripartite Group of Bank, Securities and Insurance Regulators ("the Joint Forum") identified a number of issues relating to the supervision of financial conglomerates in their 1995 publication,[3] which are still relevant today.

As the report stated, these issues discussed underscore the need for an effective financial conglomerate supervisory framework which and includes:

a) developing a group-wide supervisory framework which regulates the legal entities within the group and also assesses the group as a whole;

[1] The 2012 Principles for the Supervision of Financial Conglomerates Issued by the Bank for International Settlements, September 2012. The 2012 Principles update and expand on the 1999 Principles in line with the recommendations in the Internal Review and the DNSR Report.

[2] See for example the European Commission report titled 'Report from the Commission to the European Parliament and the Council – The review of the Directive 2002/87/EC of the European Parliament and the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate' Brussels, 20.12.2012 (Commission's Report).

[3] A report by the Tripartite group of Bank, Securities and Insurance Regulators, July 1995

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

Sectorial supervision is currently in place in South Africa. The South African Reserve Bank (SARB), through its Bank Supervision Department (BSD) supervises banks and the Financial Services Board (FSB) supervises insurers and financial market infrastructures (as depicted in figure 1).

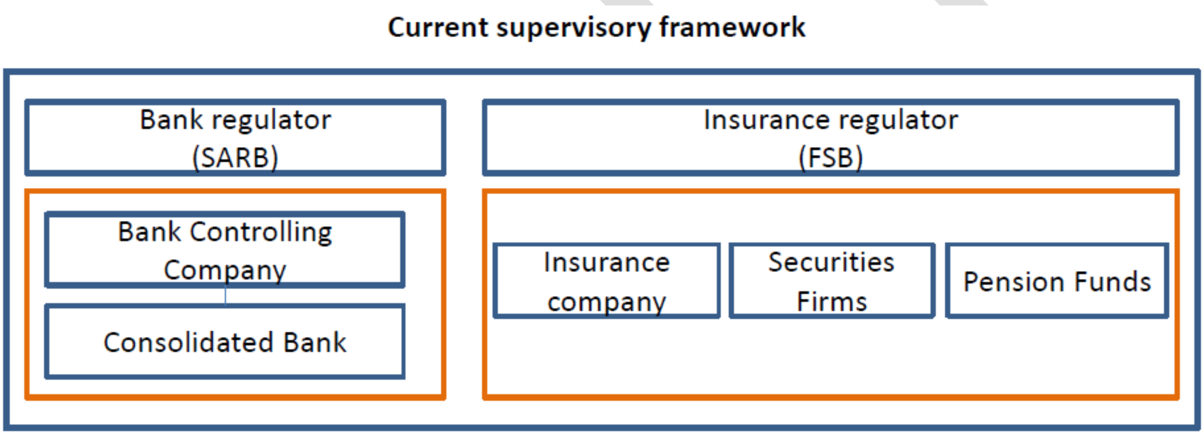

Figure 1: The Current Supervisory Framework.

The FSR Bill seeks to bring all prudential supervision of financial institutions (including financial conglomerates) under one umbrella – the PA (as depicted in figure 2).

The proposed supervisory framework, will enhance the supervision of large financial groups by ensuring, among other things, that capital is not used twice within a conglomerate and close attention is paid to group risks (not specific to banking or insurance business) such as contagion, concentration, the risk of complex structures and conflicts of interest.

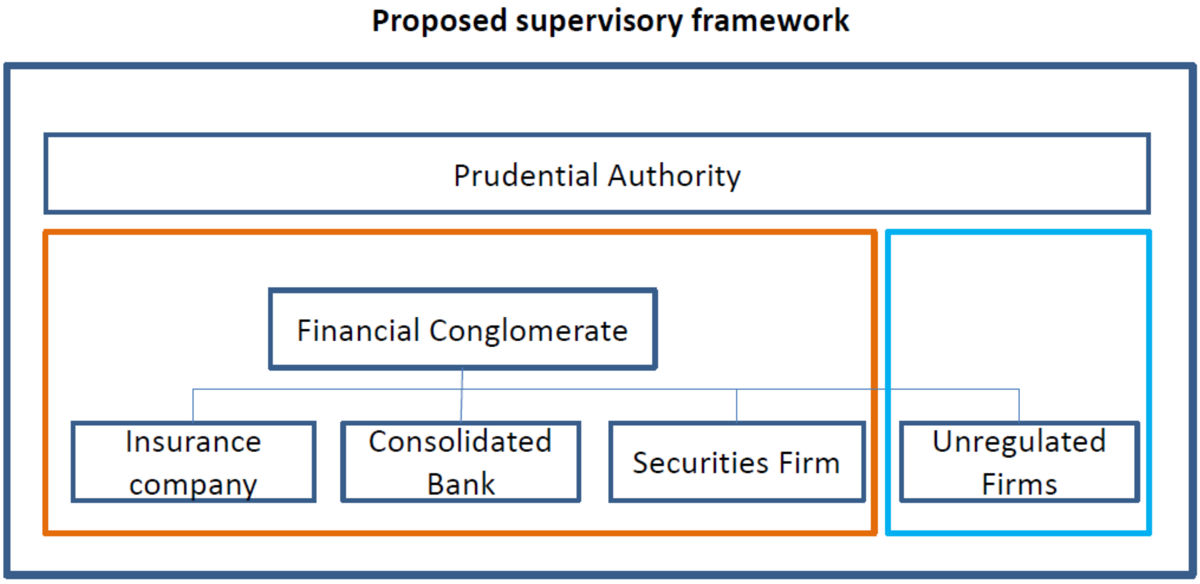

Figure 2: The Proposed Supervision Framework

The purpose of the supervisory framework for financial conglomerates set out in this document is to highlight the broad principles and requirements that will underlie the supervision of financial conglomerates, and should in all cases be read with the FSR Bill for the context within which the supervisory framework has to be applied.

The next section discusses the international standards for the supervision of financial conglomerates.

3. THE JOINT FORUM PRINCIPLES ON THE SUPERVISION OF FINANCIAL CONGLOMERATES

The Joint Forum under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) released an updated "Principles for the supervision of financial conglomerates", dated September 2012. The Joint Forum's Principles for the Supervision of Financial Conglomerates are set out in Annexure A. The essential elements of the 2012 Joint Forum Principles are duly captured in the FSR Bill, read with this document.

4. DEFINITION OF A FINANCIAL CONGLOMERATE

There is no universally agreed definition of a financial conglomerate. The Joint Forum defines a financial conglomerate as, "any group of companies under common control or dominant influence, including any financial holding company, which conducts material financial activities in at least two of the regulated banking, securities or insurance sectors."

Definitions from other jurisdictions:

Australia	Under the Australian Prudential Authority (APRA) regulatory framework for financial conglomerates, a group containing an APRA-regulated institution is considered to be a financial conglomerate if it has operations across more than one APRA-regulated industry and/or includes material non-APRA-regulated activities.
European Union	Under the European Union's (EU) Financial Conglomerates Directive, a group is considered to be a financial conglomerate if it meets the following conditions; At least one entity should be in the insurance sector and one in the banking or investment services sector. The group's activities are mainly in the financial sector. The group's insurance, banking and securities activities are significant.
International Organisation of Securities Commissions	The term 'financial conglomerate' is used to refer to any group of companies under common ownership where financial activities – whether securities business, banking, insurance or some other financial service – are undertaken on a significant scale by one or more companies in the group.

4.1 PA regulatory framework definition of a financial conglomerate

In terms of the FSR Bill, a financial conglomerate means a group of companies designated as a financial conglomerate under chapter 12 of the FSR Bill. The PA is empowered to designate members of a group of companies as a financial conglomerate. A financial conglomerate so designated by the PA must include both an eligible financial institution and a holding company of the eligible financial institution, but need not include all the members of the group as part of the financial conglomerate. In essence, a financial conglomerate would comprise members of a group of companies (provided one company is a bank, insurer or market infrastructure), under common control or dominant influence, including the holding company exercising such control or influence.

5. REASON FOR EXPANDING REGULATORY SUPERVISION

New developments in financial markets have led to the creation of financial groups, called financial conglomerates, which provide services and products in different sectors of the financial markets. Until now, there has been no form of prudential supervision on a group-wide basis of banking institutions, insurance firms and market infrastructures which are part of a conglomerate, in particular with regard the solvency position and risk concentration at the level of the conglomerate, the intra-group transactions, the internal risk management processes at conglomerate level, and the fit and proper character of the management[4].

[4] Directive 2002/87/EC of the European Parliament and of the Council

The PA supervisory framework for financial conglomerates aims to address complexities and gaps resulting from cross-sectoral activities. The framework is intended to target additional prudential risks related to the existence of financial conglomerates and address weaknesses in sectoral supervision without prejudice to sectoral supervision.

The structure of financial conglomerates brings about regulatory gaps and supervisory 'blind spots' when viewed through the current supervisory framework. The financial conglomerate framework is not intended to override or substitute capital and liquidity regulations applicable to each sector. Due care will be taken to avoid creating an undue burden through duplication and conflicts between the standards issued under sectoral laws and the standards issued under the FSR Bill framework and applied at the conglomerate level.

Financial conglomerates are formed because financial firms see prospects of achieving synergies, economies of scale and scope that will make it more profitable to provide a range of services within an integrated corporate group rather than each service through a separately managed corporation. It is claimed that conglomerates have more scope to develop innovative new products and services in response to changing technology and market conditions. Consequently, the innovative environment of such institutions introduces new, potentially more complicated and systemic risks that require closer supervisory attention.

The framework emphasises the importance of recognising structural complexity and the potential risks it poses, 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.

6. REGULATORY & SUPERVISORY FRAMEWORK: FINANCIAL CONGLOMERATE SUPERVISION

The current requirements contained in the Banks Act 94 of 1990, the proposed requirements contained in the Insurance Bill and the proposed requirements contained in the FSR Bill will introduce three levels within the supervisory hierarchy, namely:

Level 1: Supervision of a licensed entity on a standalone basis, which is (referred to as solo supervision.

Level 2: Specialist group supervision where the supervised group operates primarily in one industry (e.g. banking or insurance groups), which is often referred to as consolidated supervision.

Level 3: Supervision of a financial conglomerate, where the group of companies operates in one or more sectors (i.e. insurance, banking or financial market infrastructure).

Financial conglomerate supervision is introduced for the following reasons:

a) Capture risks not covered by the Level 1 or Level 2 frameworks;
b) Minimise risk of failure of financial conglomerate groups.
c) Level 1 and Level 2 – focus on depositor/policyholder/member protection.
d) Level 3: failure minimisation and systemic stability.
e) Obtain a holistic view of group-wide activities, intra-group relationships and large exposures.
f) Consistent application of requirements regardless of industry, structure or mix of businesses.
g) Capture a variety of corporate structure arrangements.

The introduction of the 3 level supervisory hierarchies in South Africa is important because:

a) certain eligible financial institutions are not currently subject to any group regulatory and supervisory requirements (i.e. Financial Market Infrastructures);
b) there is significant interconnectedness of banking and insurance operations in the South African market through cross-shareholding, business models (banc assurance), operational dependency, etc.;
c) the framework will enable effective supervision of Domestic Systemically-Important Financial Institutions (D-SIFIs), including in relation to the proposed special resolution regime; and
d) the approach allows for an integrated model of prudential supervision in the new PA.

At Level 3, the supervision of entities that form part of a financial conglomerate, will focus on the potential risks of contagion, complexity and concentration - the so-called group risks - as well as the detection and correction of 'double gearing' - the multiple use of capital. The global financial crisis showed how group risks materialised across the entire financial sector. This demonstrates the importance of group-wide supervision of such inter-linkages within financial groups and among financial institutions, supplementing the sector specific prudential requirements[5].

7. SUPERVISORY APPROACH

This section addresses the proposed supervisory approach for financial conglomerates in the new PA structure.

a) The supervisory approach will not replace sector-specific supervision but will be an extension of the sector-specific supervisory frameworks.

b) Financial conglomerate supervision will involve the assessment of capital adequacy and liquidity, leverage, compliance with governance and risk management best practices, risks associated with unregulated activities and additional complexities related to cross-sectoral activities to ensure that the structure of the group does not give rise to undue risks.

[5] Report from the Commission to the European Parliament and the Council Brussels, 20.12.2012

c) Supervision will take into account the individual structure and character of each group, including interconnectedness, interdependency and the risks each entity within the group may pose individually and/or to the regulated entities within the group and/or to the group as a whole.

d) The supervisory approach will promote the early identification and ongoing management of all risk types including systemic and organisational risks, allowing the supervisor to focus its supervisory attention based on the risk profile of the group. Supervisory activities will be aimed at developing a holistic view of a conglomerate's business and operating model, financial condition and risk profile, thus undertaking pre-emptive actions to stem any risk that will affect the safety and soundness of the regulated entities and the financial system as a whole. This will involve identifying material risks or areas of concern associated with the activities of the conglomerate or material entities within the conglomerate, and assessing the adequacy of group-level oversight and the risk management systems.

e) Based on the above, the PA is to establish, implement and maintain risk-based prudential standards for financial conglomerate. At a minimum, the prudential standards would cover requirements on:
    i. capital adequacy, capital planning and identification and management of specific risks that are not completely/sufficiently captured/assessed at sector-specific supervision. It is the responsibility of the financial conglomerate Board to manage the group capital plan;
    ii. leverage;
    iii. the adequacy and robustness of the risk management processes, practices and systems of the financial conglomerate;
    iv. corporate governance frameworks and their adherence to best practice; and
    v. public disclosure.

f) The PA would apply supervisory requirements relating to resolution and recovery planning for financial conglomerate to take into consideration the relationships and interdependencies within the financial group.

g) The supervisor may impose additional requirements on the group should any deficiencies be identified in any non-regulated entity within the financial conglomerate during the above-mentioned process. This will include, but not be limited to, additional capital to be held in terms of the group capital adequacy requirement as well as additional risk management and/or reporting requirements.

h) As the activities of financial conglomerates span across borders and product markets, other authorities are also likely to be responsible for regulating or supervising certain entities or activities carried out within the financial conglomerates. The PA intends to leverage on the cooperation and coordination arrangements with other regulatory authorities, both domestic and international, in the supervision of financial conglomerates to facilitate timely information flows and effective supervisory responses or interventions, while also minimising duplicative supervisory efforts. The sharing of information will allow a more comprehensive and accurate assessment of the financial performance and risk profile of the financial conglomerates.

8. LEGAL FRAMEWORK FOR CONGLOMERATE SUPERVISION

The legal framework for the supervision of financial conglomerates should grant supervisors the following authority[6]:

a) The legal framework for the supervision of financial conglomerates should grant supervisors (including the Group-level Supervisor) the necessary powers and authority to enable comprehensive group-wide supervision (Principle 1).

b) The legal framework should grant the necessary power and authority to supervisors to enable efficient and effective cooperation, coordination and information sharing among supervisors in order to facilitate group-wide supervision (Principle 2).

c) The legal framework should provide supervisors with operational independence while ensuring accountability for the discharge of their duties (Principle 3).

The FSR Bill will introduce conglomerate supervision (Level 3 supervision) within the supervisory hierarchy.

9. SHAREHOLDING/OWNERSHIP STRUCTURE

The shareholding/ownership structure of a financial conglomerate should not be a source of weakness and should minimise the risk of contagion from activities conducted by shareholders in other entities within or outside the conglomerate. The shareholders of a financial conglomerate need to be assessed and approved by the PA.

10. SCOPE OF SUPERVISION

This section describes in detail the scope of supervision.

10.1 Entities within the scope of supervision

The PA has the power in terms of section 160 of the FSR Bill, to designate a group as a financial conglomerate even when it conducts business in only one financial sector but has material financial activities that are not sufficiently captured under the respective sectoral frameworks.

[6] The Joint Forum Principles on the Supervision of Financial Conglomerates

10.2 Holding Companies

10.2.1 The general philosophy behind the regulation and supervision of controlling companies and their subsidiaries include, among other things, ensuring that groups do not affiliate with companies engaged in undesirable practices.

10.2.2 Conglomerate groups structured underneath holding companies present additional challenges to financial supervisors. Supervisors, whose primary responsibilities are oriented towards depositors (banks), policy-holders (insurance companies) and investors (securities firms), need to be assured that, with regard to banks, insurance companies and securities firms within banking groups, the holding company and its unlicensed and unregulated subsidiaries are:

a) a source of support (i.e. management and capital support); and
b) not a source of weakness.

10.2.3 Supervision of financial conglomerates will include as a minimum, and to the greatest extent possible:

a) the controlling/holding companies of a financial conglomerate, that is all majority-owned or controlled banking, insurance and securities companies in the relevant conglomerate group; and
b) all other majority-owned or controlled regulated or unregulated entities or activities conducted by such controlling/holding companies or any relevant subsidiary in the conglomerate group;

10.2.4 The proposed scope of application for the PA framework will include any holding company that is the parent entity within a financial conglomerate to ensure that it captures the risk of the entire group. Supervision may be extended to an entity higher up in the structure if a controlling/holding company is controlled by another entity, institution or person.

10.2.5 Financial conglomerate supervision thus extends to all the companies, institutions, entities or persons in a conglomerate group, including a controlling/holding company and its subsidiaries, joint ventures and companies, institutions or entities in which the controlling company or its subsidiaries have a direct or an indirect majority-owned or controlled participation.

10.2.6 All financial groups that meet the definition of a financial conglomerate will be supervised by the PA. Financial conglomerates, particularly those active across borders, need to be subject 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 regulated or unregulated) that may have a significant impact on the financial position of the group.

10.2.7 The PA framework will employ the full spectrum of supervisory tools and powers, regardless of the legal structures of financial conglomerates and extend the scope of supplementary supervision to non-regulated entities such as special purpose entities (SPEs).

10.3 Unregulated entities

10.3.1 Financial conglomerate supervision should cover all entities in the group that are applicable for the risk profile of the regulated entities in the group. This includes any entity not directly prudentially regulated, even if it carries out activities outside the financial sector, including non-regulated holding and parent companies at the top of the group. Each unregulated entity may present different risks to a conglomerate and each may require separate consideration and treatment.

10.3.2 Among unregulated entities, special importance is attached to SPEs. The number of SPEs and the complexity of their structures increased significantly before the global financial crisis, in conjunction with the growth of markets for securitisation and structured finance products. While the use of SPEs yields benefits and may not be inherently problematic, the global financial crisis has illustrated that poor risk management and a misunderstanding of the risks of SPEs can lead to disruption and failure.

10.3.3 As stated earlier, the PA framework will capture risks arising from the activities of unregulated entities, which are entities within the financial conglomerate (or the wider group to which the financial conglomerate belongs) that are not directly prudentially regulated.

10.3.4 Consideration will be given to:

a) operating and non-operating holding companies (including intermediate holding companies); and
b) unregulated parent companies and subsidiaries, and SPEs.

11. GROUP STRUCTURE OF FINANCIAL CONGLOMERATES

In the supervision of financial conglomerates, the primary concerns are contagion, transparency and autonomy. When liquidity and solvency risks manifest themselves in any member of a group, the likelihood of contagion in a group is a major concern. With regard to group structures, the following are of importance:

11.1 Transparency of legal structure

Financial conglomerate groups vary widely in structure, range of activities and complexity. This could complicate the effective supervision of such groups. Users of products and services of such a conglomerate group must be able to make a proper assessment of the group's activities and risk profile.

The financial conglomerate should have a transparent organisational and managerial structure, which is consistent with its overall strategy and risk profile and is well understood by the board and senior management of the holding/controlling company (Principle 11).

11.2 Acquisitions or the establishment of new group entities

The PA will have the power to approve or reject (or when relevant in exceptional cases, recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a financial conglomerate.

As a minimum, the following matters will be considered when applications are submitted:

a) New acquisitions and investments should not expose the financial conglomerate to undue risks or hinder effective conglomerate supervision;
b) Acquisitions should not hinder effective implementation of corrective measures in future;
c) The supervisor can prohibit financial conglomerate groups from making major acquisitions/investments (including the establishment of cross-border banking operations).

11.3 Pyramid structure

A pyramid structure weakens the control over any group and increases the complexity of the group structure. The complexity of a group structure also often reduces transparency. The enlarged group structure in a merger/acquisition should have the fewest layers possible and should be as simple as possible. The group structure should clearly indicate which shareholders exercise control over a group and which owners have the financial responsibility of providing the group with future capital.

11.4 Cross-shareholdings

Large intragroup holdings of capital increase the possibility of financial difficulties in one entity in the group being transmitted more quickly to other entities in the group. Since intragroup capital does not represent externally generated capital, intragroup capital should be excluded from the assessment of group capital.

11.5 Shelf companies

A shelf company is a company that a regulated institution establishes to keep on the 'shelf' until such a company is needed for a special purpose. The use of "shelf" companies will not be allowed by the PA.

12. MINIMUM PRUDENTIAL STANDARDS FOR FINANCIAL CONGLOMERATES

12.1 Capital adequacy

12.1.1 Objective

The objective of the assessment of capital adequacy on a group-wide basis for financial conglomerates is to identify situations such as double or multiple gearing which can result in an overstatement of group capital and which can have a material adverse effect on the regulated financial entities.

The measurement techniques of capital adequacy should be designed to:

a) detect and provide for situations of double or multiple gearing, (i.e. where the same capital is used simultaneously as a buffer against risk in two or more legal entities);
b) detect and provide for situations where a parent company issues debt and downstream the proceeds in the form of equity, which can result in excessive leverage;
c) include a mechanism to detect and provide for the effects of double, multiple or excessive gearing through unregulated intermediate holding companies that have participations in dependants or affiliates engaged in financial activities;
d) include a mechanism to address the risks being accepted by unregulated entities within a financial conglomerate that are carrying out activities similar to the activities of entities regulated for solvency purposes (e.g. leasing, factoring, reinsurance).
e) address the issue of participations in regulated dependants (and in unregulated dependants) and to ensure the treatment of minority and majority interests is prudentially sound[7].

The 2012 Joint Forum Principles reiterates the importance of capital adequacy and capital management principles for financial conglomerates. The requirements below are intended to supplement the principles for sectoral supervision and focuses specifically on the Level 3 supervision framework.

Capital is the cornerstone of a Level 3 group's financial strength. It supports the group's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of problems, enables the group to continue to operate in a sound and viable manner while the problems are addressed or resolved[8].

[7] The Joint Forum: Principles on the Supervision of Financial Conglomerates.

[8] See for example the APRA Discussion paper Supervision of Conglomerate Groups March 2010

Capital management must be an integral part of a Level 3 group's risk management, with the objective that its capacity to absorb losses is adequate for its risk appetite and risk profile[9].

a) The Board of a Level 3 holding company is ultimately responsible for ensuring the capital adequacy of the group and establishing appropriate capital management processes and plans to ensure appropriate levels of surplus capital. The PA would also require the Level 3 holding companies to prepare, on an annual basis, an Internal Capital Adequacy Assessment Process (ICAAP) or an Own Risk and Solvency Assessment (ORSA) approved by the company's Board. The ICAAP or ORSA should consider and assess all risks across the Level 3 group and to assess any potential double gearing.

b) Due to the nature of the various sectoral capital requirements and calculation, there is no uniform definition for capital or the tiered approach across the various sectoral industries and therefore the PA deemed it necessary to provide more detail on its proposed approach for determining the required capital and eligible capital at Level 3.

c) Financial conglomerates would be required, at the ultimate Level 3 holding company, to always have sufficient eligible capital exceed required capital and the PA would expect the group to set an internal capital target or range, approved by the Board, by which eligible capital should exceed required capital. This internal target or capital buffer should emanate from the Level 3 holding company's ICAAP or ORSA process.

12.1.2 Required capital

Required capital will be based on a 'building block' or the 'risk-based aggregation method' approach whereby the various sectoral capital requirements at either a Level 1 or Level 2 will be *aggregated* to determine the total required capital for the Level 3 group.

The Level 3 group will be required to hold capital for the aggregated summation through the building block approach or the risk-based aggregation method, together with any possible additional capital for unregulated entities not already included in any Level 2 capital requirements, together with additional capital pertaining to the group, based on additional risks identified by the PA.

The PA will continue to liaise with the industry on the more granular detail and any calibration of the 'building block' or 'risk-based aggregation approach', the additional capital required for unregulated entities, and capital for any additional risks identified within the Level 3 group.

[9] See for example the APRA Discussion paper Supervision of Conglomerate Groups March 2010

The proposed building block approach will mainly consist of the aggregated required level of capital of either the Level 1 or Level 2 group across the various sectoral industries.

Level 3 capital requirements = ∑Banking + ∑General (short term) insurance + ∑Life insurance +∑Other unregulated entities + ∑ Additional capital as prescribed by the PA

12.1.3 Eligible capital

Eligible capital (or capital supply) at a Level 3 group will largely be based on an equity equivalent (Tier 1 type of equity) for the definition of capital, as these are deemed to be the highest quality and have the highest loss-absorbing characteristics. Equity equivalent types of capital mainly consist of ordinary shares, retained earnings and reserves.

Level 3 groups would be allowed to determine eligible capital through two methods: (i) a top-down approach using consolidated financial statements of the group; and (ii) through a bottom-up building block approach or a risk based aggregation approach whereby the eligible capital is aggregated for all sectoral blocks. The method applied would need to be discussed with the PA and formal written approval would need to be obtained. The PA will continue to liaise with industry and define the granular detail of the eligible capital definitions for Level 3 groups, as the concept of eligible capital differs across the various sectors.

Various adjustments might have to be made at Level 3 for both required capital and eligible capital due to, for example:

a) Industry specific adjustments that apply at Level 1 or Level 2 groups;
b) Intra-group transactions; and
c) Additional risks identified across the Level 3 group.

These adjustments might be across all financial conglomerates or on a case-by-case basis, depending of the nature and structures of a Level 3 group.

The eligible capital of a financial conglomerate must at all times exceed the required level of capital for the financial conglomerate.

12.1.4 Location and transferability of capital

The PA will not prescribe where the capital should be held within a Level 3 group, as this will be left to the discretion of the Level 3 Board or management based on their capital management processes and plans, together with cognizance of capital transferability within the group.

Level 1 and Level 2 capital requirements must still be met at the various levels based on the relevant sectoral requirements. Any additional capital needed pertaining to unregulated entities does not necessarily have to be held at the unregulated entity, but should be held somewhere appropriate within the Level 3 group.

12.1.5 Unregulated entities

Unregulated entities are entities within the financial conglomerate (or the wider group to which the financial conglomerate belongs) that are not directly prudentially regulated.

As a minimum, the following characteristics, and their impact on regulated entities, should also be considered:

a) direct or indirect participation, influence and/or other contractual obligations;
b) interconnectedness;
c) risk exposure;
d) risk concentration;
e) risk transfer;
f) risk management;
g) intra-group transactions and exposures;
h) strategic risk; and
i) reputation risk.

The calculation of required capital for unregulated entities at Level 3, outside any Level 1 or Level 2 group's capital requirements - will be based on the risk weightings applicable to the standardised approach of the Basel II capital framework.

12.1.6 The PA's proposed approach

Capital adequacy

Capital adequacy is an integral part of the level 3 framework for conglomerates. A Level 3 financial conglomerate group should at all times be adequately capitalised. At the initial stage no specific quantitative levels or thresholds will be proposed for the size of the excess.

Eligible capital

Eligible capital (or capital supply) at a Level 3 group will be largely based on an equity equivalent (Tier 1 type) for the definition of capital, as these are deemed to be the highest quality and have the highest loss-absorbing characteristics.

Equity equivalent type of capital mainly consists of ordinary shares, retained earnings and reserves.

Level 3 capital comprises of the highest quality components of capital that fully satisfy all the following characteristics:

- provide a permanent and unrestricted commitment of funds;
- are freely available to absorb losses;
- do not impose any avoidable servicing charge against earnings; and
- rank behind the claims of depositors, policyholders and other creditors in the event of winding-up of the issuer.

Unregulated entities (financial and commercial)

Capital for unregulated entities at Level 3, outside any Level 1 or Level 2 groups capital requirements - will be based on the risk weightings of the standardised approach of the Basel II capital framework.

Banking, Insurance and securities entities.

The solo capital adequacy requirements of each of the banking, securities and insurance sectors are different with varying definitions of the elements of capital, and varying approaches to asset and liability valuations. Each sector's capital adequacy requirements reflect the nature of the different businesses undertaken by each sector, the differing risks to which they are exposed, and the different ways in which risk is managed by the firms and assessed (and/or constrained) by supervisors.

Required capital and eligible capital for banking, insurance and securities entities will be based on the sectorial rules applicable at Level 1.

Measurement techniques

The measurement techniques that will be used will be based on either the building block prudential approach or the risk-based aggregation method.

Reporting

Financial conglomerates will be required to submit regulatory returns on a quarterly basis for the calculation of group capital adequacy.

12.2 Leverage

To prevent the build-up of excessive on- and off-balance-sheet leverage in the financial conglomerate group, the PA framework will impose restrictions on the extent to which the conglomerate group can leverage its eligible capital or capital supply.

The requirements related to leverage in respect of financial conglomerate groups are intended to supplement the principles and requirements in respect of sectoral supervision.

The principles and requirements related to leverage in respect of financial conglomerate groups will be based on the sectorial principles and rules applicable on Level 1 and Level 2.

12.3 Concentration risk

Under the PA financial conglomerates will be required to measure and aggregate risks at the conglomerate level. One of the most significant lessons learned from the global financial crisis was that institutions' information technology (IT) and data architectures were inadequate to support the broad management of financial risks. Many institutions lacked the ability to aggregate risk exposures and identify concentrations quickly and accurately at the bank group level, across business lines and between legal entities. Some institutions were unable to manage their risks properly because of weak risk data aggregation capabilities and risk reporting practices. This had severe consequences for the institutions themselves and to the stability of the financial system as a whole.

A risk concentration refers to an exposure with the potential to produce losses large enough to threaten a financial institution's health or ability to maintain its core operations.

Risk concentrations can arise in a financial conglomerate's assets, liabilities or off-balance-sheet items, through the execution or processing of transactions (either products or services), or through a combination of exposures across these broad categories. The potential for loss reflects the size of the position and the extent of loss, given a particular adverse circumstance.

Risk concentrations can take many forms, including exposures to:

a) individual counterparties;
b) groups of individual counterparties or related entities;
c) counterparties in specific geographical locations;
d) industry sectors;
e) specific products;
f) service providers; (e.g. back office services); and
g) natural disasters or catastrophes.

The objective of ensuring that risks arising from large credit exposures to individual clients or groups of connected clients are kept to an acceptable level is part of the overarching principles of prudential supervision, which are to ensure continued financial stability, maintain confidence in financial institutions and protect consumers, in particular depositors.

A large exposure framework protects a conglomerate from significant losses caused by the sudden default of an individual counterparty or a group of connected counterparties.

Large exposures has been developed as a tool for limiting the maximum loss a financial conglomerate could face in the event of a sudden counterparty failure to a level that does not endanger the institution's solvency. To serve as a backstop to risk-based capital requirements, a large exposures framework should be designed so that the maximum possible loss a conglomerate could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the conglomerate's survival as a going concern. In addition, by extending the scope of coverage to exposures to funds, securitisation structures and collective investment undertakings, the framework is also a useful tool to contribute to strengthening the oversight and regulation of the shadow-banking system.

By combining business lines, conglomerates offer the potential for broad diversification. However, new risk concentrations may arise at the group level. In particular, different entities within the financial conglomerate could be exposed to the same or similar risk factors, or to apparently unrelated risk factors that may interact under some unusually stressful circumstances.

Financial institutions face an increased risk of loss when there is a concentration of risk to a single counterparty or a group of connected counterparties. Regulation is used, in particular on limits on large exposures, to encourage firms to control concentrations. Reporting systems will be developed in the PA to assist in monitoring risk concentrations.

A Level 3 holding company must have a large exposure policy in place that addresses all material risk exposures associated with the operations of the group. The policy must include systems and procedures to identify, measure, monitor, evaluate, report and control or mitigate all material risks arising from aggregated risk exposures[10].

Notification requirements: A Level 3 holding company must notify the PA as soon as possible and not more than 10 business days after it becomes aware of:

a) a breach of the limits in the large exposure risk policy;
b) any material breach of, or material deviation from the aggregate risk exposure policy, or
c) that the aggregate risk exposure policy did not adequately address a material risk including remedial actions taken, or to be taken, to deal with the issue.

12.3.1 The PA's proposed approach[11]

The PA proposes risk concentration requirements at the conglomerate level that draw on the key qualitative elements of the existing prudential regulations. The aim will be to ensure that a concentration of risk in one part of, or across, the group does not pose a threat to the regulated entities in the group. The prudential standards will require the conglomerate Board to identify and manage risk concentrations across the group.

It is proposed that the PA implement a large exposure framework as follows:

Definition of a large exposure

The sum of all exposure values of a financial conglomerate to a counterparty or to a group of connected counterparties must be defined as a large exposure if it is equal to or above 10% of the financial conglomerate's eligible capital base.

Eligible capital base

This refers to the effective amount of Tier 1 capital fulfilling the criteria defined in Part 1 of the Basel III framework.

Reporting requirements

Banks must report to the supervisor the exposure values before and after the application of the credit risk mitigation techniques. Banks must report to the supervisor:

a) all exposures with values equal to or above 10% of the financial conglomerate's eligible capital

[10] APRA Discussion paper Supervision of Conglomerate Groups March 2010
[11] BCBS Supervisory framework for measuring and controlling large exposures April 2014

(i.e. meeting the definition of a large exposure);

b) all other exposures with values without the effect of credit risk mitigation being taken into account equal to or above 10% of the financial conglomerate's eligible capital;
c) all the exempted exposures with values equal to or above 10% of the financial conglomerate's eligible capital; and
d) their largest 20 exposures to counterparties and included in the scope of application, irrespective of the values of these exposures relative to the financial conglomerate's eligible capital base.

Values of exposures

This refers to the values of exposures to counterparties, including to a group of connected counterparties that must be treated as a single counterparty.

General measurement principles

The exposure values that a financial conglomerate must consider in order to identify large exposures to a counterparty are all those exposures defined under the risk-based capital framework. It must consider both on- and off-balance-sheet exposures included in either the banking or trading book and instruments with counterparty credit risk under the risk-based capital framework.

An exposure to a counterparty that is deducted from capital must not be added to other exposures to that counterparty for the purpose of the large exposure limit.

Definition of exposure value

The exposure value must be defined as the accounting value of the exposure. As an alternative, a financial conglomerate may consider the exposure value gross of specific provisions and value adjustments

Minimum requirement – the large exposure limit

The sum of all the exposure values of a financial conglomerate to a single counterparty or to a group of connected counterparties must not be higher than 25% of the financial conglomerate's available eligible capital base at all times. This figure is set at 15% for a globally systemic important bank's (G-SIB) exposures to another G-SIB.

The eligible capital base is the effective amount of Tier 1 capital fulfilling the criteria defined in Part 1 of the Basel III framework.

Breaches of the limit, which must remain the exception, must be communicated immediately to the supervisor and must be rapidly rectified.

Definition of connected counterparties

In some cases, a financial conglomerate may have exposures to a group of counterparties with specific relationships or dependencies of such a nature that, when one of the counterparties fail, all of the counterparties would very likely fail. A group of this sort, referred to in this framework as a group of connected counterparties, must be treated as a single counterparty. In this case, the sum of the group's exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as specified above.

Two or more natural or legal persons shall be deemed 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).
b) Economic interdependence: one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter financial problems or repayment difficulties.

Reporting requirements
Level 3 financial conglomerates will have to submit the necessary large exposure returns to the PA on a quarterly basis to the PA.

12.4 Intra group exposures/transactions (Contagion risk)

The level of intra-group support and interconnectedness of legal entities within the group affects the extent to which the failure of one entity poses contagion risk for other entities within the group.

Intra-group exposures originate in a variety of ways, for example through:

a) intragroup cross-shareholdings;
b) trading operations whereby one group entity deals with, or on behalf of, another group entity;
c) central management of short-term liquidity within the group;
d) guarantees and commitments provided to, or received from, other companies in the group;
e) the provision of management and other service arrangements, (e.g. pension funds)
f) arrangements or back office services;
g) exposures to major shareholders (including loans and off-balance-sheet exposures such as commitments and guarantees);
h) exposures arising through the placement of client assets with other group companies;
i) purchases or sales of assets with other group companies;
j) transfer of risk through reinsurance; and
k) transactions to shift third-party-related risk exposures between entities within the conglomerate.

Wider intra-group exposures/transactions not captured by this narrower definition of intragroup support may be put in place for the following reasons:

a) to promote the development of group business activities (e.g. facilitate acquisitions, integration of acquired business, distribution arrangements, internal restructurings, and sales or other disposals of assets or businesses or similar transactions);
b) to enable the group to operate on an integrated basis across different legal entities, some of which may not be in the same jurisdictions;
c) to support entity credit ratings in a group (e.g. parental support of an entity in order to obtain the same credit rating as the parent entity) and therefore ensuring competitive financing terms for entities of the group;
d) to promote efficient use and fungibility of the group's capital resources across the different legal entities; and
e) to manage and provide liquidity and capital resources across the group.

Notwithstanding their economic and commercial benefits, both intra-group exposures/transactions and support measures have the potential to adversely affect the solvency, liquidity and profitability of individual entities within a group. They can impede effective supervision and resolution efforts, and increase contagion risk across the group[12].

Contagion risk is probably the most significant problem associated with the formation of a financial conglomerate. It refers to the risk suffered by an individual entity within the conglomerate and its adverse impact on the financial stability of the entire group or on the markets in which the constituent parts operate.

Contagion risk can occur due to a direct financial connection between a problematic entity and a healthy one. Even in the absence of direct financial connections, risk contagion can also be reflected by reduced public confidence in the stability of individual entities or the conglomerate as a whole because the public tends to view financial conglomerates as a single economic unit. Reduced confidence in either leaves regulators with a new problem to tackle.

At least three issues can be derived from contagion risk:

a) how to erect a firewall between different entities of a financial conglomerate so as to limit the financial connections and prevent financial difficulties occurring in one entity from adversely affecting another;
b) how to enhance the market discipline to encourage public disclosure for the purpose of strengthening the public confidence; and
c) how to determine the extent to which the official safety net needs to be extended to address the financial problems of financial conglomerates encompassing banking sectors.

Intra-group transactions and exposures (ITEs) can facilitate the synergies within different parts of the conglomerate and thereby lead to healthy cost efficiencies and profit maximisation, improvements to risk

[12] Report on intragroup exposures JF2012

management, and more effective control of capital and funding. Often achieving these benefits is a major goal of the organisational structures that give rise to ITEs. At the same time, material ITEs represent avenues of contagion within the conglomerate and potentially complicate the resolution of failures. Achieving the appropriate balance between the benefits and risks of ITEs is an important objective for conglomerates and for supervisors, and the appropriate balance may vary across activities and types of ITEs.

Conglomerates centralise key activities and enter into ITEs to facilitate risk management, seek efficiencies, and manage capital and funding. The emergence of financial conglomerates and the complexities of their operations have resulted in a broad range of ITEs.

12.4.1 The PA's proposed approach

The PA proposes requirements for intra group transactions and exposures (ITEs) at the financial conglomerate level that are based on the key qualitative elements of the existing industry prudential standards relating to ITEs, which include the requirement to have policies and procedures in place for the management of ITEs and to report to the PA on such exposures. The existing quantitative requirements at sector level will continue to apply. The aim will be to ensure that at the financial conglomerate level the Board manages the risk that problems in one entity may compromise the financial and operational position of another entity because of links through ITEs.

Monitor
The PA will monitor all intragroup exposures to assess the interconnectedness as well as the contagion risk in a financial conglomerate.

Reporting requirement:
These are exposures to an entity within a conglomerate group resulting in the conglomerate group being exposed to that entity to an aggregate amount exceeding 1% of the financial conglomerates eligible capital should be reported to the PA on a quarterly basis.

Arm's length:
All intragroup lending in a financial conglomerate should be conducted on an arm's length basis to prevent possible abuses arising from connected and related party lending.

Cross-shareholding
Cross-shareholding do not represent externally generated capital and increase contagion risk in a conglomerate. Cross-shareholding within a financial conglomerate will not be allowed.

Regulatory
The PA will endeavour not to duplicate or unnecessarily increase regulatory reporting to the extent where value is not added. For this reason the reporting of intragroup exposures will be similar to what is currently required by the Bank Supervision Department in respect of intragroup exposures on Level 2 reporting.

12.5 Liquidity Risk

The Joint Forum has made it clear that the Joint Forum Principles are not intended to substitute liquidity regulations applicable to each sector.

Liquidity risk is largely a legal entity and jurisdictional issue. However, stress events in the past have shown that liquidity risk can quickly spill over from legal entities and jurisdictions. Therefore, it is important to form an opinion on the liquidity risk management practises in the entities within the financial conglomerate, as well as evaluate it from the perspective of the ultimate holding company of the financial conglomerate.

The PA does not propose to add any new prudential requirements on financial conglomerates relating to liquidity risk management. The PA will look to incorporate all the Principles relating to liquidity risk into its regulatory framework and supervisory practices. This will inter alia include minimum requirements relating to governance and risk management practices as well as regulatory reporting requirements.

The PA will also specify the restrictions and requirements for intragroup exposures. Areas that would receive particular attention are any real and potential restrictions on the transferability (between entities on a same currency basis) and convertibility (from one currency to another) of liquidity between entities and jurisdictions.

Entities should also have the ability to evaluate their contingency plans on a frequent basis to ensure that they have the ability to execute their plans on it and also to ensure that the execution of the plan does not lead to negative signalling during times of stress.

13. Risk management

Risk management should be commensurate with the size and complexity of groups. In order to achieve this, a financial conglomerate should adopt a combined assurance model with regard to its management of risk in the group.

The combined assurance model entails achieving synergy between compliance, risk and internal audit. The King Report on Corporate Governance defines combined assurance as integrating and aligning assurance processes in an organisation to maximise risk and governance oversight and control efficiencies, and optimise overall assurance to the audit and risk committee, considering the company's risk appetite.

Part of the combined assurance model to support management could be external assurance providers to supplement the internal assurance providers.

Risk management is a crucial focus of financial conglomerate supervision. The PA is proposing to extend its risk management requirements to financial conglomerate in line with the Principles of the Joint Forum for conglomerate supervision issued in September 2012. Accordingly, the prudential standard would be a core tool for managing group risk.

A clear and well-defined risk management framework of the group is essential to ensure that risks arising from all relevant downstream entities of the group which have the potential for posing a material risk to the group are appropriately managed and monitored. In this regard, the interrelatedness and interdependencies of the various group entities need to be analysed and taken into account when formulating a view on risk management.

The risk management framework of the group will be sufficiently robust to ensure, among other things-

a) that risks related to outsourcing by entities in the group are duly assessed, including the appropriateness of outsourcing any particular function, when relevant;
b) that the group periodically carries out group-wide stress tests and scenario analyses for its major sources of risk.

Accordingly, the Board of the holding company of financial conglomerate should have a comprehensive group-wide view of all material risks (regulated and unregulated entities), including an understanding of the roles and relationships of subsidiaries, to one another and to the group. Further, the holding company of a financial conglomerate must develop and maintain processes to coordinate the identification, measurement, evaluation, reporting and control or mitigation of all material risks (regulated and unregulated entities) across the group, in normal times and periods of stress.

Crucial to the entire end-to-end process of risk management is the quality of risk data and how it is utilised in the group to inform effective risk management decisions by the various governance forums.

14. Corporate Governance

Corporate governance is the framework and principles of an organisation which governs its strategy, management and administration. Corporate governance incorporates relevant organisational policies, systems, processes and regulations and sets the tone for relationships between the Board, management, shareholders, the regulator and other stakeholders.

An effective system of corporate governance encourages multi-sectorial confidence and plays a pivotal role in supporting market integrity and financial stability. Good corporate governance requires transparency, fairness and balance between the varying needs of stakeholders. Consequently, corporate governance forms an integral component of financial conglomerate supervision.

The inherent complex nature of financial conglomerates, which may incorporate both regulated and unregulated entities, requires the establishment of a robust governance framework. This involves establishing a comprehensive and consistent governance framework across the group that addresses the sound governance of the financial conglomerate, including unregulated entities, without prejudice to the governance of individual entities in the group[13].

The existing requirements in relation to corporate governance for banks are codified in the Banks Act (Act No. 94 of 1990) and the Regulations relating to Banks. The governance requirements for insurance companies are effected in terms of the Long-Term Insurance Act (Act 52 of 1998) and the Short-term Insurance Act (Act 53 of 1998). These instruments are aimed at ensuring a sound and prudent corporate governance framework for banks and insurers. The PA intends for corporate governance requirements, at a financial conglomerate level, to be based on principles currently being applied to banking and insurance groups.

The PA proposes that with the implementation of financial conglomerate supervision, minimum requirements in respect of corporate governance will be applied to the holding company of the financial conglomerate. The corporate governance requirements will take the form of prudential standards. In the event that a PA regulated entity or a material entity operating outside of the borders of the Republic of South Africa is subject to less stringent corporate governance requirements in the host country, the more stringent group standard must apply, unless such standard violates local law, in which case the relevant information shall be brought to the attention of the PA.

The following are proposed areas for prudential standards in the interest of promoting a strong and robust governance framework:

[13] Joint Forum. Principle 10.

14.1 Corporate governance framework

The PA will require that financial conglomerates adopt, implement and document an effective governance framework that provides for the prudent management and oversight of its business and adequately protects the interests of its stakeholders[14]. The governance framework of the conglomerate will include suitable policies and processes which should address, inter alia, the ethical foundation and culture of the conglomerate, Board and senior management responsibility, Board composition, performance, audit arrangements, risk management, internal controls, reporting and disclosure, potential conflicts of interest, in particular at the intra-group level, and remuneration policies and practices that are consistent with the group's risk profile.

The corporate governance framework should appropriately balances the diverging interests of constituent entities and the financial conglomerate as a whole, and must be proportionate to the nature, scale and complexity of the business and the risks of the conglomerate[15]. The framework should ensure sound governance throughout all entities in the group without prejudicing the governance of individual entities.[16] The financial conglomerate should emphasise a high degree of integrity and appropriate independence in the implementation of its affairs.

14.2 The structure of the financial conglomerate

The Board of the holding company of the conglomerate must ensure that the conglomerate has a transparent organisational and managerial structure, which is consistent with the corporate governance framework and the overall strategy and risk profile of the group.

The structure, objectives, purpose, operations, and material risks of the financial conglomerate, including those of unregulated entities must be well understood and describable by the Board and senior management of the conglomerate.[17]

There should also be a formal process of information sharing between entities within the financial conglomerate to ensure effective communication within the group.

The Board of the holding company should ensure the transparency of the ownership structure of the financial conglomerate, including the ultimate beneficial owners. Information pertaining to financial soundness and integrity of significant owners must also be available.[18]

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[14] FSB. Board Notice 158. Governance and Risk Management Framework for Insurers.
[15] Insurance Bill. Section 30.
[16] Joint Forum, Principle 10. Principles for supervision of financial conglomerates.
[17] Joint Forum. Principle 10. Principles for supervision of financial conglomerates.
[18] Joint Forum, Principle 10. Principles for supervision of financial conglomerates.

14.3 Roles and Responsibilities

The prudential standards will require that the Board of the holding company of the financial conglomerate defines the strategy and risk appetite of the financial conglomerate[19]. The Board of the holding company must understand its role and responsibilities in being ultimately responsible for the sound and prudential management of the conglomerate.

The Board of the holding company is also responsible for, inter alia, ensuring that strategy is implemented and executed throughout all entities in the conglomerate[20] as well as for the governance of control functions and the maintenance of a culture of risk awareness and ethical behaviour for the conglomerate.

14.4 Fitness of board members

The prudential standards will include the requirement of a conglomerate to establish sound internal standards of ethics and integrity to ensure that appropriate and pertinent expertise, educational qualifications, competence, skills and knowledge are met by persons responsible for the management and control of the financial conglomerate. Such persons must have the ability to exercise objectivity in making judgments and business decisions[21].

The holding company of the financial conglomerate would be required to ensure the suitability of Board members, senior management and key persons whose activities for group entities may materially affect the whole, or a substantial part of the business, of a financial conglomerate or its financial standing, either directly or indirectly.

The Board of the holding company should ensure that periodic evaluations for suitability of key personnel are conducted.

Prudential standards will be issued by the PA in terms of fit and proper person requirements applicable to:

a) significant owners; and
b) Board members, senior management and key persons in control functions in relation to personal character qualities of honesty and integrity, financial standing and competence, including experience, qualifications and knowledge.

The PA may object to the appointment or continued employment of a board member, senior manager or key person in a control function if the PA reasonably believes that the Board member, senior manager or key person in a control function concerned is not, or is no longer, a fit and proper person to hold that

[19] Joint Forum, Principle 13. Principles for supervision of financial conglomerates.
[20] Joint Forum. Principle 13. Principles for supervision of financial conglomerates.
[21] Joint Forum. Principle 12. Principles for supervision of financial conglomerates.

appointment, or if it is not in the public interest that such board member, senior manager or key person in a control function holds or continues to hold such appointment.

14.5 Remuneration in a financial conglomerate

The financial conglomerate should formulate and implement an appropriate remuneration policy that takes its risk profile into account[22]. The risk policy must ensure effective governance of remuneration throughout the conglomerate and must be incorporated into the financial conglomerate's broader risk management framework. The ultimate oversight of the risk policy is the responsibility of the Board of the holding company of the conglomerate.

14.6 Interest of stakeholders

The governance framework should address the interests of policy-holders and depositors (where relevant), and should seek to ensure that it respects the interests of other recognised stakeholders of the financial conglomerate and ensures the financial soundness of entities in the financial conglomerate. The Board of the holding company should ensure that there is proactive engagement with stakeholders and that there is an appropriate balance between various stakeholder groups[23].

15. Reporting requirements

15.1 Audit related matters

The PA relies on the registered auditors at the Level 1 and Level 2 entities for assurance on aspects pertaining to the prudential requirements and the general control environment at these entities. BSD currently has to approve the registered auditors at Level 1 and Level 2, and as the PA will require some additional assurance to be obtained at a Level 3 holding company's compliance with the prudential requirements, it will also be required for some additional work to be done by auditors.

The PA will need to approve the auditors to be appointed at a Level 3 group, if different from the auditors at the Level 1 or Level 2 entities.

The PA will continue to liaise with the audit industry at the current existing forums to develop a practical approach to the level of assurance needed at a Level 3 holding company and to develop the relevant auditor reports through the relevant structures under the Independent Regulatory Board for Auditors (IRBA).

[22] Joint Forum.Principle 14. Principles for supervision of financial conglomerates.
[23] King III – Principle 8. Governing stakeholder relationships.

The approval of the auditors will follow a similar process to BSD’s current fit and proper test for auditors and it is envisaged that bi-lateral engagements be held with the auditors on a regular basis as part of the normal supervisory processes for a Level 3 group.

Further work will be undertaken with industry (financial entities and auditors) to define the exact scope of the registered auditors, including the additional reporting requirements for which assurance needs to be provided and the frequency thereof.

15.2 Consolidated Financial Statements

The holding company of a conglomerate group should prepare consolidated financial statements in terms of International Financial Reporting Standard 10 (IFRS 10).

16. INFORMATION EXCHANGE, COOPERATION AND COORDINATION

An important component of an effective group-wide supervision regime is the ability and authority to exchange key information between and cooperate and coordinate with other supervisors on either a cross border or cross sector basis. In addition to the IAIS principles as highlighted under core principle 3 and 25 and the principles of consolidated supervision as set out by the BCBS, the PA has within its legislative framework, namely the FSR Bill, the ability to cooperate, coordinate and share information with other supervisors on a financial conglomerate-wide basis in order to facilitate the comprehensive oversight, and strengthen the supervision of financial conglomerates.

The PA acknowledges the important role all relevant supervisors play in the supervisory process of financial conglomerates given the sectoral, cross sectoral, domestic and international nature of financial conglomerates. With the implementation of financial conglomerate supervision, there will commonly be more than one supervisor responsible for entities within a financial conglomerate, particularly where the conglomerate operates across borders, and cross-border and cross-sector cooperation and information sharing between the relevant supervisory authorities of the financial conglomerate will form part of financial conglomerate supervision.

In the above regard, various mechanisms available to the PA for fostering cooperation, promoting communication and information exchange and facilitate coordination include, but are not limited to memorandums of understanding, multilateral memorandums of understanding, participation in supervisory colleges, cooperating in on-site and off-site supervision, and utilising generic reporting templates to obtain frequent information/updates from other regulators in relation to financial conglomerates. Co-ordination arrangements will have due regard to the legislative frameworks applicable and authorities of the various supervisors involved.

Effective supervision of financial conglomerates requires the home supervisor to have sufficient knowledge of the operations of the group, both domestic and foreign, so as to monitor, assess and deal with risks faced by the group. The PA places reliance on other supervisors to ensure the proper supervision of the entities operating in their jurisdictions. Although home-country supervisors and host-country supervisors might have different interests in relation to the supervision of a financial conglomerate, depending on whether the group has material risk exposures in the host jurisdiction and whether it poses a systemic risk to the host jurisdiction, the host supervisor should have appropriate knowledge with respect to the group's operations within its jurisdiction and the impact of those operations on the group. Furthermore, the host-country supervisor's ability to communicate directly with entities within its jurisdiction as well as its ability to take specific supervisory action is of great value to the supervisory process.

The PA will consider who of the involved supervisors of financial conglomerates would be the lead supervisor. The lead supervisor will cooperate and coordinate with other relevant supervisors and authorities subject to confidentiality requirements. The home supervisor of the holding company of the financial conglomerate would be first considered to take the role of the lead supervisor, however, other factors would also be considered in determining the above.

17. Timely corrective actions and enforcement

The PA will ensure that adequate measures are in place, as part of its supervisory framework, to ensure the continued compliance by all relevant prudentially regulated financial institutions with the relevant provisions of the FSR Bill and other relevant legislation.

The aforementioned measures will be sufficiently robust to ensure that when a prudentially regulated financial institution does not comply with any provision contained in the FSR Bill or any other relevant legislation, the PA will:

a) requires that the relevant regulated financial institution implements timely corrective actions;
b) imposes an appropriate administrative penalty; and/ or
c) takes such other or further measures in accordance with the provisions of the FSR Bill or the Banks Act, 1990, and the relevant Regulations relating thereto, as may be deemed necessary by the PA.

Annexure A: The Joint Forum Principles on the Supervision of Financial Conglomerates

1.	The legal framework for the supervision of financial conglomerates should grant supervisors (including the Group-level Supervisor) the necessary powers and authority to enable comprehensive group-wide supervision.
2.	The legal framework should grant the necessary power and authority to supervisors to enable efficient and effective cooperation, coordination and information sharing among supervisors in order to facilitate group-wide supervision.
3.	The legal framework should provide supervisors with operational independence while ensuring accountability for the discharge of their duties.
4.	Supervisors of financial conglomerates should be adequately resourced in a manner that does not undermine their independence.
5.	Supervisors should ensure there is a clear process in place for coordinating various roles and responsibilities with clearly delineated responsibility for ensuring effective and comprehensive group-level supervision, including a coordination process to identify a group-level supervisor.
6.	Supervisors should establish a process to confirm the roles and responsibilities of each supervisor in supervising the financial conglomerate, and to ensure efficient and effective information sharing, cooperation and coordination in the supervision of the financial conglomerate.
7.	Supervisors should establish, implement and maintain a comprehensive framework of risk-based minimum prudential standards for financial conglomerates.
8.	Supervisors should develop and maintain a sound understanding of the operations of financial conglomerates through undertaking a range of appropriate supervisory activities.
9.	Supervisors should, when appropriate, utilise supervisory tools to compel timely corrective actions and/or enforce compliance of financial conglomerates with the prudential framework.
10.	Supervisors should seek to ensure that the financial conglomerate establishes a comprehensive and consistent governance framework across the group that addresses the sound governance of the financial conglomerate, including unregulated entities, without prejudice to the governance of individual entities in the group.
11.	Supervisors should seek to ensure that the financial conglomerate has a transparent organisational and managerial structure, which is consistent with its overall strategy and risk profile and is well understood by the board and senior management of the head company.
12.	Supervisors should seek to ensure that the board members, senior managers and key persons in control functions in the various entities in a financial conglomerate possess integrity, competence, experience and qualifications to fulfil their role and exercise sound objective judgment.

13. Supervisors should require that the board of the head of the financial conglomerate appropriately defines the strategy and risk appetite of the financial conglomerate, and ensures this strategy is implemented and executed in the various entities, both regulated and unregulated.

14. Supervisors should require that the financial conglomerate has and implements an appropriate remuneration policy that is consistent with its risk profile. The policy should take into account the material risks that the organisation is exposed to, including those from its employees' activities.

15. Supervisors should require that the financial conglomerate:
    a) maintains adequate capital on a group-wide basis to act as a buffer against the risks associated with the group's activities;
    b) develops capital management policies that are approved and regularly reviewed by the board, and that include a clearly and formally documented capital planning process that ensures compliance with capital requirements on a group-wide and regulated entity basis; and
    c) considers and assesses the group-wide risk profile when undertaking capital management.

16. Supervisors should require that the capital adequacy assessments undertaken by the financial conglomerate consider group-wide risks, including those undertaken by unregulated entities within a financial conglomerate, and that these assessments soundly address third party participations and minority interests.

17. Supervisors should require that capital adequacy assessment and measurement techniques consider double or multiple gearing.

18. Supervisors should require that capital adequacy assessment and measurement techniques address excessive leverage and situations where a parent issues debt and down-streams the proceeds in the form of equity to a subsidiary.

19. Supervisors should require that assessment and measurement techniques evaluate any limitations on intra-group transfers of capital, taking into account potential impediments to executing such transfers that could constrain their suitability for inclusion in the assessment of group capital.

20. Supervisors should require that the head of the financial conglomerate adequately and consistently identify, measure, monitor, and manage its liquidity risks and the liquidity risks of the financial conglomerate. Supervisors should require that liquidity be sufficient across the financial conglomerate to meet funding needs in normal times and periods of stress.

21. Supervisors should require that an independent, comprehensive and effective risk management framework, accompanied by a robust system of internal controls, effective internal audit and compliance functions, is in place for the financial conglomerate.

22. Supervisors should require that the financial conglomerate have in place processes and procedures to engender an appropriate group-wide risk management culture.

23. Supervisors should require that the financial conglomerate establishes appropriate board approved, group-wide risk tolerance levels and a risk appetite policy.

24. Supervisors should require that the financial conglomerate carries out a robust risk assessment when entering into new business areas.
25. Supervisors should require that, when considering whether to outsource a particular function, the financial conglomerate carries out an assessment of the risks of outsourcing, including the appropriateness of outsourcing a particular function.
26. Supervisors should require, where appropriate, that the financial conglomerate periodically carries out group-wide stress tests and scenario analyses for its major sources of risk.
27. Supervisors should require that the financial conglomerate aggregate the risks to which it is exposed in a prudent manner.
28. Supervisors should require that the financial conglomerate has in place effective systems and processes to manage and report group-wide risk concentrations and intra-group transactions and exposures.
29. Supervisors should require that off-balance sheet activities, including special purpose entities, are brought within the scope of group-wide supervision of the financial conglomerate, where appropriate.