# EXECUTIVE SUMMARY AND KEY RECOMMENDATIONS[1]

**The implementation of a twin peaks model represents a significant change to the South African financial supervisory architecture.** The Prudential Authority (PA), operating within the administration of the South African Reserve Bank (SARB), is responsible for promoting and enhancing the safety and soundness of financial institutions that provide financial products and securities services. A separate authority, the Financial Sector Conduct Authority[2] (FSCA), is responsible for market conduct regulation and supervision. The introduction of the twin peaks architecture was motivated by a need to increase the robustness of the financial sector regulatory and supervisory system, reinforce financial stability, improve protection of customers, and enhance cooperation among the regulators.

**In practice, the PA operates as an independent supervisor, yet there is room to further strengthen the PA's independence and accountability and better articulate its mandate.** The PA operates with staff seconded from the SARB and, as a new agency, thus benefits from the credibility, professionalism, and integrity of the SARB staff. Even though no major gaps have been observed, the Financial Sector Assessment Program (FSAP) team recommends a review of legislation to further strengthen operational independence and the accountability framework. The PA has been developing position papers for a clearer articulation and communication of the PA's risk tolerance and how the PA balances its primary objective of safety and soundness with its ancillary functions of supporting financial inclusion and competition. This is particularly important to reinforce risk-based allocation of resources and to mitigate the adverse implications on financial inclusion and the PA's credibility should additional smaller banks fail.

**To deal with COVID-19 crisis impact, the PA provided timely regulatory relief to banks designed to enable them to continue to extend credit to South Africa's economy and preserve financial stability.** Supervisory monitoring was intensified, and flexibility was provided where necessary. The PA has been working on a roadmap and phased exit strategy from these extraordinary measures, with the aim to ensure stability going forward. The assessors recommend a proactive supervisory stance and capital preservation measures, especially for more vulnerable banks, during the unwinding stage of COVID-19 policy interventions.

**South Africa has a robust prudential regulatory framework for banks, but some areas could be further strengthened.** The PA's current priorities include, among other things, ensuring effective implementation of the Basel III post crisis reforms. The PA is encouraged to fully incorporate the revised Basel Committee on Banking Supervision (BCBS)'s corporate governance principles for banks into its regulatory framework, and to align its Regulations Relating to Banks (Regulations) in the areas of related parties, large exposures, loan restructuring and problem assets with the current BCBS standards and guidance. As substantive matters are already covered in some Regulations, the PA has been working on gap analysis.

**The PA prudential oversight could be further strengthened by being more intrusive and with greater focus on governance and risk management under its new supervisory framework.** The PA

[1] This Technical Note has been prepared by Aldona Jociene, the IMF, and Katia D'Hulster, the World Bank.

[2] The Technical Note mainly refers to the activities of the PA, with little attention given to the role of the FSCA.

should take this opportunity to further refine its ongoing banking supervision processes and practices by way of better structured, more intrusive, and comprehensive supervision to give greater priority to the assessment of the effectiveness of corporate governance and risk management and structures and processes of banks. In addition, more detailed supervisory methodologies are to be developed to assist supervisors with the ratings of banks. As banks are operating in a challenging macroeconomic environment, compounded by the effects of the COVID-19 pandemic, the strengthening of on-site supervision and expanding the PA's cadre of experienced risk specialists is recommended.

**The PA is also expanding its regulatory and supervisory perimeter to financial conglomerates.** The PA is well on track for implementation of the conglomerates framework, but the existing supervisory tools and practices will need to improve and evolve and be further enhanced to specifically cover the expanded conglomerate perimeter. In this respect, further work is needed in the areas of prudential reporting, stress testing, corporate governance and Internal Capital Adequacy Assessment Process (ICAAP).

**In line with its BCBS peer regulators, the PA should regularly issue guidance to banks on observed good practice and its supervisory expectations**. The PA supervisors perform thematic reviews and the FSAP team observed that the Risk Support Department and frontline supervisors have a good understanding of cross cutting issues and industry practices. Yet, this is not shared widely enough with the industry, thus not providing incentives to banks to achieve better and more consistent industry practices. The PA started to publish supervisory outcomes in its Annual Reports.

**Considering that the supervisory approach in South Africa has historically relied heavily on external auditors, there is an urgent need for adequate oversight of external audit quality in banks.** Audit quality has come under pressure in South Africa, particularly following the failure of two smaller banks and other corporate scandals. While there is regular and active engagement between the PA and the banks' external auditors, there is no comprehensive assessment of external audit quality. The Independent Regulatory Board for Auditors (IRBA) oversees audit quality in South Africa but it does not have bank audit experts and the scope of its oversight is limited to statutory audits, (i.e. does not include the regulatory audit activities). Moreover, the VBS corruption scandal has underscored the important of enhancing independent oversight. As a matter of urgency, the PA and the IRBA must start working on a collaborative solution and find additional funding to implement independent oversight of bank audit quality in South Africa. The Reports on the Observance of Standards and Codes (ROSC) in the areas of accounting and auditing should be issued to obtain an independent assessment of the quality of the accounting and audit profession.

**The PA should introduce a more rigorous and structured framework for preventative and early intervention supervisory responses and develop and test contingency plans for weak banks.** The PA deploys various qualitative and quantitative tools and measures the outcomes of which are analyzed and synthesized on an ongoing basis by supervisory teams in order to determine the changing risk profile of supervised entities and to adjust the supervisory approach (e.g., frequency and intensity) as required. The PA analyses indicators through monthly trigger reports, heat maps, Management Information Reports (MIRs), industry analysis, risk matrices, recovery plans, etc., to identify potential issues with supervised entities and take appropriate supervisory actions. The PA has yet to develop a formalized framework for

supervisory interventions that combines quantitative triggers[3] with qualitative aspects.[4] Such frameworks are typically underpinned by early warning indicators that are used to identify early-stage deterioration in a range of risk metrics, thus enabling the supervisory authority to prepare for taking corrective actions that are commensurate with identified risks. These frameworks should not be used in a mechanistic way but are the basis for consensus-based decisions on early supervisory intervention. Contingency plans for dealing with weak banks also need to be developed.

**The power to place a bank under official control through a curator, an essential tool from the PA's supervisory toolkit, will be removed with the Financial Sector Law Amendment Bill (FSLAB).** The absence of a power to place banks under control (akin to "temporary administrators" or "special managers" in other jurisdictions) leaves a significant gap in the PA's capacity to address a stress event in a bank, particularly where the PA has lost confidence in the ability or willingness of a bank's board and management to address the situation (including, but not limit to, situations of fraud or managerial misconduct). The appointment of an administrator with extensive powers (including those of the bank's board of directors) is a basic intervention tool that allows the supervisor to provide for interim management of a bank and to facilitate remediation. The power for the PA to place banks under official control should therefore be retained.

**Continued efforts to increase staff resources for bank supervision and additional and more varied funding sources are needed to ensure that the PA has sufficient means to discharge its responsibilities.** The PA's ability to finance its supervisory activities through levies and special fees is an important feature of its autonomy. Yet, the proposed levies should cover the full operational costs of the PA. Special fees should be considered as another means to further strengthen and build up staff resources for conglomerate supervision and banks using internal models under a "user pays" assumption. The PA should also consider gradually building up a contingency fund to cover enforcement actions.

**The Financial Sector Regulation Act 9 of 2017 (FSR Act) prescribes mandatory cooperation between the financial sector regulators and four coordinating bodies have been established in statute.** These bodies have extensive and overlapping memberships**,** but no formal powers. Moreover, reliance on joint standards, inspections and enforcement actions can help reduce the regulatory burden for the industry, but such benefits need to be carefully balanced against the need for operational efficiency within the various agencies. A review of the membership and areas of responsibility of these bodies needs to be performed with the objective to streamline their membership and better align their responsibilities. One evaluation body consists solely of cabinet members which risks supervisory processes becoming politicized. It should also be assessed if there is a need to have such a high number of coordinating bodies and if all these bodies need a legal basis in the FSR Act. Finally, the coordinating bodies should increase transparency by formalizing meeting discussions or at least publishing a record of actions taken.

[3] e.g., capital ratios, liquidity ratios, impaired assets, and indicators tracking market and operational risks.

[4] e.g., supervisory assessments and risk ratings.

**Table 1. South Africa: Key Recommendations**

| Recommendation | Responsible Authorities | Timing[1] |
|---|---|---|
| Update the Regulations on corporate governance, related parties, large exposures, loan restructuring and problem assets in order to ensure closer alignment with the current BCBS standards. | PA | ST |
| Further strengthen and refine ongoing bank supervision practices and procedures specifically pertaining to better structured, intrusive, and comprehensive assessment of banks' corporate governance and credit, liquidity and other significant risk management arrangements. | PA | ST |
| Strengthen on-site supervision, make greater use of risk specialists for this function, and develop specialists for bank's governance assessment. | PA | I |
| Work on a collaborative solution and find funding to implement independent oversight of bank external audit quality. | PA, IRBA | I |
| Develop a framework for balancing the PA's primary objective of safety and soundness with its supporting mandate of financial inclusion and competition. | PA | ST |
| Increase the PA's human resources, its funding and the diversity of its funding sources. | PA, NT | ST |
| Review the legislation to further strengthen the framework of the PA's operational independence and accountability. | PA, NT | MT |
| Revisit the FSR Act to prevent the risks of political influence on the supervisory process though the cooperation evaluation body composed of cabinet members and establish a formal framework for disclosure of meeting discussions and a record of actions taken by the domestic coordinating bodies and streamline their membership and mandates | All regulators, NT | ST |
| Maintain the power for the PA to temporarily take control of weak banks, without ministerial involvement, as a pre-resolution supervisory instrument (temporary administrator, or statutory manager). | PA, NT | MT |
| Remove the 30-day notice for suspending registration or restricting activities of a bank or controlling company. | PA, NT | MT |
| Perform an Accounting and Auditing ROSC to obtain an independent assessment of the quality of the accounting and audit profession. | NT | ST |

[1] I = Immediate, with results less than 1 year; ST = Short Term, with results 1–2 years; MT = Medium Term, with results 3–5 years.

# INTRODUCTION

1. **The Technical Note presents a targeted review of selected aspects concerning the banking supervision and regulation in South Africa.** The review was carried out as part of the South Africa Financial Sector Assessment Program (FSAP) conducted jointly by the International Monetary Fund (IMF) and World Bank (WB). The findings and recommendations were based on the regulatory framework in place and the supervisory practices employed as at March 2020. The mission was also informed by insightful discussions with the Prudential Authority (PA), departments of the South African Reserve Bank (SARB), the Financial Sector Conduct Authority (FSCA), banks, the Banking Association South Africa, audit firms, and other stakeholders in Pretoria and Johannesburg during February-March 2020. Later, the mission had several virtual meetings with the PA to discuss regulatory and supervisory response to deal with COVID-19 pandemic.

2. **The mission focused on selected topics.** The previous 2014 FSAP had conducted a detailed assessment of compliance on the BCBS Core Principles for effective banking supervision. Building on this work, the review of banking supervision and regulation focused on significant Core Principles (CPs) that were not fully compliant in 2014 or have been subject to changes since the previous assessment, institutional supervisory reform—the new twin peaks model and the Prudential Authority—and topics that were of particular relevance in the current environment. A targeted review was done in the context of selected Basel Core Principles for Effective Banking Supervision (BCP). It included the following themes: powers, independence and governance (CP 1, 2), cooperation and consolidated supervision (CP 3,12,13), supervisory approach, tools and techniques (CP 8, 9), corrective and sanctioning powers (CP 11); banks' corporate governance (CP 14); credit risk, problem assets and provisions (CP 17,18); concentration risk, large exposures and transactions with related parties (CP 19, 20); and liquidity risk (CP 24).

3. **The note includes the analysis of the PA actions being taken to deal with the stresses presented by the COVID-19 pandemic.** Following the outbreak of the COVID-19 pandemic, the PA introduced temporary capital and liquidity relief, such as the allowing banks to dip into their capital conservation buffers, reduction of the liquidity coverage ratio to 80 percent, reduction of Pillar 2A capital requirements, temporary dividend restrictions and changes to the treatment of restructured loans in line with international standard setters' guidance.

4. **The team wishes to thank the authorities and private sector participants for their excellent cooperation.** The PA provided a self-assessment of compliance with the 2012 Basel Core Principles and responses to a complementary questionnaire. The authorities also provided a wide range of supporting documents on supervisory practices and assessments. The FSAP review team benefitted greatly from the inputs received and exchanges of views during meetings with supervisors and market participants. The team sincerely thanks the PA' staff for their professionalism, spirit of cooperation, and for making enormous efforts to respond to the team's requests and for other excellent arrangements that have greatly facilitated the work of the mission.

5. **The rest of this note is structured as follows.** Following this brief introduction, the note is divided into two main parts. The first chapter focuses on banking sector structure. The remaining part discusses the review and main findings.

# BANKING SECTOR STRUCTURE

6. **South Africa's financial sector is large, well developed and sophisticated.** Total financial sector assets of about 300[5] percent of Gross Domestic Product (GDP) continue to exceed most other emerging economies (December 2020). Banking sector assets account for 44 percent of total financial sector assets (the share of banks' assets as a proportion of GDP is 132 percent). The nonbank financial sector (insurance companies, pension funds[6] and collective investment schemes) continues to grow.

7. **The banking sector in South Africa is highly concentrated.** There are 31 banks,[7] but the sector is dominated by five large banks, which account about 90 percent of the total banking sector assets. Four of the five large banks are providing full-scale banking services, while a fifth focuses on corporate and private banking businesses. In recent years, a few digital banks have started its activities in South Africa. Additionally, 4 mutual banks and 5 cooperative banks operate in the country.

8. **South Africa's large banks are closely connected with other segments of the financial sector.** For example, the largest bank holds the majority of shares in one of the large insurers in South Africa; another insurance company has a significant shareholding in one of South Africa's largest banks. These bank-affiliated insurance companies underwrite a substantial proportion of private pension fund assets, and some banks also own asset management companies that offer unit trusts. These cross-sectoral linkages require comprehensive group-wide supervision.

9. **Many of South Africa's banks have cross-border linkages.** The shareholders of large South African banks have ownership links with many foreign countries. Certain banks are indirectly owned by the United Kingdom (U.K.) financial institutions. One of the largest 5 banks is dual listed on the Johannesburg Stock Exchange (JSE) and London Stock Exchange and has a parallel structure where the U.K. holding company oversees the group's non-African operations. Additionally, 13 branches of international banks operate in South Africa (their assets account for 6 percent of total banking sector assets). Moreover, the large banks have been expanding to other sub-Saharan African countries (the four large banks have more than 40 subsidiaries in many sub-Saharan African countries). While the cross-border operations of the South African banks represent a relatively small part of their consolidated balance sheets, operations continue to grow and are systemically important in some host jurisdictions (e.g., Botswana, Lesotho, Malawi, Mauritius, Namibia and Swaziland)—underscoring the importance of effective home-host coordination.

10. **South Africa's banking sector entered the COVID-19 pandemic with strong capital and liquidity buffers.** Banks' capital and liquidity ratios remain comparable to the pre-COVID levels despite increased credit risk and lower profitability. The aggregated total capital adequacy ratio of the banking sector was 16.2 percent as at December 2020. The average banking sector Liquidity Coverage Ratio (LCR) was around 142 percent at the end of 2020. The outcomes of the mission's analysis and discussions of the

[5] Financial Stability Review, First Edition 2021, SARB. In the Financial Stability Review, financial sector includes banks, insurance companies, pension funds, and collective investment schemes.

[6] Government Employee Pension Fund is included.

[7] Prudential Authority Annual Report 2021.

PA's regulatory and supervisory measures taken in response to the COVID-19 pandemic are summarized in Box 1 and Box 2.

**11. Banks are dependent on wholesale deposits.** While deposits make up the largest source of bank funding (more than 70 percent), this wholesale funding is coming from nonbank financial institutions and non-financial corporates in similar proportion. Retail deposits account for less than a fifth of total funding, however, authorities have been putting efforts to increase these deposits. In South Africa households prefer to invest in non-deposit products such as pension funds, insurance products and unit trusts.[8] The providers of these products invest these funds, some of them in bank deposits which increases the interconnectedness of the South African financial system. However, the authorities state liquidity risk is mitigated by exchange control restrictions that help maintain domestic currency—denominated funding within the rand system. Moreover, funding is largely sourced domestically, with banks' foreign-currency liabilities remaining well below 8 percent of total liabilities.

### Box 1. Regulatory Measures in Response to the COVID-19 Pandemic

*South Africa's banking sector entered the COVID-19 pandemic with strong capital and liquidity buffers. In line with international standard setters' recommendations for responding to the COVID-19 crisis, the PA provided regulatory relief to banks designed to enable them to continue to extend credit to South Africa's economy. These measures were aligned with the array of other authorities' actions, including fiscal, monetary, and financial stability, taken to stabilize the country's economy. While the PA policy response to the COVID-19 crisis was timely, it will need to remain proactive and ensure capital preservation, especially for more vulnerable banks, during the unwinding stage of COVID-19 policy interventions.*

**Temporary capital and liquidity relief.** In April 2020, the PA allowed banks to utilize their capital conservation buffer and reduced Pillar 2A minimum capital requirements (the systemic risk add-on) from 1 to 0 percent. However, at this stage, the majority of banks have not dipped into their capital buffers raising questions about usability of the capital buffers as intended by international standard setters. With regards to the liquidity relief measures, the PA reduced the LCR requirement from 100 to 80 percent. In April 2020 and March 2021 some banks temporary reported ratios < 100 percent but the temporary 80 percent requirement was not breached.[1] While Basel III standards did not explicitly envisage a reduction of the minimum requirement, the framework envisages that banks would use their stock of high-quality liquid assets (HQLA) during periods of stress, with supervisors being expected to assess such use and request corrective actions, to be executed over a reasonable amount of time to prevent additional stresses on the bank and the financial system as a whole. The authorities find that the temporary LCR reduction appears to have achieved its objectives of providing stability and predictability in banks' liquidity management.

**Restriction on capital distributions.** The PA recommended banks pause distribution of dividends on ordinary shares and cash bonuses to executive officers and material risk takers during 2020. The guidance on restricting capital distributions helped to preserve capital in the banking system. However, several banks paid dividends in 2020; majority of them had already declared dividends before the PA guidance was issued. In February 2021, the PA relaxed its guidance recommending Banks Act 1990 (Act No.94 of 1990, as amended) (Banks Act) prudently when considering capital distributions, but at the same time shifted the responsibility to banks' boards of directors. Some banks have continued to hold back on distributions, but some banks have paid dividends, although not to the same magnitude as in the past. Considering the weak macro outlook that could result in

[8] Pension funds, except for the Government Employee Pension Fund, are generally defined contribution schemes and are supervised by the FSCA and the South African Revenue Service. Prudential supervision of insurance companies is performed by the PA.

### Box 1. Regulatory Measures in Response to the COVID-19 Pandemic (concluded)

asset quality erosion and reduced profitability, further capital preservations measures are advisable—in particular for banks with pre-existing weaknesses.

**Changes to the treatment of restructured loans.** In April 2020, the PA issued guidance on the treatment of COVID-19 related restructured credit exposures. This guidance was intended to provide temporary relief on the minimum capital requirements relating to corporate and retail credit exposures to enable and encourage banks, within their risk appetite, to continue to extend credit to the real economy during this period of financial stress. Importantly, the guidance clarified that the classification as COVID-19 related restructures is limited to borrowers in good standing before COVID-19 and expected to remain in an up-to-date status once the relief period ends. The PA indicated that it has been working closely with banks and external auditors to align the impact in terms of International Financial Reporting Standard (IFRS) 9 and regulatory capital. At this stage, the PA does not expect that the restructurings under this guidance will have a material impact on the NPV of cash flows as relief is for limited period (3-6 months). In July 2020, COVID-19 restructures reached the peak (12.1 percent of corporate and retail credit exposures), but later subsequently decreased to 2.1 percent in April 2021. The PA must ensure that banks timely recognize all defaulted restructured exposures from a prudential perspective. In interest of transparency and maintaining trust in the financial system, banks and the PA should consider more extensive and regular public disclosure on COVID-19 restructured loans. This disclosure would cover the magnitude, trends and risk profile of COVID-19 forborne loans.

**Guidance on the application of IFRS 9 during the COVID-19.** The PA's guidance to banks also outlined its expectations if the requirements of IFRS 9 are applied to payment holidays and other relief measures, including restructured loans, government guarantees, and other subsidies provided as a result of COVID-19. This guidance informed banks how they should account for and calculate the expected credit losses over its business cycle during COVID-19 time.

**Unwinding COVID-19 Policy interventions for SA banking sector.** The PA has developed a roadmap and phased exit strategy from the extraordinary regulatory measures, with the aim to ensure stability going forward. Banks are required to reinstate the Pillar 2A capital buffer by January 2022. A gradual approach will be used for the withdrawal of temporary liquidity measure. Banks need to comply with the revised minimum LCR requirements: January 1, 2022—90 percent, April 1, 2022—100 percent. The PA decided to withdraw the relief measure for restructured credit exposures from April 1, 2022. As long as uncertainty remains high, continued restrictions on capital distributions are advisable on grounds of prudence. However, a case-by-case approach on capital distribution can be considered to avoid penalizing banks with strong capital positions and solid profit generation capabilities. Fund staff recommends a proactive supervisory stance in challenging banks' capital projections and ensuring that banks can meet capital requirements under a broad range of scenarios accounting for uncertainty.[2]

[1] Two events impacted the temporary deterioration of banks' liquidity situation, i.e., the downgrade of South Africa's credit rating by Moody's in March 2020, and the COVID-19 crisis.

[2] Also see IMF Staff Note on Unwinding COVID-19 Policy Interventions, March 2021; FSB Paper COVID-19 support measures: Extending, amending, and ending, April 6, 2021.

### Box 2. Supervisory Measures in Response to the COVID-19 Pandemic

The PA responded to the COVID-19 pandemic by reprioritizing supervisory work, intensifying supervisory monitoring, and continuing to promote and enhance the safety and soundness of banks in a more difficult macro-economic environment.[1]

**Reprioritization of supervisory work.** The PA reported that it has reviewed supervisory priorities by intensifying supervisory monitoring, suspending 'the flavor of the year' review, extending the implementation timelines for certain regulatory reforms and re-prioritizing some policy initiatives (e.g., low default portfolio initiatives/Basel III reforms). The PA has used flexibility in operational requirements where possible (e.g., extended the submission of external audit reports, Pillar 3 disclosures). Planned on-site reviews were replaced by desktop reviews and virtual meeting discussions (e.g., assessment of banks' model post-implementation, ICAAPs). In line with its significance, credit risk received heightened attention in the PA's supervisory work. Operational resilience, including business continuity, disaster recovery and cybersecurity, has become high priority for the PA during this period as well. During the exit phase, supervisors should remain focused on the most meaningful risks while progressively reintroducing other activities in the supervisory cycle.

**Enhanced monitoring.** During the COVID-19 crisis, the PA has relied on its strong relationships with banks' boards and senior management to promptly discuss new developments and/or emerging concerns. The PA introduced additional reporting to monitor liquidity ratios (LCR and Net Stable Funding Ratio (NSFR)), COVID-19 restructured credit exposures and operational risk metrics. At the height of the market turmoil, banks were requested to provide additional quantitative and qualitative information daily and weekly, and later monthly. During this turbulent period, the PA monitored COVID-19 impact to banks' financial conditions from different perspectives. The PA surveyed 10 banks to obtain a view of the impact of the COVID-19 pandemic on collateral valuations, and has considered the utilization of independent credit analyses by experts from audit firms in some banks to deepen its understanding of emerging risks. Intensified supervisory monitoring will remain critically important to ensure that any adverse developments are detected on a timely basis and the prospective unwinding of COVID-19 related measures can be executed in an orderly manner. As part of this monitoring, the PA should also assess banks' governance, risk management and internal controls surrounding the implementation of COVID-19 loan forbearance measures. Particular attention should be paid to weaker banks, including their ability to assess borrowers' repayment capacity and viability and to tackle high NPL levels.

**Deepened cooperation and coordination with FSCA, SARB and National Treasury.** The PA and FSCA reported strong coordination and collaboration which allowed them to address many challenges caused by COVID-19 in a timely way. Several joint communications were issued to financial institutions, frequent joint meetings were organized, and data sharing was intensified. Bi-monthly meetings were held with SARB and National Treasury to discuss supervisory issues. The PA cooperated closely with the SARB, including the monitoring of Domestic Systemically Important Banks (D-SIBs). As part of the enhanced macroprudential monitoring of the COVID-19 impact, the SARB conducted a top-down solvency stress test of the 6 largest banks and developed a new liquidity stress metric.

[1] Also see IMF Staff Note on Supervisory Actions and Priorities in Response to the COVID-19 Pandemic Crisis, October 2020.

# MAIN FINDINGS

## A. Powers, Independence and Governance

### Organization and Governance

**12. The implementation of a twin peaks model in the financial sector significantly changed the South Africa financial supervisory architecture.** On April 1, 2018 two new regulatory authorities started operating. The Prudential Authority (PA), a juristic person operating within the administration of the South African Reserve Bank (SARB), is responsible for the prudential regulation and supervision of banks, insurance companies and market infrastructures (MIs).[9] A separate authority, the Financial Sector Conduct Authority (FSCA), is operating as a standalone entity and has a mandate for financial sector conduct regulation and supervision. The new Financial Sector Regulation Act (FSR Act) also made significant changes to the financial sector regulatory landscape. The FSR Act provided a legal framework for establishing the PA and FSCA; gave the SARB an explicit mandate to protect and enhance financial stability; obliged to seek the concurrence of financial sector regulators (the PA and FSCA) on licensing matters; introduced the power to the PA to regulate and supervise financial conglomerates; and to collect supervisory levies and special fees, and addressed some recommendations arising from the FSAP 2014.[10] There are high expectations from society that this significant institutional supervisory reform will contribute to safeguarding the stability of the financial sector, including by further strengthening supervision, consolidating regulation across different industries, and enhancing cooperation among financial sector regulators.

**13. The recently established PA has implemented a modern governance structure for prudential supervision of financial institutions.** The establishment of the PA integrated the Bank Supervision Department (BSD) of the SARB, the Insurance Prudential Supervision teams of the erstwhile Financial Services Board, and the CFI Supervisory Unit of the Cooperative Banking Development Agency of the National Treasury. The PA organizational structure comprises a Prudential Committee (members of which are the SARB Governor as chairman and the three SARB Deputy Governors, one of whom is the PA Chief Executive Officer (CEO), and four departments:

- **The Financial Conglomerate Supervision Department** is responsible for the prudential supervision of financial institutions that are potentially to be designated as financial conglomerates (e.g., the six largest banks currently being supervised as well as the large insurance groups). The department is also responsible for the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) supervision within PA-regulated financial institutions.

[9] "Market infrastructures" comprise: (a) a central counterparty; (b) a central securities depositary; (c) a clearing house; (d) an exchange; and (d) a trade repository. The PA is preparing to develop its prudential regulatory and supervisory framework to promote and enhance the safety and soundness of MIs. The biggest focus is on operational risk, liquidity risk management, and capital adequacy for unforeseen events.

[10] National Credit Regulator (NCR), established under the National Credit Act, is responsible for oversight of consumer credit institutions and development of credit market. The FSR Act introduced powers to FSCA to regulate and supervise certain consumer credit institution's conduct issues as well.

- **The Banking, Insurance and Financial Market Infrastructure Supervision Department** supervises other banks (including cooperative and mutual banks), small and medium sized insurance companies, MIs and cooperative financial institutions.

- **The Risk Support Department** provides specialized regulatory and supervisory support to all departments on among other things credit, Asset and Liability Management (ALM), operational, market and insurance risk, as well as quantitative and actuarial support.

- **The Policy, Statistics and Industry Support Department** is charged with the development and maintenance of the regulatory and supervisory framework, providing industry analysis, enforcement, and technical support on capital and accounting issues.

**14. The PA governance is clearly prescribed in the FSR Act and in internal procedures.** The Prudential Committee oversees the management and administration of the PA, although daily operations of the PA are managed by the CEO, the Heads of Departments and Divisional Heads. The PA Management Committee (MANCO) supports the CEO in the operational management of the PA. The CEO has established six advisory and decision-making panels covering Policy, Licensing, Designation, Restructuring and Expansion, Regulatory Action as well as Risk and Capital. These panels provide an effective forum for discussing regulatory and supervisory matters at an operational level. The majority of panels are not decision-making bodies, but make recommendations to the CEO, who takes the final decisions. The PA has developed the Regulatory Action Blueprint list, which sets out the comprehensive decision-making framework for all regulatory and supervisory decisions.

**15. The PA has made significant progress on integrating bank and insurance supervision, preparing a regulatory framework for financial conglomerates and implementing other strategic priorities set out in the PA Regulatory Strategy 2018-2021.** The integration of different supervisory approaches and cultures was a key primary operational task for the newly established PA. Achievements to date include supervising the large financial groups which comprise banks and insurance companies by integrated supervisory teams, and the preparation of a roadmap for harmonizing their regulatory framework in common areas such as governance, licensing, etc. The PA continues work on implementing the supervisory framework, preparing secondary legislation for implementing the framework for financial conglomerates (e.g., designation criteria for financial conglomerates and prudential standards on governance, intragroup exposures, audit, capital and risk concentration), aligning Regulations with Basel III post crisis reforms, establishing close cooperation with other national regulators, etc.

### Objectives and Powers

**16. The broad objectives of the new PA are prescribed in legislation and the PA is in the process of translating them at the operational level.** The previous FSAP recommendation on defining the objectives of the supervisor in the legal framework has been addressed in the new FSR Act. The primary objective of the Prudential Authority is, inter alia, "to promote and enhance the safety and soundness of financial institutions that provides financial products and securities services." The PA is in the process of rolling out its new supervisory framework and drafting internal operating procedures. When in place, these will provide further guidance on how the PA conducts its supervision and its tolerance for risk. The PA's stated aim is to maintain a regulatory and supervisory environment with an acceptably low

probability of institutional failure. This tolerance for risk is reflected in, among other things, the use of the bank's rating and supervisory stance (see more on C. Supervisory approach, tools, and techniques).

**17. The PA's broader mandated responsibilities (to support financial inclusion and sustainable competition) support and remain subordinate to its primary objectives.** The FSR Act mandates the PA to perform certain ancillary functions in order to help achieve its primary objectives. The PA Regulatory Strategy 2018–2021 notes its role to enhance financial sector transformation, financial inclusion, and sustainable competition. In support of these ancillary responsibilities, the PA, including National Treasury, for example, is exploring steps towards a greater tiering of the financial sector—supported by a proportional supervisory and regulatory framework—to allow for a wider range of participants and greater potential for innovative technologies to help to improve access and efficiencies in the financial sector. The PA also recognizes the need for collaboration with the SARB in monitoring fintech developments that may facilitate financial inclusion. The PA is in the process of developing its policy on how to operationalize these ancillary functions in support of its objectives.

**18. Broadly speaking, the PA has the powers to address banks' non-compliance and intervene early; but some gaps remain.** The Banks Act (BA), FSR Act and Regulations provide the PA with a broad range of supervisory tools that can be used to take timely corrective actions or intervene in banks in case of non-compliance with laws or Regulations, unsafe and unsound practices and/or activities that pose risks to banks or to the banking system at large. The PA can issue directives to a bank, a controlling company, an eligible institution or a bank's auditor either as a non-financial sanction or require them to i) cease or refrain from engaging in specified activities, ii) perform necessary actions, and iii) provide documents and information. Under the FSR Act, additional enforcement tools have been introduced, including the imposition of administrative penalties on individuals. Moreover, the PA has raised concerns about banks' operations in prudential meetings and has followed-up on identified observations, issues and concerns through feedback letters (also see the section on Corrective and sanctioning powers of the supervisor).In addition, a decision-making mechanism (i.e., a dedicated unit and panel) has been established to impose corrective and sanctioning measures on banks. However, the toolkit for corrective actions is still subject to some constraints, some of which may have important implications for the effectiveness of supervisory intervention. Notably, the PA's ability to revoke a license is potentially constrained by its obligation to give 30 days prior notice in suspending registration or restricting activities of a bank and the need to gain the prior concurrence of the FSCA in respect of specific matters as set out in the FSR Act.. Similarly, the PA needs to give prior notice in suspending registration (license) or restricting activities of a bank or a controlling company.

### Operational Independence and Accountability

**19. Supervision is carried out independently by the PA, although the institutional structure whereby the PA is housed within the SARB could be usefully adjusted to improve both independence and accountability.** The PA is operating within the administration of the SARB and has many ties with it and the independence of the SARB is enshrined in the Constitution of the Republic of South Africa, which stipulates that "the South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favor, or prejudice, but there must be regular

consultation between the Bank and the Cabinet member responsible for national financial matters."[11] The SARB has built up its credibility over time, based on the professionalism and integrity of its staff and the PA benefits from this credibility through its close linkages with the SARB (e.g., appointment of the PA CEO by the Governor,[12] without any scope for political interference; enhanced accountability of the PA through oversight of its activities by SARB's Governor and deputy Governors (through the Prudential Committee). In addition, the PA operates with staff seconded from the SARB and SARB otherwise provides the PA accommodation, facilities, use of assets, financial resources, and other services.[13] The PA and SARB have a Memorandum of Understanding (MoU) in place and cooperate closely in many areas, such as financial stability, resolution, recovery plans, etc.

**20. To mitigate the risks that systemic events may occur, the SARB can, after consulting with the PA, give the latter directions with regards to specific systemically important financial institutions, or to such institutions generally.** These powers relate, among others, to solvency, leverage ratios, liquidity, risk management, and recovery and resolution planning. It will be important, however, to ensure that the ability of the SARB to issue directions to the PA is clearly confined to issues that affect the SARB's core mandate (e.g., macro prudential policy, stability of the financial system as a whole, resolution) and cannot be used to infringe upon the PA's microprudential mandate.

**21. While the decision to establish the PA within the administration of the SARB enables efficiency gains, its advantages need to be carefully balanced against the need for operational autonomy.** Under the current model, the PA is part of the SARB, as it relies on staff seconded from the SARB, receives financial support from the SARB to cover its operational costs (only the staffing costs of the PA are expected to be funded by levies), and operates with strong representation of the SARB in its decision-making bodies. While it is crucial that the SARB and PA work in a highly coordinated and collaborative way, there may be instances where the interests of the SARB and the PA are not always aligned. For example, decisions on the allocation of funds and resources between the SARB and the PA, which may have a direct impact on the PA's objectives, will be made by SARB representatives. This has the potential to dilute the PA's accountability for delivering on its own mandate. The authorities should strive to evolve to a model where the levies cover the totality of the PA's budgeted expenditure to ensure more financial autonomy of the PA and a mitigation of potential tensions that can arise from the current setting.

**22. The processes for appointing and dismissing the PA CEO are clearly defined in legislation but can be strengthened.** The FSR Act sets out clearly the requirements for the PA CEO, including qualifications, conflict of interests, and integrity issues. The person appointed as the CEO must be a SARB Deputy Governor who has appropriate expertise in the financial sector, other than the Deputy Governor responsible for financial stability. The CEO of the PA is appointed by the Governor with the concurrence of the Minister of Finance (MOF). When appointing the CEO, the Governor must agree, in writing, on the individual's performance assessment measures. These performance measures are not disclosed. A person appointed as the CEO holds office for a term no longer than 5 years with the possibility of re-appointment for one further term. The PA CEO may be dismissed in two ways. The Governor can remove

[11] Section 224 of the Constitution of the Republic of South Africa, 1996.

[12] In terms of section 36(1) of the FSR Act, with the concurrence of the Minister of Finance.

[13] In line with sections 50 and 51 of the FSR Act.

the CEO if the individual becomes a disqualified person. In such cases, the legislation does not require the reasons for the individual's dismissal to be disclosed publicly. Alternatively, the Governor may, with the concurrence of the MOF, remove the CEO from office if an independent inquiry has found issues which are stipulated in the FSR Act. In such cases, the MOF must submit the inquiry report to the National Assembly at which point the report becomes publicly available.

23. **The FSR Act requirement that the PA seek the concurrence of the FSCA on licensing matters may give rise to regulatory paralysis if disagreement between the two agencies materializes.** The PA may not issue, vary, suspend, revoke or grant an exemption on a license without the agreement of the FSCA. The Authorities noted that the practical implementation of this requirement is challenging as the PA and the FSCA have different mandates and objectives, there is no resolution (dispute) mechanism[14] prescribed in the FSR Act, and the deadlines for the FSCA to take decisions are often very tight etc. In practice, in the response for concurrence, the FSCA provided the condition that the bank must comply with legislation on financial conduct matters which is not in the responsibility of the PA. The Authorities noted that the concurrence of the FSCA in licensing matters may only be necessary for a transitional period until the FSCA establishes its own licensing process. Still, the authorities are encouraged to reflect on how the dual licensing regime, once in place, will work in practice. As banks will need a dual license to operate, it is unclear if the loss of one license would automatically result in the loss of the other one, and how any diverging views about the issuance or revocation of licenses would be handled.

24. **The authorities should consider further limiting the MOFs involvement (approval, concurrence) in the PA activity.** In line with recommendations in the FSAP 2014, ministerial (National Treasury) involvement in the licensing process has been removed, and prudential standards have been replacing MOF's approved Regulations. However, some important powers remain with the Minister. While the PA notes that, in practice, its recommendations have usually been followed by the MOF; ministerial involvement has the potential to bring other considerations (e.g., competition-related concerns potentially delaying a merger that seeks to reinforce financial stability), into prudential decision making which in turn could hamper the effectiveness of prudential supervision. The authorities explained that ministerial involvement in the PA's decision-making processes is meant to provide checks and balances, but this objective might also be met through consultations, rather than *de facto* veto powers. The authorities should consider reducing the MOF's involvement by limiting the cases that require his approval and concurrence. For example, approval of an acquisition of shares (more than 49 percent) in a bank or controlling company (Banks Act), etc. Additionally, specific criteria and circumstances for exclusion from the application of the Banks Act of any institution or body should be prescribed in the Act (Minister's power). In 2019, the Banks Act was amended by providing that a state-owned company could apply for PA authorization to establish a bank under the Act. To date, only the Post Bank has applied. In the context of state-owned banks, because of a potential conflict of interest, it is particularly important that the PA has operational independence in licensing decisions and subsequent supervisory activities.

25. **The FSR Act strengthens the independence of the PA by introducing new regulatory instruments—prudential standards—that do not require ministerial approval.** In the future, all Regulations currently in force will be converted to prudential standards and the PA will need to go

[14] The PA stated that any deadlock between the PA and FSCA would ultimately be addressed through the highest decision-making structures within each organization.

through a public consultation process on their existing regulatory framework. As part of the approval process, the PA must submit prudential standards to Parliament through the National Treasury for a period of at least 30 days while Parliament is in session (in case of urgent prudential standards, the draft prudential standards should be submitted for a period of at least seven days.) Although Parliament cannot stop the issuance of secondary legislation, the FSR Act requires that any deliberations of Parliament should be considered by the PA. Authorities explained that Parliament involvement in this area is part of South Africa's broader democratic processes. South Africa's authorities should consider providing the PA with sufficient delegated powers, clearly circumscribed to the prudential sphere, to ensure that the authority can issue prudential standards (secondary legislation) without Parliament involvement.

**26. The PA is transparent in its dealings and provides information publicly on its objectives and achievements, even though the accountability framework can be strengthened.** As required by the FSR Act, the PA published its Regulatory Strategy 2018–2021, which sets out the PA's approach to achieving its strategic objectives. The Strategy sets out the PA's regulatory and supervisory priorities and the intended key outcomes of the strategy. Under the FSR Act, the PA CEO is also required to prepare annual financial accounts for the PA, which form part of the annual report of the SARB. Additionally, an annual report on the activities of the PA during the financial year should be submitted to the MOF for tabling in the National Assembly and publication. While in practice, the PA CEO participates in Parliament's sessions to present the PA activity, prescribing such participation in the legal framework[15] would help strengthen the PA's accountability framework.

**27. The ability to finance its supervisory activities through levies and fees is an important feature of the PA's autonomy, but some shortcomings remain.** The FSR Act provides the PA with the power to impose levies to fund its operations, and to charge fees to fund specific functions. The draft Levies Bill[16] sets out the methodology for the calculation of the levies that will be paid by each financial institution. Legislation prescribes the process by which the PA should collect levies and fees, and that the process be transparent. To meet this requirement, the PA must publish, for public comment, an annual budget that includes an estimate of its expenditure for the following two financial years, and its proposals for the fees and levies. This transparency requirement instils discipline in the PA's budgetary and planning processes, but the need to estimate resourcing requirements for a two-year period may be problematic should there be a material change of circumstances and the need for more intensive supervision. To buttress financial autonomy of the PA, the authorities are encouraged to set the level of funds the PA receives from levies to meet the PA's budgeted expenditure in full.

**28. Notwithstanding steps taken to improve funding support for the PA, additional efforts remain desirable.** The PA's supervisory model with some reliance on independent reviewers for detailed supervisory work raises concerns for the supervision of weak banks with poor profitability (see section on Credit risk, problem assets and provisions). As the high cost of the independent review is to be borne by

[15] BCP requires that supervisory authority's accountability should be prescribed in legislation and publicly disclosed (Principle 2).

[16] In February 2021, the National Treasury released the draft of Financial Sector Levies Bill for public consultation; in December 2021, the National Treasury issued the revised draft Financial Sector and Deposit Insurance Levies Bill for public comment. In FSR Act, it is envisaged that deals with matters relating to fees, levies and finances of the PA to come into effect on April 1, 2022.

the bank, there is a risk that this leads to delayed intervention or outright supervisory forbearance in order to not further erode the bank's profitability, particularly for smaller banks. The mobilization of additional funding sources can mitigate this risk, while ensuring that the PA remains well positioned to discharge its responsibilities. Additionally, under a "user pays" model, the PA should consider introducing special fees, as FSR Act provided this power to the PA, to cover the supplementary supervision of financial conglomerates and banks using internal models. These complex institutions require greater supervisory resources of a higher caliber. Additionally, the building up of a special contingency fund to cover legal enforcement proceedings should be considered.

**29. Staff resources for the banking supervisory function should be increased**. The PA acknowledges that increasing supervisory demands are posing a substantial burden on its staff. However, it is not experiencing major difficulties in attracting and retaining high caliber staff for its banking supervision functions, given the unique intellectual challenge of the work and the strong reputation of the SARB as an employer. In recent years, the PA has been able to attract experienced staff from the banking industry, but it remains a challenge to attract risk analysts, quantitative experts and data scientists. The PA noted that the turnover rate has been relatively low but the FSAP team observed that several vacancies remain. The competence and professionalism of PA senior staff is recognized by the banking industry, but there is a need to establish an effective training program for junior staff to acquire the necessary skills and qualifications and support long-term succession planning. In addition, continued evolution of the regulatory landscape (see, for example, the pending roll-out of conglomerate supervision, discussed later in this document), combined with mounting vulnerabilities, underscores the importance of further efforts to boost operational capacity through staffing increases and investments in specialized skillsets.

### Recommendations

**30. The authorities are encouraged to:**

- Develop an operational definition of the PA's primary objective for banking supervision and clearly articulate the PA's tolerance for risk.
- Develop a framework for balancing the PA's primary objective of safety and soundness with its supporting mandate of financial inclusion and competition.
- Strengthen human resources to ensure the quality and comprehensiveness of banking supervision.
- While balanced by an effective accountability framework, review the legislation to further safeguard the independence of the PA:

    i. Review the relevant provisions of FSR Act to include a requirement to publicly disclose the reasons for removal of the PA CEO and performance assessment measures of the CEO.

    ii. Clearly prescribe the PA accountability and operational independence framework in the legislation; review the legislation to further limit the cases that require the MOF's involvement in the PA's activity (approval, concurrence); review the relevant provisions of FSR Act to remove the requirement that the PA must receive the concurrence of the FSCA on licensing matters.

iii. Ensure that directives given to the PA by the SARB do not encroach on the PA's microprudential responsibilities.

iv. Further strengthen funding support of the PA to enhance its operational effectiveness.

## B. Cooperation and Consolidated Supervision

### Domestic Cooperation

**31. The FSR Act imposes mandatory cooperation between the regulators—namely the PA, the SARB, the FSCA, the National Credit Regulator (NCR), and the Financial Intelligence Centre (FIC).** The cooperation and collaboration extend to the making of regulatory instruments, taking joint enforcement actions, and conducting inspections and investigations. The FSR Act also includes a requirement to implement MOUs. In addition, there is a legal requirement for the MOUs to be published and reviewed every three years. The PA had signed and published MOUs with the SARB, the FSCA, the NCR and the Financial Intelligence Centre (FIC) at the time of the assessment. Work on PA-FSCA joint standards is ongoing, with the regulators having already released standards on fit and proper person requirements for significant owners, margin requirements and requirements relating to central counterparty license applications.

**32. As described in the section on independence in this note, the PA and the SARB cooperate very closely on financial stability related issues, including recovery planning.** Staff of the SARB are sitting on many decision-making bodies of the PA such as the Prudential Committee which consists of the Governor, the CEO and other Deputy Governors. The PA also provides regular presentations in the SARB's two senior committees—the Monetary Policy Committee and the Financial Stability Committee. The SARB is also invited to monthly Prudential Authority Management Committee (PA MANCO) meetings and the PA's policy Panel. The SARB is also a member of the PA's Regulatory Action Panel. The SARB, except the Governor and Deputy Governors, has access to all supervisory information of individual banks. The Financial Stability Department of the SARB assists the PA in the assessment of recovery plans of systemically important banks.

**33. The FSR Act also establishes four cooperating bodies, with extensive but overlapping memberships, but without formal powers or decision responsibilities**. The four platforms for cooperation are the Financial System Council of Regulators (FSCR), the Financial Stability Oversight Committee (FSOC), the Financial Sector Contingency Forum (FSCF) and the Financial Sector Inter-Ministerial Council (FSMC). The FSCR has nine members[17] and meets minimum twice a year. It is a forum to facilitate cooperation and collaboration between the institutions represented. It has discussed issues related to the FSAP and the Financial Action Task Force (FATF) assessments. The Financial Sector Regulation Body (FSRB) established nine working groups[18] under the umbrella of the FSCR, but their

[17] The members of the FSCR are the Director General of the Treasury, the Director General of the Department of Trade & Industry, the Director General of the Department of Health, the CEO of the PA, the Commissioner of the FSCA, the CEO of the NCR, the Registrar of Medical Schemes, the Director of FIC, the Commissioner of the National Consumer Commission, the Commissioner of the Competition Commission, and the Deputy Governor responsible for Financial Stability. The MOF may appoint a head of any other organ of state or organization, but he has not done so at the time of writing.

[18] One working group covers financial stability and resolution. This seems out of place, as this is within the mandate of the FSOC.

memberships are not a reflection of the full membership. The FSOC comprises ten members[19] and meets at least twice a year. It is an advisory committee to the Governor, the SARB and the MOF and its mandate covers financial stability, crisis management and prevention. The FSOC is assisted by the FSCF, comprising 8 members[20] including financial sector industry representatives. The FSCF's main role is to identify potential financial risks, coordinate and mitigate these risks. As such, the FSCF has been particularly active in the areas of crisis simulation exercises and climate risk. Finally, FSMC facilitates cooperation and collaboration between cabinet members. It has four members[21] but has yet to meet for the first time.

**34. The FSMC has a role in the evaluation of the cooperative and collaborative mechanisms between the financial sector regulators.** The FSRB requires the FSMC to commission an independent evaluation of the effectiveness of the cooperative and collaborative mechanisms between the financial sector regulators six months after the establishment of the MOUs and then every two years. Moreover, the FSRB may, at its own initiative, or at the request of another financial sector regulator, commission an independent evaluation of the effectiveness of cooperation and collaboration among financial sector regulators. No such evaluation has been performed yet, but as the MOUs are now in place and regulators have started closer cooperation, it is important to develop and disclose the assessment criteria as soon as possible to ensure that the review process is used for the intended purpose.

**35. The domestic cooperation framework is prescriptive, has a high level of overlapping membership and some overlapping mandates in its coordinating platforms and has the potential to be resource intensive.** Regulatory cooperation is not an absolute good; more is not always better. The benefits of cooperation depend on how well it is focused, and on a clear and agreed allocation of responsibilities among the member agencies. Under the existing framework, there is a risk that regulators may become overly focused on "ticking the boxes" and ensuring compliance with the formalities, instead of finding ways to cooperate effectively and efficiently. Also, cooperation among regulators in the form of joint standards, joint inspections and joint enforcement actions may well reduce regulatory burden on the industry but is at risk of transferring that burden to the regulators. Regular independent evaluations of cooperation, evaluations "on request" and overlapping memberships, particularly between the FSOC and the FSCR, raise similar resource efficiency concerns.

**36. One body, solely composed of cabinet members, has a role in evaluating the cooperative and collaborative mechanisms between the regulators.** While a practice of conducting such reviews has not yet been established, the involvement of political actors (through the Financial Sector Inter-Ministerial Council), together with a lack of clarity on the evaluation criteria, may provide an avenue for politization of supervisory processes. There is a need to revisit the FSR Act to mitigate this significant risk.

[19] The members of the FSOC are the Governor, the Deputy Governor responsible for financial stability, the CEO of the PA, the Commissioner of the FSCA, the CEO of the NCR, the Director General of the National Treasury, the Director of FIC and three additional persons appointed by the Governor, being the Head of Division of Financial Stability, the Head of Division of Financial Surveillance and the Head of Division of National Payment System Department (NPSD).

[20] The FSCF members are a Deputy Governor designated by the Governor, representatives of each of the financial sector regulators, representatives of financial sector industry bodies.

[21] The FSMC members are the MOF, the Cabinet members responsible for consumer protection and consumer credit, the Cabinet member responsible for health and the Cabinet member responsible for economic development.

**37. There is limited transparency surrounding the work of the coordinating bodies.** Even though it is too early to fully assess the effectiveness of the domestic cooperation, formalization of meeting discussions, at least of the FSOC and the FSCR, and a record of the actions taken, should be publicly disclosed. The absence of formal records could give rise to a perception of inaction by the authorities. A more formal framework will also strengthen accountability.

### Consolidated and Conglomerate Supervision

**38. The PA regulates the bank and the banking group on a consolidated basis.** Banking groups in South Africa are engaged mainly in financial activities. Regulations prescribe that all directives, instructions or requirements specified in the Regulations that apply on a solo basis (Level 1) shall apply *mutatis mutandis* to that bank or its controlling company on a consolidated basis (Level 2). The PA collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and consolidated basis, including the controlling company, and verifies these reports either through onsite examinations or the use of external experts. The PA has a dedicated consolidated supervision analyst for every large banking group and during onsite reviews consolidated groups are discussed. All banking groups submit a detailed organizational chart, biannually, reflecting all interests under the bank and the controlling company. During the meetings with banks, issues are discussed at a consolidated level. The PA's supervisors showed a good understanding of the banking group structure and the activities of the group and how these might impact the risk profile of the bank.

**39. The FSR Act enhanced the powers of the PA in the area of conglomerates supervision.** The PA can designate members of a group as a financial conglomerate and it is expected to have finalized its designation by November 2020. A financial conglomerate 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 of companies. This requirement diverges from international practice which requires that the group be engaged in at least two activities (banking, insurance, or capital market activities) that are regulated and supervised by the authority. The PA can issue directives to holding companies of financial conglomerates requiring the company to take actions to manage and otherwise mitigate risks to the prudent management or financial soundness of bank arising from other members of the conglomerate. This includes the power to impose a restructuring of the conglomerate. The PA is in the process of developing designation criteria and five prudential standards: on risk concentrations, on governance, on external auditor requirements, on capital and on intragroup transactions. Full implementation of conglomerate supervision is expected to be in place by early 2022.

**40. While the PA has well-established practices for consolidated supervision and the work on conglomerate supervision is progressing, further enhancements of supervisory tools and practices will be required to improve and evolve with the expanded conglomerate perimeter.** The supervisory framework in respect of financial conglomerates should be aligned across the different sectors and guidelines, tools, and practices for the supervisor to obtain a holistic view of group-wide activities, including intragroup relationships and large exposures should be developed. New tools and guidance for monitoring risks stemming from nonbanking activities of a larger financial groups should also be embedded in the new supervisory framework. The prudential reporting forms should be expanded to Level 3 data and analysis. For example, stress testing as part of the ICAAP should cover the risks from insurance activities on the banking group, or the reputational spill-over from a parent bank.

**41. Special fees should be considered as one means of increasing resources staff resources for complex group supervision.** As outlined in the previous sections, staff resources for bank supervision need to be increased. Conglomerate supervision adds an additional dimension of complexity and judgement to prudential supervision and will likely require generate additional needs for experienced, skilled, and highly qualified staff to ensure effective supervision from a holistic perspective. Special levies on the entities subject to conglomerate supervision could be considered to fund this additional work on a "user pays" basis. A similar case can be made for Basel II Internal Ratings-based Approach (IRB) modelling banks.

**42. Group wide recovery and resolution plans are still under development.** The PA has required all banks to prepare recovery plans that cover the entire group and include material entities (banking and nonbanking), although the coverage of nonbanking activities and beyond the controlling company is still sporadic. The PA plans to address the issue of resolution plans for large banks provided they are given the necessary mandates by the FSLAB—which will establish the Resolution Authority within the SARB and will be responsible for the resolution of all banks and systemically financial institutions. The Resolution Authority is expected to contribute to the development of resolution plans that will initially be prepared for the systemically important banks and gradually extended to cover smaller institutions.

### Cross-Border Cooperation and Supervision

**43. In recent years, the PA has strengthened its cross border supervisory activities.** A few large South African banks have expanded to other African countries and some banks have very close relationships with the U.K. and in this context, the PA has organized supervisory colleges for its large banking groups with the host country supervisors in Africa. Given that South African banks' market share in host countries can be material, all the African countries were the banking group has presence are invited. The FSAP team reviewed the agendas and presentations made during the supervisory colleges and concluded that the information shared was substantive and comprehensive. The PA is also attending supervisory colleges of foreign banks as host supervisor. In addition, various ad hoc meetings are held with supervisors from other jurisdictions.

**44. In addition, cross-border visits conducted by the PA frontline teams provide an important source of information on cross-border operations.** These include meeting with the relevant banking supervisory authorities in the host jurisdiction for information sharing purposes and also conducting meetings at the banking subsidiary where discussions are generally held with the executive management team responsible for the banking entity in the particular jurisdiction. These visits occur typically two to three times a year for the large cross border groups and have deepened engagement with host authorities. There are detailed records of meetings and correspondence from the PA to the banks where issues and concerns regarding their offshore operations are articulated. The AML team within the Financial Conglomerate Supervision Department in the PA also conducts AML/CFT supervision of subsidiaries of South African banks in foreign jurisdictions. The team further monitors remedial actions to ensure improved compliance standards. In such offsite monitoring the AML/CFT team works together with the frontline teams responsible for prudential supervision.

**45. Nonetheless, the South African authorities will need to continue deepening cooperation globally specifically with other African and U.K. authorities, particularly in the area of early**

**intervention, recovery and resolution plans.** Given that a few big banks have strong ties with the U.K., the recovery and resolution plans need to be developed in strong collaboration with the U.K. authorities. Furthermore, as foreign operations of some South African banking groups have become systemically important in certain host jurisdictions, it is crucial the PA takes into account the impact of potential stresses on these jurisdictions in the context of recovery and resolution planning, as well as early intervention measures.

**Recommendations**

**46. The authorities are encouraged to:**

- Establish a formal framework for disclosure of meeting discussions and a record of actions taken for the coordinating bodies such as the FSOC and the FSCR;
- Streamline the domestic coordination and collaboration bodies membership and mandate to ensure efficient operation of the authorities involved;
- Develop criteria for the independent evaluation of cooperation and collaboration among regulators with relevant stakeholders;
- Develop group wide recovery plans to include nonbanking activities beyond the controlling company;
- Articulate and embed group-wide and conglomerate-wide supervisory tools in the supervision framework;
- Incorporate Level 3 data in the prudential reporting forms to assess the impact of conglomerates' supervision.

## C. Supervisory Approach, Tools, and Techniques

**47. South Africa has committed to implement the BCBS' internationally agreed standards, with adjustments, as appropriate, to reflect local requirements.** As effective supervision is dependent on the regulatory framework, the PA takes the implementation of international standards in a timely and consistent manner seriously. It is working on the implementation of the Basel III post crisis reforms and updating the large exposures regime. Although South Africa implemented IFRS and International Standards on Auditing (ISA) in 2005, a major challenge in recent years has been the implementation of IFRS 9 in the banking sector. The PA plays an active role in international standard-setting bodies in order to influence the formulation of prudential standards that contribute to the achievement of its mandate. It has adopted a collaborative and consultative approach to developing the regulatory framework in South Africa, actively engaging with other regulators, industry bodies and stakeholders. It also supports and encourages its supervisory counterparts in neighboring countries with their implementation of key standards to help ensure better oversight of South African banks' cross-border operations as they expand.

**48. The PA is in the process of implementing its new supervisory framework, which sets out a unified approach and tools for prudential supervision of all supervised entities across sectors**

**(banking, insurance and other sectors).** A priority of the PA is to implement the supervisory framework fully, which was published together with the PA Regulatory Strategy 2018–2021. The framework sets out the key features of the PA's supervisory approach, which include being risk-based and proportional, forward-looking (pre-emptive), outcome-focused and integrated. The framework is based on four pillars, derived from a typical life cycle of a bank. These are licensing, ongoing supervision, enforcement, and resolution. The implementation of the framework has commenced with the ongoing supervision phase, incorporating the Supervisory Review and Evaluation Process (SREP) principles adopted by the former Banking Supervision Department (i.e., supervisory planning, risk assessment, off-site and on-site supervision, including banks' ICAAP assessment, reporting to banks, follow up, and quality assurance).

**49. The PA has also commenced the development of a new Risk Framework which seeks to define more clearly and guide supervisors on risk identification and assessment.** This framework—which will cover inherent risk and risk management, corporate governance and business model assessment, ratings and tolerance of risk, including the application of supervisory judgment—will inform the intensity of supervision for banks at solo, consolidated and conglomerate level. The framework has also strengthened the linkage to industry analysis and better incorporated this analysis to entity level supervision. The PA is developing detailed methodologies, describing supervisory processes and other internal procedures for implementing the new framework. Four interim supervisory guidelines covering supervisory planning, off-site analysis, appointment of independent reviewers and governance and culture reviews were approved in December 2019. While the PA is in the process of strengthening its supervisory framework, a mix of former supervisory methodologies and new guidelines are continuing to be used in the transitional phase. Meanwhile, considerable work remains to complete ongoing implementation efforts and fully transition to the new processes and procedures. The PA has a dedicated unit responsible for drafting supervisory internal procedures, but it will be important to assign more resources for this work to progress.

**50. Different levels of supervisory engagement should be clearly prescribed in supervisory procedures.** To support the allocation of resources to the different banks in a way that best achieves its primary objectives, the PA needs to clearly define its risk tolerance and apply a level of supervisory engagement that is commensurate with its risk assessments for individual banks. The PA is developing its supervisory intensity model and should consider including the following in this model:[22] i) not only the overall rating of the bank, but also the ratings of individual risks and components should drive the supervisory cycle; ii) the systemic importance and complexity of the bank; iii) its own reputational and political risk in the case of failures and iv) supervisory activities for the minimum level of (annual) supervisory engagement. The approaches and techniques for different levels of supervisory engagement should be prescribed in the related methodology and framework.

**51. The supervisory approach in South Africa has historically been based on a strong relationship between the supervisory authority and banks' Boards, senior management, internal and external auditors.** The PA attaches importance to regular prudential meetings with, among others, banks' Boards, Board committees, CEOs, heads of internal audit and compliance functions, heads of risk functions and business units, as well as with external auditors in a variety of formats (trilateral, bilateral, etc.). These regular interactions support timely and open dialogue between the bank and the PA on a

[22] Some elements, mentioned in the TN, are already included in the PA Draft Risk Framework.

range of issues, including the bank's strategies, business model and risks, corporate governance arrangements at the bank, the bank's culture, management issues and succession planning, and other supervisory findings or expectations. During these prudential meetings, the PA provides insights to the bank on its operations relative to its peers, market developments and emerging systemic risks. The PA's approach to banking supervision relies on banks' Board members, senior management, and system of the three lines of defense for ensuring that day-to-day operations are conducted prudently and in accordance with prevailing Regulations. Moreover, the PA considers banks' self-assessments and self-reporting, and internal audit function and external audit reviews of supervisory returns and governance arrangements. Although there are benefits to this approach, it may also give rise to blind spots, particularly if too much reliance is placed on others without conducting its own assessments of the quality and comprehensiveness of their work (see more on Credit risk, problem assets and provisions section). In particular, there is a significant risk that insufficient depth or scope of the banks' risks would not allow the supervisor to identify emerging risks and unsafe and unsound practices at early stage and to take timely corrective actions.

52. **In view of the aforementioned, PA on-site supervision should be further strengthened.** On-site inspection is included as a supervisory tool in the PA supervisory framework. It is envisaged that such inspections will be used to challenge and test the effectiveness of a bank's processes and procedures, to test validity of risk assessments performed based on off-site information, to identify risks and assess whether they are well managed, and to identify areas for improvement. Prior to the PA being established, an on-site review team had embarked on a series of inspections to review banks' application of the standardized approach for credit, the basic indicator and standardized approach reviews of operational risk (Basel II), reviews of the adequacy of banks' impairment processes on retail mortgages and unsecured lending, and on governance. Upon the establishment of the PA, the separate on-site review team was dissolved, with the work partly been shifted to the various specialists in the Risk Support Department who, together with frontline analysts, currently undertake on-site visits to review particular risks or to discuss banks' ICAAP submissions, etc. The PA's limited resources and reliance on external experts have resulted in a level of on-site supervisory intensity that is on the lower end of the scale compared to international peers, risking gaps in the identification[23] of emerging risks and the assessment of governance, risk management and control functions.[24] Against this backdrop, the PA is encouraged to perform more in-depth reviews of key internal processes, including governance and risks, to complement the existing approaches and more closely align the supervisory framework with international best practices.[25] Recently the PA has drafted its on-site supervision guidelines and is prepared to strengthen this tool.

53. **In special cases, the PA uses independent reviews to gather further information about emerging concerns.** Acknowledging the importance of in-depth reviews, the Banks Act (Section 7)

[23] PA confirmed that newly drafted on-site supervision guideline will address this finding.

[24] It should be noted that the supervision of AML/CFT issues and cooperative banks is characterized by more frequent on-site inspections and other verification work.

[25] On-site work is used as a tool to provide independent verification that adequate policies, procedures and controls exists at banks, determine that information reported by banks is reliable, obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, monitor the bank's follow-up on supervisory concerns, etc.

empowers the PA to engage independent reviewers, at the cost of the bank, to commission detailed assessments of any areas where required to assist in achieving its supervisory mandate—for example banks' calculation of capital requirements, the value of assets or liabilities, and its governance framework. The FSAP team reviewed several independent review reports and found them comprehensive and substantive, with the findings providing an important contribution to the PA's ability to discharge its prudential responsibilities. The recently approved guidelines on the process followed to select an independent reviewer includes criteria used to assess the skills and capability of the potential reviewer to carry out the required work. Still, the PA should have the procedures for assessing whether the third parties' output can be relied upon to the degree intended.

**54. As banks are operating in a deteriorating macroeconomic situation, the intensity and the mix of on-site and off-site supervision should be revisited.** The PA should consider increasing the frequency and intensity of on-site supervision and making greater use of risk specialists for on-site supervision (in particular, for D-SIBs and higher risk banks). As a matter of importance, the duration of on-site visits should be extended to ensure that risk specialists are able to fully scrutinize a bank's own understanding and risk management practices. The PA should also consider using the on-site supervision function for a deeper assessment of the effectiveness of corporate governance arrangements. To strengthen the on-site supervision function, a detailed on-site supervision methodology, including the usage of different on-site inspection techniques, should be developed. More resources will also be required to achieve this objective.

**55. Enhancements of the PA's risk-rating methodology could help enhance supervisory focus and help optimize resource allocation.** As a rating is a main driver in supervision, frontline analyst teams use a dual rating system, with one component reflecting the systemic relevance of the bank, and the other tracking the risks that the bank is facing.[26] Under the current risk-rating methodology, quantitative ratios attract a weighting of 70 percent, and the assessment of corporate governance, management and staff, compliance, AML/CFT, internal audit issues attract a weighting of 30 percent. Although semi-annual risk review reports are more detailed and more descriptive, they do not provide a comprehensive assessment of a bank's risks and governance. Supervisory ratings determine the length of the supervisory cycle, but the PA's processes do not (yet) provide for a structured and formal approach for varying the intensity of the supervisory engagement in accordance with the risk ratings (in practice the approach for large banks and other smaller banks differ and is based on judgement). In a more risk-based environment, the supervisory intensity is differentiated by the rating of individual risk components (credit risk, market risk, operational risk, liquidity risk) instead of being driven mainly by the overall rating of the bank. In other words, a worse risk rating for operational risk would result in increased supervisory intensity in that particular area, but not necessarily in other risk areas. Going forward, however, such an approach will be integrated in the new supervisory framework. The PA communicates its findings and concerns to a bank, among other ways, in prudential meetings, followed-up by a feedback letter. While such engagement can help underscore the importance of safe and sound operations, documentation reviewed by the FSAP mission indicated a relatively widespread use of regulatory exemptions that can undermine these efforts.

[26] Ratings are included in monthly MIR reports that provide information on key changes over the period.

**56. To enhance supervisory effectiveness, the PA is encouraged to, as practical as possible, pivot towards a supervisory model that is more intrusive, comprehensive, and structured.** Implementation of the Supervisory framework, including the new Risk Framework, should result in a more structured, intrusive supervisory approach, with greater priority being given to effectiveness assessments of banks' governance and risk management arrangements. However, achieving this objective will require additional resources, more detailed supervisory methodologies, and the development of additional guidance to be issued to the industry on supervisory expectations and best practices. In particular, the PA should consider providing more feedback[27] to the industry on practice observed during thematic reviews, "flavor of the year" discussions, and prudential meetings, with the aim to guide industry behavior and fostering greater risk awareness across the industry at large. Direct access to the data of credit registers[28] and other databases, and continuous improvement of IT systems, including innovative technologies in financial supervision ('suptech'), should facilitate the ongoing supervision.

**57. More detailed internal supervisory methodologies need to be developed as part of the ongoing overhaul of the supervision framework.** The ratings of many banks have also not changed for a number of years. The FSAP team observed that there limited written internal guidance for supervisors to rate the risk profile of their banks, even though the necessary knowledge is present within the PA. When probed, supervisors explained that they mainly refer to the Regulations to risk-rate their banks. Regulations are essential, but they are not granular enough to assess where the bank is sitting on the risk spectrum. Going forward, it is recommended to develop internal supervisory methodologies that describe best practices for all relevant risk areas (including corporate governance and risk management) and allow supervisors to assign consistent and timely ratings across the entire risk spectrum. As staff in the PA are very aware of this range as they have performed many thematic and bank on-site visits, this is more a matter of formalizing guidance and sharing the relevant materials internally to ensure a more granular and consistent rating process.

**58. The PA should set out annual priorities for banking supervision, focusing on the key challenges facing banks in the macroeconomic, regulatory, and supervisory environment.** The PA has a process for developing a supervisory plan for individual banks (the outcome is the calendar of prudential meetings). Additionally, the PA decides annually on two or three "flavor of the year" topics for raising awareness of new issues or highlighting certain emerging risks and vulnerabilities. These topics are incorporated into banks' supervisory plans and are discussed in meetings with banks during the year. For 2020[29], however, neither of the two topics chosen as' flavor of the year' are directly relevant to the banking sector financial risks and vulnerabilities (i.e., "IFRS 17 Insurance" and "The impact of new technologies, including FinTech and disruptive technologies on the regulated institutions").[30] While the FSAP team appreciates the authorities' considerations for prioritizing other sectors and new technologies at this juncture, also taking into account the prominence of banking sector related themes in previous

[27] Main supervisory outcomes were published in the Prudential Authority Annual Report 2019–2020.

[28] In South Africa there are 33 private credit bureaus (2019), but no public credit register. In November 2020, the PA together with the SARB, FSCA, NCR and FIC signed a multilateral MoU to establish a single national register of outstanding credit agreements.

[29] In May 2020, the PA suspended the flavor-of-the-year topics for the remaining 2020 meetings with banks. In February 2021, the PA published the flavor-of-the-year topic "The impact of new technologies on regulated financial institutions" (this topic is the same one that was suspended last year).

[30] The results of the last topic review could be useful for bank's strategy and business model analysis by the PA.

years, the PA should consider setting annual priorities for each sector under its supervision, to help focus industry attention to key issues and emerging risks, elucidate supervisory expectations and ensure that industry-specific vulnerabilities are given sufficient attention in supervisory risk analyses. Depending on the PA's preferences, such priorities could either be encapsulated in the 'flavor of the year' exercises and topics for thematic review; or be rolled out as separate initiatives.

**Recommendations**

**59. The authorities are encouraged to:**

- Direct more resources to implement the supervisory framework, including the new Risk Framework, effectively.
- Ensure that the implementation of the supervisory framework results in a more structured, intrusive, comprehensive ongoing banking supervision with greater focus on assessing the effectiveness of banks' corporate governance and risk management arrangements.
- Assess the specific mix between on-site and off-site supervision and its effectiveness, with the aim to enhance bank's governance and risks assessments.
- Strengthen the on-site supervision function by increasing the frequency and intensity of on-site supervision and making greater use of risk specialists for on-site supervision function (D-SIBs and other higher risk banks).
- Develop more detailed supervisory methodologies listing the range of observed good practices that will assist supervisors with rating their institutions and carrying out on-site inspections.
- Set out annual priorities for banking supervision to focus resources on the key challenges facing banks in the macroeconomic, regulatory, and supervisory environment.

## D. Corrective and Sanctioning Powers

**60. The PA raises supervisory concerns at an early stage, yet a formal classification of the severity of the issues, a clearer prioritization of actions and a structured escalation process to the bank's Board would significantly strengthen the regulator's message.** Following onsite meetings and offsite reviews, the PA submits its key findings or issues identified in the form of feedback letters, which are comprehensive and substantive. Yet the wording of the feedback letters does not clearly distinguish between concerns that reflect deficiencies and concerns that require strengthening of risk management practices but are not deficiencies, making it difficult to judge the nature and severity of matters raised. A more formal classification of the nature and severity of the issues raised and a clearer articulation of the urgency for the bank's management to address them is recommended. Also, industry discussions revealed uneven practices with internal escalation. Some banks table every feedback letter to their Boards; in other banks management has the discretion to select those matters that deserve the Board's attention. It is good practice for supervisors to decide which matters need to be raised with the Board instead of leaving it up to the bank's management discretion.

**61. In some instances, concerns raised in the feedback letters had been raised in the previous prudential review and took a long time to be addressed demonstrating an enforcement appetite on the lower end of the spectrum.** This may be because the PA prefers to address issues in a cooperative manner and use moral suasion powers. While such an approach may often work, it can result in supervisory resources being drawn into protracted engagements with non-cooperative institutions, thus resulting in a less effective use of the PA's resources. Also, the longer the delay in addressing issues, the higher the probability a risk will crystallize, or a relatively small matter will become material. While the FSAP team did not identified specific high-risk outstanding matters, there is scope to be more proactive, escalate issues quicker to the institutions' Board and be more forceful in setting the PA's expectations for timely resolution of the issues raised with banks.

**62. Good international practice is to develop structured and rigorous supervisory response frameworks, which serve as a basis for early intervention decisions when certain triggers or indicators have been breached.** Supervisory responses are normally developed by using the combined risk assessment and impact assessment, and the resultant supervisory intensity level, as the framework for determining the types of supervisory actions that would apply for given levels of assessments. It is typically linked to early intervention arrangements, such as prompt preventive or corrective actions such that given levels of supervisory concern will act as triggers for the PA's interventions. In addition, formalized intervention frameworks include quantitative triggers for actions, such as triggers linked to levels of capital ratio, liquidity ratio, impaired assets, and indicators of operational risk and market risk. Usually, Early Warning Indicators (EWIs) are used to identify early-stage deterioration in a range of risk metrics that enable the supervisory authority to timely prepare for supervisory interventions. The EWIs will typically include leading indicators relating to earnings, interest rate margins, profitability, capital, asset quality, liquidity, funding, market risk and operational risk—with relevant thresholds set well above regulatory requirements to ensure that actions are taken in a timely basis, with the aim to maximize the probability of successful remediation. These frameworks will usually be applied at the level of the licensed bank and, where applicable, at banking group level. However, they are not to be used in a mechanistic way and should form the basis for discussion and decision within the supervisory authority.

**63. The PA has not implemented a structured intervention framework, with triggers (qualitative and quantitative) and indicative response actions in relation to triggers.** While the PA does make use of various prudential and financial indicators in its supervisory analysis, including some EWIs, the indicators tend to be mainly in relation to an institution's current financial condition rather than early indicators of possible future deteriorations in financial condition. Hence, it is recommended that the PA develop a s formalized intervention framework, with triggers and responses that are anchored both to the risk/impact ratings and to specific calibrations of current condition indicators and early warning indicators. It is also recommended that the PA develop more comprehensive EWIs covering a range of risk metrics, with particular focus on indicators that can assist in foreshadowing or adumbrating future deterioration in financial condition.

**64. The Risk Support Department prepares a watchlist of banks that raise specific concerns which is circulated to the Prudential Committee.** The monthly watch list is tabled at the PA MANCO for discussion. This is an independent process that is driven by RSD and only PA MANCO can remove a bank from the list. This process was introduced during 2019.

**65. The enactment of the FSR Act has granted a suite of new powers to the PA and it now has a range of supervisory powers to decide on timely corrective actions at its disposal.** New powers include enforceable undertakings and debarment orders and issuing a directive to a key person of a financial institution. The Regulatory Action Blueprint lists the actions the PA can take and the delegation of powers to Heads of Division and Heads of Department by the CEO. The Prudential Regulatory Action Committee (PARAC) recommends to the CEO of the PA the regulatory action to be taken. The PARAC includes SARB representatives.

**66. The PA has not yet developed contingency plans for dealing with weak banks.** Typically, contingency plans include checklists of the kinds of actions, and strategies, including coordination arrangements, the PA might appropriately take in common scenarios of emerging bank stress and deteriorating financial conditions in a bank. These contingency plans are helpful in establishing preparedness for dealing with weak banks, as is recognized by the BCBS (e.g., the 2015 paper). Moreover, the PA does not undertake regular testing of its capacity for responding to bank stress situations. The FSAP team recommends the PA develop of contingency plans and undertake regular testing of their capacity in this area.

**67. The appointment of a curator requires the approval of the MOF which, as noted earlier, undermines the independence of the PA.** In a case where the PA believes that a bank will be unable to repay deposits or will probably be unable to meet any other obligations, the MOF may currently appoint a curator of the bank, in whom the management of the bank is vested. The curator, who operates under the supervision of the PA, can take such actions as suspending or reducing the right of creditors of the bank to claim or receive interest; making payments to creditors; cancelling any agreement between the bank and other parties to advance funds or extend facilities; convening a meeting of creditors; negotiating with creditors; and, canceling guarantees issued by the bank. The curator is required to provide the PA with monthly reports indicating whether there is a reasonable probability that the bank will become a successful concern.

**68. The FSLAB will eliminate the power to appoint a curator, thus removing an essential tool from the PA's supervisory toolkit.** The appointment of a curator (in other jurisdictions also referred to as 'temporary administrator', "statutory manager" or 'special manager') with extensive powers is a basic intervention tool that allows the supervisor to provide for interim management with the curator assuming the powers of the Board and shareholders of a bank in difficulty—although in the case of South Africa, this instrument is typically associated with resolution actions (e.g., in the cases of African Bank or VBS Mutual Bank). The power to place institutions under official control is particularly important in situations where the supervisory authority has lost confidence in a bank's board and/or senior management to address identified, serious supervisory concerns and where the bank's viability is potentially at stake. It is a power explicitly required under the Basel Core Principles, and it can reduce contagion risk and can be crucial to maintaining financial stability. The authorities are therefore recommended that the power to temporarily place institutions under PA be retained in pre-resolution situations, subject to appropriate triggers (such as the PA being satisfied, on reasonable grounds, that a bank's viability is potentially at risk and that timely remediation is not likely to materialize if the bank's current management remains in control).

69. **The requirement to give 30 days prior notice in suspending registration or restricting activities of a bank or a controlling company can hamper timely supervisory responses and potentially undermine confidence.** During that time, cancellation or suspension of the registration or restriction of the activities does not become effective, potentially exacerbating the impact of market rumors about the condition of the bank. The PA could apply to the court for an order of cancellation or suspension of the registration, in which case the 30-day notice period would not apply. That said, it is not clear if such a request can be processed expeditiously and in strict confidence. The Legal Services Department of the PA is of the view that the suspension or cancellation of a license is an administrative action that is subject to the Promotion of Administrative Justice Act (PAJA). Since PAJA allows for immediate action, the Legal Services Department is of the view the PA can take steps to immediately cancel or suspend a license. Still, this opinion as well as the potential court application remain untested in practice and it is essential that supervisors are prepared for urgent crisis situations when informal measures may not work.

**Recommendations**

70. **The authorities are encouraged to:**

Develop a formal classification of the nature and severity of the issues raised and a clearer articulation of the urgency in the feedback letters.

- Clearly define the matters that need escalation to the Boards of Directors of supervised institutions in the feedback letters.
- Maintain the power for the PA, as a pre-resolution instrument, to place institutions under official control (via a temporary administrator or statutory manager) without ministerial involvement.
- Remove the 30-day notice for suspending registration or restricting activities of a bank or controlling company.
- Develop a rigorous and structured framework for a consistent early intervention supervisory response.
- Strengthen EWIs and make them more forward looking.
- Develop and regularly test contingency plans for dealing with banks and bank stress scenarios.

## E. Banks' Corporate Governance

**Even though high standards of corporate governance are set for banks and controlling companies in South Africa, the BCBS' revised Guidelines on Corporate Governance have yet to be fully integrated in the Regulations.** The Banks Act establishes high level requirements for banks' corporate governance arrangements and governs the ultimate responsibility of banks' Board of Directors to ensure that an adequate and effective process of corporate governance is established. Regulations provide detailed requirements for certain governance areas. Additionally, many banks need to comply with the King IV Report on Corporate Governance for companies listed on the JSE. Since the 2014 FSAP, the corporate governance framework for banks has not changed significantly. Only one new Directive 4

(2018) has been issued since 2014, strengthening the requirements for the appointment of directors and executive officers, including the composition of the Board, independence of Board members, time limits, etc. Following the Organization for Economic Co-operation and Development (OECD), the BCBS issued revised Guidelines on Corporate Governance principles for banks in 2015. Subsequently, the PA issued Guidance Note 5 (2016), requesting banks to assess their current policies, processes and practices against the principles contained in the BCBS Guidelines, taking into account the nature, size, complexity and risk profile of their activities. Banks were also requested to develop a plan to remedy any deficiencies identified during the assessments. Some elements and principles of the BCBS Guidelines are already incorporated in the South African governance framework, but the PA should consider full incorporation of the revised BCBS Corporate Governance Guidelines into its Regulations. Of importance is the need to update the Board's overall responsibilities, the requirements for corporate culture and values, the risk management function and the role of the Chief Risk Officer (CRO). The PA is prepared to do a gap analysis to identify matters of corporate governance that need to be addressed in the domestic regulatory framework.

**71. The PA's assessment of a bank's corporate governance arrangements relies on among other things on banks' own self assessments and their review by external auditors.** Although the analysis of a bank's corporate governance is part of the PA supervisory framework, the supervision of a bank's corporate governance arrangements by the PA also relies on banks' own self-assessments and on external auditors' reviews. Regulation 39 requires a bank's Board of directors to assess at least annually whether the processes relating to corporate governance, internal controls, risk and capital management and capital adequacy implemented by the bank successfully achieve the objectives specified by the Board. External auditors have an obligation to review annually the process followed by Board of directors in performing the self-assessment, and to report to the PA within 120 days of the bank's financial year end. This report forms the basis of discussion at the annual trilateral discussions between the PA, external auditor, and the bank's Audit Committee. Discussions with external auditors revealed these reports are drafted from a compliance perspective and do not opine on the effectiveness of corporate governance or the implementation of the actual arrangements. It is crucial for supervisors to carry out their own assessment of banks' governance policies and practices, and how they are implemented.

**72. The PA's supervision of corporate governance should include a more comprehensive assessment of a bank's governance.** The scope and depth of the PA's supervisory assessment of banks' corporate governance arrangements needs further strengthening to achieve full compliance with CP 14. Given that the PA does not have experts specializing on governance issues, frontline analysts are responsible for the assessment of banks' corporate governance arrangements (inputs for monthly rating update, semi-annual risk review). Written supervisory assessments focus on compliance with the corporate governance requirements of the Banks Act and Regulations (changes in governing bodies, composition of Board, etc.), but do consist of a full and comprehensive assessment of the effectiveness of a bank's corporate governance arrangements with a forward-looking view.

**73. Risk-based supervision seeks to leverage off banks' governance arrangements but more guidance for supervisors is required.** The PA is currently drafting a new Risk Framework which includes corporate governance as one of its most important elements. The PA should prepare a detailed internal methodology for the assessment of banks' corporate governance arrangements. The PA has already produced an interim Guideline on Governance and Culture based on questionnaires sent to banks in the

culture of ethics exercise ("flavor of the year"). However, the internal methodology should be expanded and incorporate all elements required in the assessment of the effectiveness of a bank's corporate governance, and supervisory techniques.

**74. Similarly, the supervision of financial conglomerates should involve more specialized resources on governance issues.** As financial conglomerates are often complex groups with multiple regulated and unregulated financial and other entities, a key focus of the supervision of financial conglomerates should include the effectiveness of corporate governance arrangements. Group-level supervisors should undertake, together with governance specialists, a comprehensive assessment of corporate governance policies and practices, which are often more complex.

**75. The PA has effective mechanisms for the fit and proper assessment of members of governing bodies and of key personnel**. The Banks Act, Regulations and Directive set clear requirements for the composition, qualification and integrity of the members of a bank's governing body. The PA collects the information needed for the fit-and-proper assessment through a comprehensive questionnaire (containing 40 questions). The questionnaire also includes a matrix setting out the board memberships of proposed members and the time spent on these board memberships to assess time available for its responsibilities to the bank. The questionnaire includes a declaration by the Board chair that the individual is fit and proper to take the position within the bank or controlling company. In addition, the PA conducts an interview with a proposed director or executive officer where appropriate. Certain areas within the PA also prepare comprehensive memoranda detailing assessments of prospective candidates. The PA discusses succession planning for executive management positions as part of regular meetings with the Board. The PA has the powers to remove a director or executive officer and has exercised these powers. The PA received additional powers under the FSR Act to make prudential standards for, or in respect of, key persons of financial institutions.

**76. The PA has strengthened the requirements for Board membership of experienced non-executive members.** The Banks Act specifies that 51 percent of the Board must be non-executive directors. Additionally, Directive 4 (2018) provided new requirement that a bank's policy must clearly specify that the chairpersons of the Board and Board's sub-committees (an audit committee, a risk and capital management committee and a remuneration committee) must be an independent non-executive director. In special circumstances, the PA has the power to exercise its discretion and approve the appointment of a non-independent non-executive director to serve as the chairperson for such a period determined by the PA, but extensive use thereof blunts effectiveness of the regulatory requirement (recently around 60 decisions were taken for small banks). The PA stated that banks' self-assessment of their governance against the requirements of Directive 4 (2018) identified a range of gaps in policies and in respect of the independence of the chairperson of the Board (for example, if they served on the Board for a period longer than 9 years, they cannot be treated as independent). The PA should consider benefitting from prudential meetings held only with independent non-executive Board members, which can bring an objective view to performance of the board and senior management and on areas where interest of shareholders, senior management and the bank may diverge such as the audit function, executive remuneration, large acquisitions, etc.

**77. The PA has started to raise awareness of the importance of corporate culture in banks.** In 2019, a "flavor of the year" exercise was "the creation and institutionalization of a culture of ethics and

awareness". All banks with an asset size in excess of R 50 billion participated in the exercise, which involved the PA discussing corporate culture in various meetings with banks and complementing this work with off-site analysis involving responses to questionnaires. The discussions with banks included domestic and international regulatory developments in promoting an effective corporate culture in banks. The PA does not appear to have the necessary specialized skillset to assess the culture of a bank. The PA should consider upskilling its staff and or recruiting new specialist resources to assess this complex area to promote the PA's expectations and industry best practice on corporate culture issues. Finally, the findings of the 2019 "flavour of the year" should be published in the form of a Guidance Note to share good practices observed in front running banks with the rest of the industry. Also, the PA should consider issuing more guidance to banks on its expectations for sound corporate governance.

**Recommendations**

**78. The authorities are encouraged to:**

- Incorporate the revised BCBS requirements on corporate governance into Regulations.
- Prepare an internal rating methodology to evaluate the effectiveness of a bank's corporate governance arrangements.
- Increase specialized resources for the supervision of corporate governance (banks and financial conglomerates) and consider setting up a specialized division in the Risk Support Department.
- Organize bilateral prudential meetings only with independent non-executive Board members.
- Share good corporate governance and corporate culture practices observed in South African banks.

## F. Credit Risk, Problem Assets, and Provisions

**79. The PA's credit risk regulatory framework sets credit risk management requirements and expectations.** Regulations set out the requirements for adequate policies and procedures related to credit risk management, approved by the Board of Directors and effectively implemented by management. PA's staff including the frontline analysis team, and the credit risk support team take an active role in in assessing the quality of credit risk management at all banks. Stress testing performed by banking entities and groups is generally assessed in terms of the review of the bank's Internal Capital Adequacy Assessment Process (ICAAP) document submitted to the PA. The PA reviews the bank's stress testing results covering the scenarios, assumptions and parameters used, and their feasibility to determine the impact on the supervisory approach. Industry participants commented on the technical strength of the PA's credit models team.

**80. The Credit risk models' team has conducted thematic reviews on internal models for the larger banks, partly in line with global efforts to reduce risk weighted assets variabilities among internationally active banks and strengthen implementation of the Basel framework.** Based on these thematic reviews, the PA has proposed to constrain the use of internal models for certain portfolios, e.g., public sector entities and local government exposures, to prescribe stricter requirements regarding the

role of independent valuation units and enhanced reporting requirements for unrated exposures and internal models with material weaknesses.

**81. Although credit risk is the main driver of the South African banks' risk profile, there is heavy reliance on external auditors for the review of credit risk management and provisioning.** The PA considerably relies on external auditors. For example, they prepare annual reporting for significant weaknesses in the system of internal controls relating to the granting of loans, the making of investments, the ongoing management of the loan and investment portfolios and the relevant credit impairments or loan loss provisions and reserves. Auditors are also required to determine that the banks give due consideration to off balance sheet exposures.

**82. There may be an expectations gap in the PA's reliance on the external auditors for consistency in application of principles-based accounting standards across banks.** All South African banks are required to comply with IFRS 9. This is a principles-based standard that allows a high degree of management discretion. The PA has, through its a technical accounting and auditing unit in the Policy department, engaged early with the industry and the auditors. The PA issued guidance note 3 on IFRS 9 in 2016 and Directive 5 in 2017. Its engagement was mainly through working groups facilitated by South African Institute of Chartered Accountants (SAICA) where all large banks, IRBA and the audit firms were represented. Most small banks, however, were not regular attendees. The position papers reflecting the discussions and decisions of these working groups are not publicly available. The IRBA issued a staff practice alert on the audit implication of the Expected Credit Loss (E)model for the external auditors. External auditors as well as banks commented that there is divergence in the application of the IFRS 9 definitions across banks, for example in the areas of segmentation, modifications, Small and Medium Size Enterprises (SMEs) and write offs. External auditors stated that they ensure compliance with IFRS on an individual bank basis but cannot ensure consistency in application across the industry. More guidance and direct engagement by the PA with banks would help to address this. Ultimately it is the bank's board that is responsible to ensuring that the financial statements are prepared in accordance with accounting policies and practices.

**83. While the prudential reporting forms are being updated to align with IFRS 9, more data on restructuring like cure rates and roll rates need to be collected.** The PA is in the process of updating the prudential reporting forms and aligning them to IFRS 9. This should be an opportunity to collect additional data on distressed restructurings, like cure rates and migration rates for restructured and defaulted exposures, at individual bank level then to be aggregated for the banking system. These trends should then inform the intensity of supervision.

**84. There is regular and active engagement between the PA and bank external auditors during meetings, but no comprehensive and deep assessment of audit quality[31] is performed by the PA.** The relationship has been described by both parties as open and constructive. The auditors hold preliminary discussions with the PA prior to the commencement of the final audit. These are referred to as bilateral meetings. After completion of the audit, the PA meets with the auditors as well as the bank in what is referred to as trilateral meetings to discuss the outcomes of the audit. Moreover, the PA requires

[31] A deep and compressive assessment would include a review of audit working papers.

two audit firms to act as joint auditors for large banks, each auditor taking equal responsibility for the audit. Feedback from auditors and banks confirmed this practice has contributed to audit quality.

**85. The PA relies on the IRBA to oversee audit quality of external auditors, but their scope is limited to statutory audit.** Audit quality has come under pressure in South Africa, particularly following the failure of two smaller banks and other corporate scandals. The IRBA was established under the Accounting Profession Act in 2006 and now has around 40 projects ongoing to support confidence in the audit profession. Moreover, it has developed a suite of audit quality indicators to empower stakeholders to play a role in audit quality. The inspections performed by the IRBA resulted in 50 and 60 percent of the inspected audits with one or more findings, well above the international rate of 33 percent.[32] It is important to note that the IRBA only oversees statutory audits and its reach does not extend to the regulatory audit the PA requires the external auditors of banks to perform. While there are overlaps and synergies between the statutory and regulatory audit work, some aspects of the regulatory audit work have more of a stand-alone nature.

**86. The IRBA does not have any staff with bank expertise and cannot be relied upon to oversee audit quality in the banking sector.** The current environment has put increased pressure on the IRBA to deliver on its mandate with limited resources. The IRBA has spent 10 percent of its budget to investigate the external auditors of African bank using external consultants and guidance of foreign peers. It does not have the expertise and skills to oversee the quality of external audits in the banking sector on an ongoing basis. As a result, the ongoing oversight of the IRBA of external auditors for the banking sector cannot be relied upon by the PA because of a lack of adequate skills.

**87. Ongoing investigations by the IRBA of one audit firm, following allegations[33] of complicity of an audit engagement partner in a bank failure, underscore the importance of establishing adequate oversight of bank audit quality.** Following the VBS corruption scandal, several banks have decided to migrate to a different audit firm or have sought enhancements of the audit team at their own initiative (e.g., addition of non-local staff and external review partners). The PA, however, has refrained from withdrawing the firm's approval to perform bank audits, citing confidence in measures taken by the firm to strengthen its internal procedures. While this perspective is well taken, it would still be important (i) to disseminate the factors underpinning this decision, including to guide future interaction between PA staff and external auditors; and (ii) to consider the introduction of additional safeguards across the audit profession, informed by careful cost-benefit analyses, that seek to prevent recurrence (e.g., via independent reviews, strengthening of external audit teams, broader rollout of joint audit requirements that are already applicable for the largest banks). As part of such measures, the PA (jointly with the IRBA, as appropriate) should push for a substantial enhancement of the oversight framework of bank audits in South Africa. Whatever approach for achieving this objective is ultimately chosen, it is important that the work be adequately funded so that several experts with background in bank audit can be allocated to the

[32] International Forum of Independent Audit Regulators (IFIAR), Survey of Inspection Findings, 2019.

[33] The audit firm concealed the bank's financial position as an unqualified audit opinion was issued even though it was known to the audit firm that the financial statements were materially misstated. The regulatory audit opinion was also materially misstated. The external audit firm partner who signed the opinions also received very substantial loans from the bank which were not declared, thus compromising his independence.

task, and options for implementing independent oversight can be explored and implemented as soon as possible. The Accounting and Auditing ROSC performed in 2013 should also be updated.

**88. Mandatory audit firm has been introduced in South Africa, in addition to the existing mandatory partner rotation.** The Companies Act states that the same individual may not serve as the auditor or designated auditor of a company for more than five consecutive years. Furthermore, the IRBA has issued a rule on mandatory audit firm rotation of ten years which will apply to all banks for financial years commencing on or after April 1, 2023. These rotation requirements are putting strain in an oligopolistic market with joint audits and strict independence requirements.

**89. IFRS 9 skills in the small banks are thin and effective implementation of the three lines of defense has been a challenge.** Discussions with smaller banks and external auditors showed a heavy involvement of the second line of defense in the implementation of the IFRS 9 models and a lack of IFRS 9 skills in the third line of defense. The PA is aware of these weaknesses, but for now no proactive supervisory stance has been debated. Potential supervisory actions could take the form of a regulatory provisioning overlay with fixed percentages, additional capital requirements or a direction to the bank to source more resources with the relevant skills, internationally or domestically.

**90. Collateralization should not influence the classification of exposures into asset quality categories such as substandard, doubtful and loss.** For the standardized banks, credit exposures are classified into substandard, doubtful and loss categories. However, and contrary to international best practices, these classifications consider the value of any underlying security, thus potentially distorting the identification of nonperforming loans. In accordance with the Basel requirements,[34] an exposure could be considered as nonperforming, substandard or doubtful even when the security or collateral value exceeds the amount of past due exposures.

**91. The regulation dealing with collateral is in line with Basel II requirements but falls short on many qualitative good practice requirements.** Collateral requirements have evolved and improved since Basel II and many supervisors have developed their Regulations and supervisory guidance accordingly. For example, there is no requirement for external valuation of collateral for significant credits, no prohibition for reliance on collateral to be a substitute for the borrower's ability to meet contractual obligations, no requirements for policies to ensure that the collateral continues to be enforceable and realizable, no requirements for evaluation of external appraisers for independence, no requirements for back-testing of collateral valuations, no specifications for the use of indexed valuations. These requirements should be integrated in a prudential standard or at least in a guidance note so that banks understand what the PA's expectations are. Collateralization practices are an important component of sound credit management, a more granular stock take of supervisory expectations which will also assist frontline supervisors to grade their institutions.

**92. The PA has issued a directive on distressed restructuring, but the Directive is yet to be fully aligned with the Basel Guidelines.** Directive 7/2015 defines distressed restructuring and has measures to prohibit banks from using restructuring as a means of concealing the extent of problem loans. The Directive states that banks are required to keep evidence in support of whether a restructure is

[34] BCBS, Prudential Treatment of problem assets—definitions of nonperforming exposures and forbearance.

considered necessary because of financial distress of the obligor, in which case the exposure must be assessed for impairment. The Directive states that a loan, once restructured, must be reported at a minimum as special mention for standardized banks and as default for IRB banks. This treatment appears to be rather lax for standardized banks, and inconsistent with IRB banks. Directive 7/15 further requires restructured exposures to be classified as nonperforming assets for a minimum of six months, or six consecutive payments, under the revised terms and conditions before the exposure can be reclassified as performing. Nevertheless, the Basel guidelines on restructuring require this observation period to be at least one year. It is recommended to update the Directive with the latest Basel Guidelines.

### Recommendations

**93. The authorities are encouraged to:**

- Align the Regulations on restructuring with the Basel Guidelines "Prudential Treatment of Problem Assets".
- Extend the observation period for restructured exposures to one year in accordance with Basel Guidelines "Prudential Treatment of Problem Assets".
- Amend the asset quality definitions of Substandard, Doubtful and Loss for standardized banks by eliminating the impact of the value of the security on the asset classification in accordance with the Basel Guidelines "Prudential Treatment of Problem Assets".
- Develop a prudential standard or at a minimum articulate the supervisory expectations in the area of collateral valuation.
- Perform an Accounting and Auditing ROSC to obtain and independent assessment of the quality of the audit profession.
- Assess IFRS 9 skills in the second and third line of defense in the small banks and consider imposing additional requirements while banks are building up expert resources.
- Develop formal supervisory expectations reflecting good industry practice for credit risk and IFRS 9
- Establish independent oversight of the quality of bank audits.
- Align the classification of restructured exposures as nonperforming between the IRB and standardized banks.

## G. Concentration Risk, Large Exposures, and Transactions with Related Parties

### Concentration Risk and Large Exposures

**94. Regulations require that the Board and senior management establish and maintain adequate policies and procedures related to large exposures and concentration risk.** The Regulations stipulate that a bank may not make investments or grant loans or other credit to any person in an aggregate amount exceeding 10 percent of its capital and reserves without the permission of its

board of directors or a committee appointed for such purpose. In addition, a bank or controlling company may not make an investment or grant any form of credit to a private sector nonbank person that exceeds 25 percent of the bank's capital and reserves without the prior written approval of the PA. The PA staff has discussions with the management of the banks to determine how loans approvals are being governed, including Board approval of larger credit exposures. No specific thresholds for sectoral, geographic, or other forms or concentration are in place, even though these are regularly monitored and overseen by the PA. Credit risk mitigation concentrations are not covered by the Regulations and not always actively monitored by banks.

**95. Several banks have exceeded the 25 percent limit single name concentration.** In line with the Basel standards, a risk weighting of 1250 percent (i.e., similar to a deduction against capital) to the portion of the exposure in excess of the 25 percent limit has been applied. The concentrations often represent exposures to the South African sovereign (including public sector entities) that should be separately reported, as well as exposures to other banks. Some banks also hold specific capital add-ons for product concentration risk (e.g., unsecured lending, SME, etc.), sector concentration (mining, construction, real estate, etc.).

**96. The new BCBS large exposure framework, which came in force on January 1, 2019, is expected to be implemented on April 1, 2022.** In April 2014, the BCBS introduced a new standard with the aim of ensuring that internationally active banks' exposures to single counterparties are appropriately monitored and limited. The scope of the new standard is limited to losses incurred due to the default of a single counterparty. It also requires all banks to report to national supervisors not only their large exposures but also all other exposures that would have been large exposures without considering the effects of credit risk mitigation or exemption clauses. Only sovereign exposures are exempted from the standard thresholds, but still require monitoring.

**97. The new BCBS large exposure framework also changes the way exposures to single counterparties and groups of connected parties are measured, aggregated, and controlled**. The concepts of "control relationship" and "economic interdependence" are defined. Specific criteria where counterparties are deemed to be connected have been specified in the new standard. These concepts and criteria have yet to be included in the PA's Regulations. A preliminary impact assessment by the PA indicated that some smaller banks will be struggling to meet the interbank large exposure cap. Policy options to address this gap are currently being explored. The PA could decide to exclude the small banks from the scope, to exempt them or to grant transitional arrangements.

### Transactions with Related Parties

**98. Related-party transaction Regulations require banks and controlling companies to lend money to a related person on an arm's-length basis, and to have in place robust board-approved policies, processes, and procedures to monitor these transactions as well as to provide supervisory returns.** Banks report related-party transactions to the PA. Related party exposures that exceed 0.1 percent of total capital, are required to be reported on an individual basis, whereas related party exposures less than 0.1 percent of total capital are reported on an aggregate level. Exposures in excess of 1 percent of Tier 1 capital are subject to prior approval by the bank's board. In addition, the banks need to attest through responses to three questions that all related party transactions are done at arms-length,

are board-monitored and whether steps have been taken to control or mitigate these exposures. Regulation 39 requires the Board and senior management of a bank to ensure the monitoring and reporting of individual and aggregate exposures to related persons are subject to an independent credit review process. In the Regulations, the exposure to related parties is treated as a subject to concentration limits and the PA has the power to impose limits on a bank's exposure to connected or related person as it deems prudent or appropriate. However, no limits have been set by the PA on any bank's aggregate or case by case exposures to related parties.

**99. These Regulations, unchanged since 2012, exhibit gaps with the relevant Basel Core Principle (BCP) on related party transactions (BCP 20) and should be updated:**

- **The definition of "related party" does not capture certain groups.** Related interests of the bank's major shareholders, Board members, senior management, and key staff as well as corresponding persons[35] in affiliated companies are not included in the definition. At the same time, definitions of certain related persons provided in the Regulations are not fully aligned with the definitions in the new FSR Act or Banks Act, for example different persons are included in definitions "key members of staff" and "key person"; "close relative" and "close family member"; "significant shareholder" and "significant owner." This gives rise to a potential risk that the identification of related parties across the banking sector can be inconsistent.

- **Insufficient scope of transactions with related parties.** The definition of "transactions with related parties" covers on-balance sheet and off-balance sheet credit exposures and claims, but does not cover dealings such as service contracts, asset purchases and sales, construction contracts, lease agreements, borrowings, and write-offs.[36] In the Regulations, the term "transaction" is not interpreted sufficiently broadly to incorporate situations in which an unrelated party (with whom a bank has an existing exposure) subsequently becomes a related party. For this reason, the Regulations require banks to have policies, processes, and procedures only for lending transactions with related parties, but not for all transactions with related parties.

- **The specific governance requirements for transactions with related parties are not clearly prescribed.** Regulation 39 sets broad requirements on the responsibilities of a bank's Board and senior management, including an independent credit review process on monitoring and reporting transactions with related parties. However, specific requirements on governance issues for related party transactions are not prescribed in enough detail in the Regulations.[37] For example, there is no clear requirement that (1) the Board must provide oversight of transactions with related parties; and (2) exceptions to policies, processes and limits must be reported to the appropriate level of a bank's senior management and, if necessary, to the Board, for timely action; etc.

- **There is insufficient depth of review of banks' practice on transactions with related parties**. The PA obtains supervisory returns on exposures to related parties quarterly. Any matters of concern are

[35] Board members, senior management and key staff, their direct and related interests, and their close family members.

[36] Requirements for banks' write-offs are included separately in Regulations.

[37] BCP (Principle 20) requires that supervisor should determine the governance requirements to banks, which are specifically related with transactions with related parties.

included as a topic of discussion in prudential meeting held with banks. The PA uses external auditors to review banks' compliance with Regulations in this area and to verify the supervisory returns, however, as it was mentioned in previous sections, there is an expectations gap in the reliance on the external auditors. In recent years, no on-site inspections (visits) on related-party exposures have been carried out by the PA.

**Recommendations**

**100. The authorities are encouraged to:**

- Implement the new BCBS large exposure framework including the new requirements for connected counterparts and the limits on interbank exposures.
- Ensure active monitoring of credit risk mitigation concentrations in banks
- Expand the definitions of "related party" and "related-party transactions" to ensure they are consistent with BCP 20; ensure that there is consistency of definitions for identification of related parties in the FSR Act, BA and Regulations.
- Clearly prescribe specific governance requirements for transactions with related parties.
- Conduct an independent verification that adequate policies, procedures and controls on transactions with related parties exist at banks, and the information reported by banks on these transactions is reliable as well as issue guidelines on industry best practices for areas of concern.

## H. Liquidity Risk

**101. Banks in South Africa are currently subject to the LCR and the NSFR, on a solo and consolidated basis**. In addition, two other liquidity ratios, the cash reserve requirement and the liquid asset requirement were maintained when the LCR and the NSFR were introduced. Regulation 26 and Directive 8/2017 provide detailed requirements on the calculation of the LCR and the NSFR. Banks report the LCR on a daily basis to the PA. The implementation of the LCR was assessed by the Basel Regulatory Consistency Assessment Program (RCAP) assessment as "Compliant" in June 2015. The average banking sector LCR was around 140 percent at the end of 2019.

**102. The South African NSFR implementation is not fully compliant with the Basel III requirements.** Certain aspects of the South African financial market made the implementation of the NSFR difficult (e.g., a limited supply of government bonds, an illiquid and small corporate debt market and disintermediation of retail funding through money market funds into the banking sector). For the NSFR calculation, the authorities assigned an Available Stable Funding (ASF) factor of 35 percent to secured and unsecured funding received in Rand from financial corporate customers, excluding banks, with a residual maturity of less than 6 months. The PA has opined that the 35 percent ASF calibration (instead of zero percent in the Basel III requirements) better reflects the stability of this funding source in South Africa. In particular, the various regulatory and economic barriers that prevent liquidity from flowing out of the domestic economy are used to justify this stance. These barriers include the foreign exchange control regime that is in place, and the limited foreign exchange funding by South African

banks. The SARB also made a Committed Liquidity Facility available to commercial banks to assist them in meeting their LCR, in view of the limited availability of high-quality liquidity assets (HQLA) at the time that the requirements were introduced. This facility is now being phased out due to increased supply of government bonds in the market.

**103. The PA conducts both onsite and offsite ALM reviews as part of the supervisory framework.** For the larger banks, a questionnaire on liquidity risk is completed every two years. This questionnaire covers qualitative and quantitative questions, based on the Basel Principles for Sound Liquidity Risk Management. The PA's liquidity risk analyst reviews the responses to the questionnaire and asks additional questions. During the onsite meetings, the results of the questionnaire on liquidity risk are discussed with the management of the relevant bank. For the smaller banks, the frequency and intensity of ALM reviews is decided on an ad hoc basis, but the objective to achieve a 3-year supervisory cycle for liquidity risk in the medium term.

**104. Small foreign banks display liquidity funding concentration**. The monthly trigger reports indicate the ten largest deposits as part of total funding. A better articulation of the PA's risk tolerance for liquidity funding concentration risk with specific triggers and timelines for the foreign banks peer group is recommended. This should be decided by peer group and embedded in the internal reporting.

**105. Externally facilitated liquidity simulations have been used to test and complement Liquidity Contingency Plans and Recovery plans of the large banks**. Currently, all banks, branches of foreign institutions and controlling companies are required by the Directive D1/2015 section 6(6) of the Banks Act no 94 of 1990 of the minimum requirements for the recovery plans of banks to conduct stress tests. Section 8.2 is particular on Reverse stress testing.[38] The simulations are dynamic in nature, meaning that the scenario is continuously steered based on the participants' response. Senior management of the relevant banks as well as the SARB Financial Markets Department, the SARB Financial Stability Department, the National Payment System Department, and the PA participate in the simulations. Given that the simulations are resource intensive and require long preparation times, they have been performed on an ad hoc basis. Going forward, it is recommended to formalize their scope and objectives and set a minimum frequency, for the large banks and for those small banks that have an elevated risk profile for liquidity risk.

### Recommendations

**106. The authorities are encouraged to:**

- Formalize the requirement for regularly externally facilitated liquidity simulations to test liquidity contingency plans for the large banks.
- Embed a requirement for an externally facilitated liquidity simulation for smaller banks with elevated liquidity risk profile in the supervisory response framework.
- Clearly articulate risk tolerance for funding risk concentration by peer group.

[38] Reverse stress testing consists of identifying a scenario or combination of scenarios that lead to an outcome in which the institution's business plan becomes unviable and the institution insolvent, i.e., stress events which threaten the viability of the whole institution, as well as assessing the probability of realisation of such scenarios.

# Appendix I. Status of the Recommendations of the 2014 FSAP

| Recommended Action | Status |
|---|---|
| **CP1 – Responsibilities, objectives, and powers** | |
| Define objectives of the supervisor in the legal framework. | Addressed. The objectives of the PA have been clearly defined in the FSR Act. |
| Review the extent of delegation of powers in the Banks Act, with a view to transfer the power to set granular requirements from tier 2 rules (Regulations), which need to be issued by the Minister, to tier 3 rules (circulars, directives), which can be issued by the Registrar. | Addressed. The FSR Act introduced prudential and joint standards. There are plans for all Minister's approved Regulations to be converted in prudential standards or joint standards, as applicable. |
| Review the composition of the Standing Committee for the Revision of the Banks Act, with a view to require its members to be not currently involved in not only any regulated entities but also bodies that represent interests of those regulated entities, to insulate the process from direct industry interests. Instead, as experts on financial business, the Committee could include retired officials from the industry or academics. | No change since 2014. During this period the Committee has not met, nevertheless the Banks Act was amended four times. The authorities should consider reviewing the Banks Act for removing the Committee or to prescribing its composition and role. |
| **CP2 – Independence, accountability, resourcing, and legal protection for supervisors** | |
| Revise the legal framework for the head of the supervisor to include (A) a fixed term of the appointment, (B) specific reasons for the removal, and (C) the requirement to publish the reasons for removal, as required in EC2. | Progress has been made since 2014 but effort still ongoing. The FSR Act provides for the PA CEO to be appointed for a fixed term and the basis for its removal. The requirement to publish the reasons for its removal should be prescribed in legislation. |
| Review the legislation to limit the cases that require the Minister's involvement to those that are absolutely necessary and clarify in the laws objectives for intervention. | Progress has been made since 2014 but effort still ongoing. Ministerial involvement in the licensing process has been removed, and prudential standards have been replacing Minister's Regulations. The authorities should consider further limiting the Minister's involvement in the PA activity. |
| Review the adequacy of resources reflecting expected changes in the responsibility of the supervisor under the new twin peaks structure, taking into account the need for further improvements in its supervisory approach as recommended in CP 8, 9 and 12. | Ongoing. By establishing the PA, the adequacy of resources was reviewed, there remain some vacancies. In forward looking perspective, the PA should consider increasing the resources necessary for implementing further supervisory reforms. |
| **CP3 – Cooperation and collaboration** | |
| Review the relevant provisions of the BA to ensure the confidential information shall only be used for supervisory purposes, unless specifically required by court orders or provisions in other laws. | The weaknesses identified have now been addressed through section 251 of the FSR Act. |

| Recommended Action | Status |
|---|---|
| **CP 8 – Supervisory approach** | |
| Enact legislation to provide the supervisor power related to resolution of banks expeditiously and develop resolution plans. | Ongoing. A Resolution Authority is in the process of being established within the SARB Financial Stability Department. In December 2021, FSLAB has been passed by Parliament and its implementation is underway. |
| The new prudential supervisor should review the supervisory approach once the organizational changes are completed in order to equip it with capacity to monitor the prudential risk of the entire financial system as well as that of financial conglomerates. | Ongoing. The FSR Act empowers the PA to regulate and supervise financial conglomerates. The PA starts the process of designating the members of a group of companies as a financial conglomerate. |
| **CP 9 – Supervisory techniques and tools** | |
| Continue the effort to enhance the supervisor's ability to conduct deep-dive on-site reviews. | Ongoing. The on-site review team was dissolved upon the establishment of the PA. The PA conducts short-term on-site visits or can appoint an independent reviewer. The PA should consider strengthening on-site supervision function. |
| Improve tools and technique to assess and monitor spill over risks to the banks from nonbanking activities in their financial groups. | Ongoing. The FSR Act empowers the PA to regulate and supervise financial conglomerates. Currently the large financial groups which comprise banks and insurance companies are supervised by integrated supervisory teams with support by risk experts. |
| **CP 11 – Corrective and sanctioning powers of supervisors** | |
| Strengthen laws to provide the supervisor with the power to suspend or limit a bank's activities without delay. | No change since 2014. |
| Provide the power to fine individuals related to banks. | Addressed through the adoption of the FSR Act. Individuals can now be fined. |
| **CP 12 – Consolidated supervision** | |
| Strengthen the supervisory technique, such as group-wide stress testing, to monitor and assess risks arising from nonbanking activities or parent entities of a financial group in which a South African bank belongs to. | Ongoing. |
| Improve the recovery and resolution planning of large banking groups particularly once the necessary power is given to the supervisor by the expected new legislation. Such planning should also consider scenarios where shocks originate from nonbanking entities or parent groups | Progress has been made since 2014, but effort still ongoing. |

| Recommended Action | Status |
|---|---|
| **CP 13 – Home-host relationships** | |
| Continue efforts to support the capacity building of host supervisors of African operations of South African banking groups to further improve the effectiveness of cooperation and ensure adequate oversight of those operations. | Even though this is a longer-term objective, but the PA has significantly strengthened cross border cooperation since 2014. |
| Finalize policies, processes, and practices to conduct on-site reviews/inspections of South African banks' cross border operations in other African countries. | Addressed. The PA has conducted 10 onsite inspections in African countries in 2018-2020, and 9 inspections in other parts of the world. |
| Enhance its effort in cross-border recovery and resolution planning with close collaboration with the U.K. authorities as well as paying due regards to the impact on financial systems of jurisdictions where South African banks' operations are significant. This will also require close cooperation with supervisory authorities in these jurisdictions. | Progress has been made since 2014, but this is still ongoing. |
| **CP 18 – Problem assets, provisions, and reserves** | |
| Finalize as soon as possible the draft Directive on restructured credit exposures which will help to prevent banks from using restructuring to improve their classified loan levels. | The Directive has been finalized. New Guidance was issued in 2017 by the BCBS which still need to be incorporated in the Regulations. |
| **CP 20 – Transactions with related parties** | |
| Amend the Regulations so that the Registrar has the ability to set limits on exposures to any related parties. | In the Regulations, the exposure to related parties is treated as a subject to concentration limits and the PA has the power to impose limits on a bank's exposure to connected or related person as it deems prudent or appropriate. |
| **CP 23 – Interest rate risk in the banking book** | |
| Continue with the plans to further strengthen its review of banks' internal interest rate risk measurement systems. | Addressed, the oversight of Interest Rate Risk in the Banking Book (IRRBB) has been strengthened since 2014. |
| **CP 28 – Disclosure and transparency** | |
| Review Pillar 3 disclosures consistently either by the BSD's internal staff or by requiring external auditors to do it. | Addressed, Pillar 3 disclosures are now reviewed. |

| Recommended Action | Status |
|---|---|
| **CP 29 – Abuse of financial services** | |
| Proceed with the planned revision of the FICA to incorporate the risk-based approach to the AML/CFT issues and ensure the enforceability of a number of essential elements currently included in the FICA Guidance Notes. | Addressed. The amendments to the FICA (2017) enhanced key preventive measures, including customer due diligence requirements, and introduced a risk-based approach in the identification and assessment of AML/CFT risks. The amended FIC Act requires banks to develop and implement Risk Management and Compliance Programs. |
| Continue the current effort on the AML/CFT on-site inspections to cover all banks expeditiously and improve approaches and techniques based on the lessons learned. | Progress has been made since 2014 and enhanced risk-based supervision (RBS) and efforts are still ongoing. A specialized AML/CFT review team continue to work within the PA, which conducts off-site and on-site supervision in order to fulfil its supervisory mandate as per the provisions of the FIC Act. The PA AML/CFT team is responsible for supervising compliance with the FIC Act obligations by both the banks and life insurers.<br><br>New AML/CFT Manual contains detailed guidelines for off-site and on-site supervision.<br><br>The AML/CFT on-site inspections are carried out in banks, followed by supervisory actions that includes directives for remedial actions and financial penalties.<br><br>The PA imposed many administrative penalties (fines) for the breaches of AML/CFT legislation, which have been publicly disclosed. The PA should consider the incorporation of AML/CFT findings into prudential supervision framework (assessment of bank's governance, business model, fit-and-proper of governing bodies, etc.).<br><br>The AML/CFT unit within the Financial Conglomerate Supervision Department of the PA also supervises subsidiaries of South African banks in foreign jurisdictions. The AML/CFT unit has conducted various onsite inspections in foreign countries since 2013 to assess the higher of home or host AML/CFT standards. The said onsite visits are joint inspections conducted together with the Banks Supervision Departments and the Financial Intelligence Units in those countries. |