Research Report
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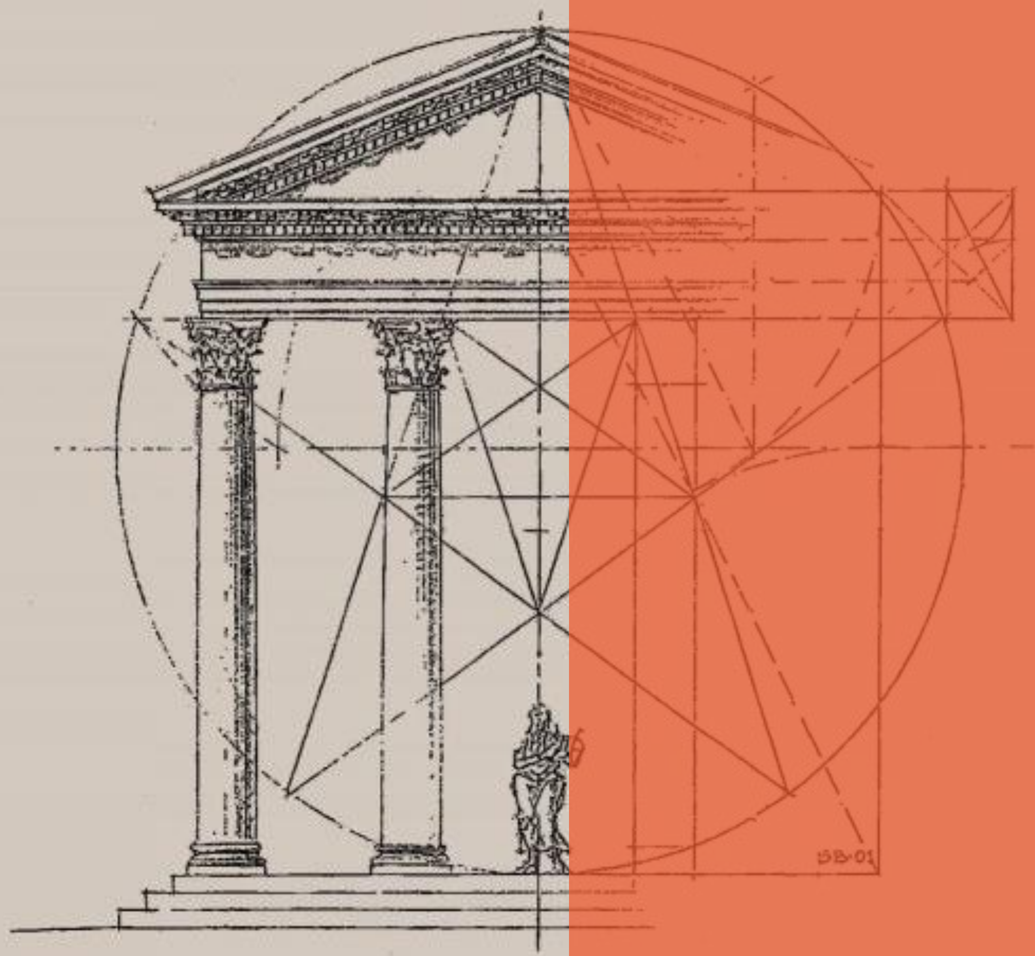
Researching Capital Markets and Financial Services

Proportionality in Banking Regulation and Supervision

A Study of South African Banks



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THE BANKING ASSOCIATION SOUTH AFRICA

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Researching Capital Markets and Financial Services

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Disclaimer

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Abbreviations

AML	Anti Moneylaundering
AT1	Additional Tier 1 Capital
Basel 3	Third Basel Capital Accords
BIS	Bank of International Settlements
CET1	Comment Equity Tier 1
CFT	Combatting Financing of Terrorist
COFI	Conduct of Financial Institutions
DRI	Designated Resolution Institutions
FATF	Financial Action Task Force
FLAC	First Loss After Capital
FSB	Financial Stability Board
FSCA	Financial Sector Conduct Authority
HQLA	High Quality Liquid Assets
ICAAP	Internal Capital Adequacy Assessment Programme
ILAAP	Internal Liquidity Adequacy Assessment Programme
KYC	Know Your Client
LAC	Loss Absorbing Capital
LCR	Liquidity Coverage Ratio
NSFR	Net Stable Funding Ratio
NT	National Treasury
PA	Prudential Authority
RWA	Risk-Weighted Assets
SARB	SA Reserve Bank
SIFI	Systemically Important Financial Institution
SREP	Supervisory Review and Evaluation Process

1. Executive Summary

- South Africa largely reflects best practice in bank supervision and regulation, which has been overhauled since the global financial crisis. Internationally, however, a debate is under way regarding the proportional impact of regulation on banks, particularly given that countries including South Africa have applied Basel 3 universally to their banks.
- Proportionality is well-embedded as a principle in South Africa's financial regulations. The Financial Sector Regulation Act requires microprudential regulation to follow a "risk-based approach" while bank resolution plans intend to be "proportional to the systemic importance" of individual institutions. Similarly, "know your customer" and other integrity regulation should follow a risk-based framework in line with international agreements. Conduct regulation is also explicitly being developed in line with proportionality principles.
- Proportionality serves the public good in ensuring that the cost of regulation is calibrated to the benefits. A key public benefit of regulation is a safe and stable financial system. However, unnecessarily burdensome regulation constrains market activity, leading to less competition and innovation in delivering on policy objectives, including expanded access to financial services.
- South Africa has developed microprudential regulation in terms of the Banks Act in tandem with Basel 3's development internationally. In several respects, South Africa exceeds Basel 3 minimums in terms of capital requirements, with a total minimum capital ratio requirement of 9.0% compared to 8.0% required. South Africa also applies a more stringent approach for risk-weighting of assets, particularly for small business exposures and mortgages. South Africa makes limited use of national discretion available for exemptions from Basel requirements in respect of banks registered through the Banks Act.
- We find some weak evidence that banks that use internal rating approaches to measuring risk-weighted assets have lower RWA balances than banks that use standardised approaches, resulting in a disproportionate bias upward in RWA for smaller banks.
- In addition to minimum capital levels, banks are required to hold capital and liquidity appropriate to their business models as assessed through internal capital adequacy and liquidity programmes. These are reviewed by the regulator resulting in agreed additional capital under Pillar 2B of Basel 3. This in part explains why all banks in South Africa hold capital significantly above minimum requirements, but the lack of public disclosure of Pillar 2B requirements makes it difficult to distinguish regulatory causes of excess capital or other causes including requirements from funders and ratings agencies. This creates an information asymmetry between regulator views and the rest of the market which may result in higher capital costs, particularly for small banks.
- South Africa applies Pillar 2A as a standard buffer to capture systemic risk at a fixed amount of 1% across all banks. This differs from international practice and creates disproportionate impact on the sector because it applies to all banks irrespective of their contribution to systemic risk.
- South Africa applies both the liquidity coverage ratio and the net stable funding ratio to all banks. Proportionality regimes elsewhere relieve smaller banks from complying with the NSFR given that it is proportionately expensive for smaller banks to attract long-term funding.
- Banks cite total capital ratios as the biggest driver of funding costs. Given that South Africa does not currently apply countercyclical buffers, these are cited as the least impactful of regulatory instruments. Most banks believe that prudential supervision in South Africa is positive for consumers.
- Smaller, less complex banks report that statutory returns often ask for information that is irrelevant to them, but this necessitates monitoring systems in case of incidental exposure. Banks do not feel that the frequency of statutory returns is problematic.

- The Banks Act regulations impose significant additional governance requirements on banks, but banks generally do not believe this creates unnecessary duplication or complexity.
- The forthcoming bank resolution regime should be positive for market entry and smaller banks by derisking banks for retail depositors. This has positive proportionality impact in removing some perceived risks around small banks.
- Conduct regulation is evolving and a more comprehensive supervision process will be introduced shortly. This has strong proportionality principles but implementation and effect will need to be monitored for appropriate proportionality in practice while eliminating duplication across regulators as much as possible.
- Banks have a mostly negative view of anti-money laundering and combating of terrorist financing measures including the Financial Intelligence Centre Act. They see reviews as highly resource draining while not necessarily improving monitoring of systems for criminal use. They view the FICA regime as restricting financial inclusion and disproportionate relative to the benefits, given that few prosecutions result from the information gathered.
- Globally, several jurisdictions are introducing proportionality regimes. These include differentiated structures with certain categories of banks perceived to be low risk subject to a lighter regulatory approach. This can include reduced capital and liquidity requirements, simpler capital or liquidity requirements and reduced reporting requirements.

2. Recommendations

The recommendations outlined below emerge from the discussion set out in the rest of this report, which discusses the status quo and motivates for the recommendations that are briefly outlined here.

Our recommendations are of two types: calibrations that could be made to the existing framework through subsidiary regulations; and legislative changes to amend the structure of the banking sector. The second set of recommendations are more fundamental: if South Africa is to maximise the public benefit outcomes of regulation, it will be important to create a framework for a second tier of registered banks subject to a purpose-built proportionate regulatory framework.

Capital and liquidity recommendations

Based on the discussion in section 4, we make the following recommendations:

1. The system would benefit from greater transparency on individual banks' Pillar 2B requirements to provide peers and the market with insight on regulator perspectives. This would be consistent with some international practices, including in the UK where banks routinely disclose Pillar 2 capital requirements. Disclosure of Pillar 2 requirements would also support market discipline (in line with Pillar 3 objectives) and may in part solve the information gap that leads to funders demanding higher capital ratios than those required by regulators. This would benefit banks more than any harm from disclosing competitively sensitive information. Banks' Pillar 2 requirements should be reassessed after business model changes (new products or acquisitions) rather than periodically.
2. Replace the Pillar 2A buffer. This could either be done using dynamic macroprudential requirements or D-SIB buffers to allow for proportional application. This would bring SA into line with Basel standards and remove an existing distortion in the SA market in which the Pillar 2A requirement is imposed on all banks, whereas in most other jurisdictions this capital element is instead applied more narrowly as a D-SIB buffer.

3. Introduce a separate Pillar 2 component to reflect PA's view on additional add-ons arising from stress tests or other forward-looking risk considerations. This could be a Pillar 2C or replacement for 2A. This would further support transparency and Pillar 3 objectives.
4. Update the definition of the small business exposure threshold to qualify as retail exposures to R17m from R12.5m, more closely aligning with the €1m Basel threshold.
5. Consider calibrating the large exposure framework for smaller banks. One option would be to allow higher exposures for smaller banks to DSIBs which can absorb balance sheet risk on behalf of small banks, thus allowing them to service larger clients (as we were finalising this report, the Prudential Authority published D3 2022 which was not specifically considered in this study).
6. We also recommend that smaller banks be given leeway on liquidity requirements in line with international precedent. One possibility is that banks below a certain threshold of capital that meet the LCR should be exempt from meeting the NSFR.

Supervisory practice recommendations

As we discuss in this report, supervisory practices are invasive and resource intensive, both for banks and supervisors. These requirements can be disproportionate for small banks which must often maintain a fixed cost infrastructure to deliver the same reporting capacity as large banks. The literature reviewed in this report considers addressing this disproportionate impact either by reducing the frequency of reports for certain categories of reports or reducing the complexity of reports that are submitted. While the banks we studied report that complexity is a problem, particularly for smaller banks, there is not a clear view that frequency of reports is disproportionate. Banks also see ad hoc requests and tight deadlines as being a high cost driver. These findings suggest that focus should be directed to simplifying reporting requirements particularly for smaller banks, and greater discernment in ad hoc requests, particularly in focusing requests on relevant banks, depending on the request.

Consideration should be given to exempting smaller banks from RDARR requirements as well as removing certain lines from standardised returns where such banks have only small incidental exposures, which would allow them to remove the corresponding tracking and reporting infrastructure. Our research suggests that these have a disproportionate impact on smaller banks relative to the benefit and that requiring disclosure of certain exposures in returns forces banks to implement monitoring systems, despite these usually being left blank.

Supervisory practices include vetting the acquisition of a subsidiary by a bank (section 52 applications). Thought should be given to calibrating these processes where risks are low, for example when a subsidiary being acquired represents a small fraction of assets of the bank, or operates in a low-risk business area. Applications can be cause delays for a transaction leading to higher chances of transaction failure with no public benefit in the case of small acquisitions in low-risk business areas.

Conduct recommendations

Conduct regulation is undergoing considerable development in South Africa in terms of the COFI Bill. Proportionality considerations are well entrenched in this approach, but implementation of new reporting and supervision requirements will have to pay ongoing attention to the proportional impact of conduct supervision. As reporting requirements are developed, consideration should be given to harmonised information gathering with other regulators, particularly the PA, to ensure duplication of reporting requirements is minimised.

Integrity recommendations

KYC and FICA supervision stand out in the views of banks we surveyed as having a disproportional impact relative to the benefits. AML reviews undertaken by the PA are seen as highly resource intensive to the detriment of institutions' ability to undertake routine surveillance of client activity. FICA requirements conflict with principles of financial inclusion by restricting banks' ability to engage with clients who cannot easily produce documents verifying residence or identity.

We recommend that the PA, alongside relevant regulators and policymakers:

- Work to establish clearer guidance on risk-based approaches to different client groups that can be easily systematised in banks' client onboarding and monitoring processes, removing ambiguity that currently forces banks to take the most conservative approach; and
- Finalise a risk-based approach to financial institutions, specifying activities that would qualify institutions for less intrusive supervision and AML reviews, in line with FATF guidance.

A wider programme is under way to take on board the recommendations of the FATF mutual evaluation report (FATF, 2021) that would potentially resolve some of the proportionality concerns raised in our research, particularly that the costs of FICA supervision outweigh the benefits while information does not lead or support prosecutions and convictions for criminal activity.

Market structure recommendations

The recommendations made above would assist in improving the proportionality of supervision as it applies to South Africa's existing framework. However, as the research in this report makes clear, there is a deeper structural feature of the market, shared with many other jurisdictions, that has increasingly conflicted with the principle of proportionality in banking regulation. This has emerged as Basel standards have evolved since the global financial crisis (GFC), which has substantially reduced the discretion that regulators had been free to apply to registered banks before the GFC, one consequence of which was flexibility to apply proportionality in practice. Basel rules have come to bear, often not intentionally, on all registered banks, irrespective of their size or complexity. Ultimately, we do not believe that proportionality can properly be practised, particularly in prudential regulation, without deeper change in the industry by introducing a second tier bank licence with reduced prudential requirements.

South Africa does have a broadly proportional structure in the three main types of banks allowed by legislation: cooperative banks, mutual banks and banks registered under the Banks Act. However, there is a large gulf between mutual banks and Banks Act banks in several respects, most obviously minimum capitalisation, with mutual banks at R10m and Banks Act banks at R250m. There have been recent new entrants to the market that have used the Mutual Banks Act licence rather than the Banks Act, some of which do not exhibit the mutualistic features one would expect (for example Bank Zero and Finbond Bank). For such banks the mutual features of the regime are an incidental inconvenience rather being than closely aligned to the ownership and funding strategy of the bank. The mutual bank licence has become a *de facto* simplified regulatory and supervision instrument rather than the *de jura* feature that the bank has members who are also funders.

While the structure of the South African industry was not a principal objective of the study presented in this report, it has nevertheless become clear to us that much of the proportionality issues that arise are directly linked to the structure imposed by underlying legislation. It is also clear from our study of international comparisons that major jurisdictions are introducing a tiered structure for their banking systems by creating a different regulatory regime for non-systemic banks (e.g. UK, Canada, Australia and Switzerland). Given that all Banks Act banks must be subject to the same basic regulations and supervision, there is limited scope for appropriate proportionality considerations to be made. Banks are effectively treated as universal banks and regulated accordingly, even if their activities are narrow and of low risk. There is limited scope for a graduated structure with supervisory requirements calibrated to the risk of institutions in each gradation, beyond the awkward function that the Mutual Banks Act and the Cooperative Banks Act play in this regard. These acts envisage institutions based on a common bond and are typically at the smallest end of the scale (not always true in other jurisdictions).

This problem is certainly not uniquely South African and sits at the core of many of the debates about proportionality internationally. The Banks Act is 31 years old and until the introduction of the Basel Capital

Accord and Basel 3 in particular, regulators had greater discretion in the supervisory approaches they applied. However, since Basel 3, many jurisdictions have come to the view that problems have arisen in its universal application to banks under their supervision. Basel 3, as we have noted in this report, was designed for internationally active banks such as G-SIBs. It has since become the international standard for D-SIBs too. However, there has been no simple way to segment banks that are registered in terms of the same legislation and regulations so as to selectively apply Basel standards and supervisory practices to non-D-SIBs.

These considerations suggest that South Africa should follow the lead of the UK and Switzerland in considering a new regime to apply specifically to a tier 2 group of banks that are lower risk than larger, more complex banks. This would not be a new discussion necessarily – the topic of a separate regime for "narrow banks" was first tabled in 2002 and the Dedicated Banks Bill was tabled in 2004. This envisaged an enabling environment for savings and savings & loan banks in order to improve financial inclusion (National Treasury, 2004). The bill, however, did not progress, although there have been several reports subsequently that it would again be tabled, e.g. Fin24 (2010). In 2008 it was suggested that the bill would be replaced by a set of amendments to the Banks Act (CGAP, 2008), although this was not ultimately delivered either. In part, delays were blamed on the changing environment, particularly following the global financial crisis which led jurisdictions worldwide to reconsider banking legislation and regulation. The original bill was intended to be promulgated at the same time as the Cooperative Banks Act and provide for reduced minimum capital requirements and separate regulations for banks registered under the main Banks Act, for banks restricted in activities to savings, transaction and payments services, and secured loans.

The objectives in the current environment, however, would have shifted from the motivations for the original Dedicated Banks Bill which pre-dated Basel 3 as well as much of the conduct and integrity regulations that banks are now subject to. A tier 2 banks regime would be able to be tailored specifically to manage the proportionality issues that now arise.

The UK and Swiss approaches discussed in this report focused on providing simplified or streamlined application of regulation to qualifying tier 2 banks and not only a reduced minimum capital requirement. The literature considers a categorisation approach (CAP) and specific standard approach (SSAP) to differentiate between different tiers of banks. The first categorises institutions separately by their risk while the second focuses on activities and risks at individual institutions. The UK regime also specifically considers the needs of new entrants that are scaling up versus long-established banks, and the specific needs of digital banks with no branch infrastructure. A tier 2 regime in South Africa could similarly allow for a gradual ramp up of regulatory requirements for new entrants and differentiated frameworks for banks that operate a digital-only model. Such a regime has the potential to enhance efficiencies while improving overall public benefit of regulation by supporting enhanced competition, inclusion and innovation in the sector.

We recommend that such a regime be considered for South Africa. The specific details for graduation of institutions and different requirements can be developed drawing on international precedent.

3. Introduction

Since the global financial crisis (GFC) of 2007-2009 there has been an international overhaul of bank regulation, largely to improve the safety and soundness of financial systems. South Africa has played an important role in international developments as a member of the Financial Stability Board (FSB) and the Bank of International Settlements (BIS), including its Basel Committee on Banking Supervision (BCBS). Its domestic policy environment has been strongly influenced by international developments. As we outline in this report, various regulations reflect best practice.

Internationally, a debate has been evolving regarding the proportionality of regulation. While there is little debate that the overall riskiness of the financial system has improved, a view confirmed by the relative ease with which it managed the Covid-19 pandemic, questions are being asked about whether regulation is appropriate to the costs and benefits that arise. Much of the response to the GFC has been designed with globally systemically important banks (G-SIBs) in mind because they were the main drivers of the crisis, but non-systemic banks have also often been included in the renewed regulatory ambit. The Basel 3 Capital Accord provides the international standard for regulation of G-SIBs, but many countries have adopted the framework for all banks, occasionally using national discretion to adjust certain requirements.

The Bank of International Settlements recently reviewed proportionality practices across 100 jurisdictions. It found that "the lack of global prudential standards for non-internationally active banks has led national authorities to implement a range of proportionality approaches" (BIS, 2018). Those proportionality approaches are still evolving. For example, in April this year the Bank of England's Prudential Regulation Authority published a discussion paper *A strong and simple prudential framework for non-systemic banks and building societies* (BoE Prudential Regulatory Authority, 2021) with a view to developing a more nuanced proportionality approach there. A joint study by the World Bank and Basel Committee recently found that "the use of proportionality is growing" with two thirds of respondents surveyed saying they were planning to implement or revise their proportionate approaches (World Bank and BIS, 2021).

These questions have been most asked in the context of small banks. While these can be risky and the costs of their failure substantial, regulation that is designed for G-SIBs could be disproportionate for smaller banks. The notion of proportionality that informs these debates considers costs to banks, regulators and the public, relative to the benefits.

Proportionality is a principle well accepted in both international regulation and domestic policy. While the concept of proportionality can be defined in different ways (see sidebar), generally regulation should be proportional to the benefit it provides. This is usually interpreted as a risk-based approach, with regulatory resources and cost impact on banks scaled to the risk profile of the institution. Large, complex institutions generally represent higher risk than small, simple institutions.

What is proportionality?

The Basel Committee on Bank Supervision (BCBS) (BCBS, 2019) defines proportionality as setting regulatory and supervisory standards for banks that are commensurate with their risks, in achieving objectives such as institutional and systemic safety and soundness. For regulatory and supervisory purposes, a bank's risk profile encompasses the bank's size, systemic importance, complexity, business model, cross-border activity and the risks to which it is exposed.

The European Central Bank's (ECB's) view on proportionality is similar. According to the ECB (Hakkarainen, 2019), proportionality in banking supervision is adjusting the form and intensity of supervision to the specifics of the bank – its risk profile, business model and size. However, this should be guided by the objectives of banking supervision and should not compromise prudential soundness, financial stability and market integrity but create or maintain level competitive playing fields.

These definitions imply that proportionality is not necessarily a reduction in prudential standards or requirements for small banks. Rather, the aim is to avoid excessive compliance costs and regulatory burdens for smaller, less risky and non-complex banks that may disproportionately reduce these banks' competitiveness without prudential justification.

While the debate has focused on prudential regulation, particularly that underpinned by the Basel 3 Capital Accord, it has also extended into other domains. As part of the general overhaul of regulation, many jurisdictions also considered conduct regulation post the GFC. This was because certain elements of that crisis involved mis-selling of financial products and because the restructuring of supervision often involved separating dedicated prudential regulators from what had been conduct and prudential regulators combined. This is certainly the case in South Africa, as we outline below. Additionally, as part of the response to international terrorism and transnational crime, integrity regulation has also been a key feature of reforms in the past two decades. Conduct and integrity regulation therefore provide two more aspects to the regulatory reforms that have been fundamental in the reshaping of global financial regulation.

Regulation in South Africa

Proportionality is well-embedded in the financial regulatory architecture of South Africa. The foundation for the post-GFC regulatory overhaul of South Africa's financial system has been National Treasury's policy document, *A safer financial sector to serve South Africa better* (National Treasury, 2013). This set out a new regulatory framework for South Africa with four policy objectives:

1. Financial stability, being the safety and soundness of both the financial system (macro-prudential) and financial institutions (micro-prudential),
2. Consumer protection and market conduct,
3. Expanding access through financial inclusion for both individuals and small business, and
4. Combating financial crime.

The policy document is guided by 15 principles. Relevant to the issue of proportionality, principle 2 stipulates that regulation and supervision should be risk-based where appropriate and proportional to the nature, scale and complexity of risks present in a regulated financial institution and the system as a whole. This clearly reflects that proportionality is central to the regulatory approach in South Africa.

Furthermore, principle 15 states that South Africa has committed itself to international best-practice and will adopt standards for banking, insurance and securities market such as Basel 3 and standards set by the International Association of Industry Supervisors (IAIS) and International Organisation of Securities Commissions (IOSCO).

The document laid the foundation for the "twin peaks" regulatory architecture later enabled by the Financial Sector Regulation Act, with the SA Reserve Bank hosting the Prudential Authority (PA) while conduct regulation is invested in the Financial Sector Conduct Authority (FSCA).

A recently published Financial Sector Assessment Program report by the International Monetary Fund noted that transaction costs in South Africa remained relatively high although there seems to have been increased banking sector competition particularly via digital banks (IMF, 2022). The FSAP noted that cooperatives and mutual banks are one way of promoting competition and contestation in the sector enabled by the proportionate legal and regulatory frameworks but noted that the impact of this on competition is "still to be determined".

Microprudential regulation

Microprudential regulation focuses on risks at individual institutions and is undertaken by the PA. The Financial Sector Regulation Act requires that in performing its functions, the PA must be "pre-emptive, outcomes focused and implement a risk-based approach" (PA, 2021). The PA's supervisory approach is in terms of the FSR Act and various industry-specific sector laws such as the Banks Act. The PA is committed to continuously improving its supervisory practices. It models its frameworks on applicable internationally recognised principles for the regulation and supervision of financial institutions including principles set by standard-setting bodies such as the Basel Committee, International Organisation of Securities Commissions (IOSCO) and the Committee on Payments and Market Infrastructures.

Macroprudential regulation

The SARB is host of the Financial Stability Department which oversees macroprudential regulation. Macroprudential instruments target sources of systemic risk and are designed to control factors such as leverage, liquidity, system interconnectedness or maturity mismatches (SARB, 2016). It is independent of the PA so as to ensure that its systemic risk focus is distinct from the PA's institution-level focus, but its set of instruments often overlap with microprudential instruments including capital buffers, loan-to-value restrictions and liquidity requirements. These are determined with reference to overall systemic stability rather than institution-level stability, so macroprudential regulation is relatively blind to proportionality considerations between institutions. Macroprudential regulation can include industry wide instruments like countercyclical capital buffers, and dynamic provisions which could be applied at institution-level should such institutions be deemed to be inadequately capitalised against the systemic risks they contribute to. This, however, is responsive to the specific risks the bank takes, rather than the proportional contribution of the bank to those risks. For example, the macroprudential regulator may require capital buffers if it detects a bubble in commercial property lending. The relevant feature of institutions on whether they should hold additional capital would be their exposure to that sector, rather than the size or complexity of the institution itself.

Bank resolution

The Reserve Bank's Resolution Department is the third plank of regulatory supervision overseen by SARB but this role is still being developed. South Africa's intended approach to bank resolution was set out in a 2019 discussion paper (SARB, 2019). The resolution approach will include a deposit insurance scheme and the use of loss-absorbing capital that can be "bailed-in" in the event of bank distress. The 2019 paper states: "Resolution planning will be conducted proportional to the systemic importance of individual designated institutions" and envisages that banks designated as systemically important financial institutions (SIFIs) will be subject to more detailed resolution requirements. Smaller banks can be wound up or sold with relative ease and so would be subject to a lighter resolution requirement. Deposit insurance also has proportionality effects in that it can support smaller banks to overcome depositor risk aversion, depending on how premiums for the scheme are set.

National payments system

The NPS is operated and supervised by the Reserve Bank. It has limited proportionality built into its structure, other than that required collateral posted by member banks be proportional to risks posed. However the NPS is currently undergoing review, an overarching principal for which is that the regulatory, supervisory and oversight frameworks should be risk-based and proportional (SARB, 2018).

The development trajectory is guided by the Reserve Bank's Vision 2025 (SARB, 2018) document which sets out how the system can promote competition and ensure an enabling regulatory framework. Vision 2025 highlights that a level playing field can be achieved through fair application of regulation to all participants offering similar services. This will not only have proportional outcomes for the participants but will also boost competition and innovation. In developing an enabling and appropriate regulatory regime, the expected outcome is for qualified participants (both banks and non-banks) to be able to provide products and services across the value chain.

Integrity regulation

In line with international commitments, South Africa has embraced anti-money laundering (AML) and combating the financing of terrorism (CFT) global standards set by the Financial Action Task Force (FATF). To implement FATF's guidance on risk-based supervision in South Africa, the Financial Intelligence Centre (FIC) Amendment Act was tabled in 2017. The FIC Amendment Act incorporates a risk-based approach to the South African AML regulatory framework and to compliance elements such as customer due diligence (or know your customer, KYC).

The PA is a supervisory body for banks and is thus responsible for the AML/CFT supervision of banks as accountable institutions. The PA applies a risk-based supervisory framework to identify, assess and understand money laundering and terrorist financing risks in the banking sector. The application of the risk-based approach to AML/CFT supervision means the PA changes the intensity and frequency of its supervisory interactions depending on the ML/TF risk profile of an accountable institution (FIC, 2017). Since 2014, the PA has imposed 25 administrative sanctions on banks ranging from a fine of R75m to a caution not to repeat the conduct which led to non-compliance (SARB, 2021).

Conduct regulation

Conduct regulation has been invested in the FSCA but is still being developed through the Conduct of Financial Institutions Bill (COFI). The fifth principle of South Africa's market conduct framework (National Treasury, 2014) requires that regulatory requirements be proportional to the risk of poor consumer protection outcomes. FSCA in its 2021-2025 strategy (FSCA, 2021) committed to explicitly providing for proportionality in the legislative framework. Proportionality will be applied to its activity-based licensing model to ensure that the licensing approach and requirements are not "one-size-fits-all" but proportionate to the risks underlying the business activities of different applicants, ie, licensing requirements should not pose an unnecessary barrier to entry into the financial services sector. COFI requires licensed financial institutions to have governance arrangements proportionate to the nature, size, scale and complexity of its conduct risks or business model and activities performed by the bank. The Bill also emphasises proportionality in consequential changes to the Financial Sector Regulation Act.

Understanding the public benefits

Inherent in the concept of proportionality is a notion of the public good that is being served. Regulation and supervision are proportional if the public benefit that arises from that supervision exceeds its cost. However, the value of the public benefit that arises from a safe and stable financial system is difficult to determine. Financial crises are expensive. The GFC has been estimated to have cost every American $70,000 in lifetime lost income (Regis Barnichon, 2018). Although South Africa did not have any bank failures during the GFC, it has experienced its own banking crises including the small banks crisis (1998-2001), the upward contagion from the collapse of Saambou in 2003, and collapses like that of African Bank (2014) and, most recently, VBS Mutual Bank (2018). All told, since 1990 there have been 31 bank failures, including banks that gave up their licences (Havemann, 2019)[1]. In some cases, these have led to direct costs to the fiscus and the tax payer, for example, the resolution of Saambou involved a state guarantee that had to be called at a cost to the fiscus of almost R4bn.

Examples of failure are, of course, not evidence of unsuccessful supervision or regulation. It is the absence of costly failure or systemic instability that marks success, but reasoning about counterfactuals is problematic given that there are no control experiments. The fact that there were no failures of South African banks in the GFC might have been a sign of success of proactive countercyclical regulation (Havemann, 2019). Similarly, the introduction of macroprudential policies after the GFC may have assisted in facing the Covid-19 pandemic when several capital and liquidity buffers were released to allow banks greater flexibility to respond to the crisis, including in South Africa (Benediktsdottir, et al., 2020). Edwards (2021) argues these had an important effect in managing the impact of the crisis on the financial systems of emerging markets, while Sam Woods, CEO of the UK's Prudential Regulation Authority, says that the Covid crisis provides clear evidence that post-GFC reforms enabled the banking system to support the economy through the crisis. "You only have to ask yourself the question, 'How would the financial system have fared if Covid had hit in 2007?' to appreciate this point" (Wood, 2020).

Macroprudential regulation must be complemented by microprudential as systemic crises can be triggered by an individual institutional failure. Bank failure itself is not the cost the public should aim to avoid – indeed, failure is inherent to the functioning of the market system and banks that are not competitive or able to build sustainable business models should exit. Successful regulation will allow weak banks to exit without inflicting high costs on the system or the public. What must be managed is the costs of failure to the public, both through direct impact on the fiscus and through attendant costs into the rest of the financial system and the economy. The probability of failure cannot and should not be reduced to zero, but the cost of failure should be reduced as far as possible. Regulation is also important in maintaining soundness of the system by preventing excessive risk taking and maintaining confidence. Several well-controlled studies show

[1] uBank was placed into curatorship as this report was being finalised, bringing the total to 32.

that reduced supervision tends to lead banks to accumulate riskier assets and for insolvent banks to remain in operation for longer (e.g. Kandrac & Schlusche (2021) and Ongena, et al. (2012)).

Successful supervision must include microprudential and macroprudential supervision to ensure the system functions well, but also resolution supervision to ensure the costs of failure are low. The overall public benefit, then, is a safe and sound financial system (which is itself a valuable benefit) that manages institutional failure with minimal cost to the public. Of course, regulation comes at a cost too, and the question of proportionality is, in part, one of weighing up these costs vs the benefits. High costs of regulation may serve as a barrier for entry of new banks or limit the agility of existing banks, leading to less competitiveness and innovation. As we discuss in the next section, though, our key focus in this study is proportionality of the impact at institution level, rather than the overall cost vs benefit of regulation.

Key questions of the study

As this brief introduction makes clear, proportionality is well established in South African regulation across prudential, conduct and integrity domains. The question of concern is whether these principles and regulations are fully reflected in practice. In the chapters that follow we consider in some detail how proportionality is applied in each of these three domains. In considering whether proportionality is appropriately incorporated into practice, the focus must be on the ultimate public benefit. If regulation is overly complex and expensive for smaller and less complex banks, it limits competition in the market, creating harms that may be larger than the benefits in terms of greater resilience of institutions and of the wider the financial system.

In a sense, South Africa's banking system already has a clear categorisation of banks through the different primary legislative instruments under which they function. Cooperative banks are established in terms of the Cooperative Banks Act (2007) and Mutual Banks under the Mutual Banks Act (1993), while mainstream banks register under the Banks Act (1990). This legislation creates broad categories that do represent sharp differences in risk and complexity and therefore in regulation. Cooperative Banks have very limited business models and light compliance requirements and Mutual Banks relatively low capital requirements (minimum capital requirement of R10m) and are subject to Basel 1 and some locally developed add-ons (see Table 1). Banks Act-registered banks require minimum capital of R250m and to comply fully with Basel 3. There is therefore a gulf in requirements between Mutual Banks and Banks Act-registered banks. One of the questions raised by this study is whether this gulf should be narrowed with further categorisation within the set of Banks Act-registered banks. There are different ways that categorisation can be undertaken, and difference consequences in terms of compliance requirements. This question is central to the global debate on proportionality.

Table 1: Proportionality built into South Africa's banking legislative framework

Legislation	Categories of bank	Capital requirements
Banks Act	D-SIBs	R250m minimum Basel 3 D-SIB add-on Pillar 2A add-on
	Non-DSIBs	R250m minimum Basel 3 Pillar 2A add-on
Mutual Banks Act	"Non-mutual" banks	R10m minimum Non-Basel 3 Basel 1 and locally developed
	Mutual banks	R10m minimum Non-Basel 3 Basel 1 and locally developed
Co-operative Banks Act	Co-operative banks. Co-operative financial institutions	Non-Basel 3 Locally developed prudential standards (July 2021 draft)

Proportionality is also a consideration when assessing the overall impact of regulation on the banking industry, rather than the relative impact on different banks, to assess whether, overall, regulation is proportional relative to the benefits that the public receive. However, the focus of this study is on proportionality in the differentiated treatment of institutions, rather than holistic proportionality, so we do not consider this issue further in this study. Our key question therefore is whether there is an appropriate allocation of costs between banks relative to the contribution each bank makes to macro risks and the risk of default, i.e. is regulation and supervision appropriately risk-weighted for institutions.

Methodology

This study was undertaken with a mixed methodology that included a literature review, desktop data analysis, a questionnaire process with banks and interviews with banks and regulators.

The literature review assessed global research and commentary on proportionality in prudential, conduct and integrity regulation, as well as domestic policy papers, legislation and regulation.

A comprehensive questionnaire to assess regulatory impact and proportionality opinions was completed by the 13 banks that are Banks Act-registered and South African-controlled. Follow-up interviews were then conducted with these banks to interrogate the information provided. These interviews were usually with groups of executives, which in some cases included senior leadership of the banks and in other cases with compliance teams. We used the interviews to validate the information provided in the questionnaires by assessing whether banks were consistent in how they interpreted the questions and the basis for the answers they gave, and to understand the feedback they provided on various aspects of proportionality. This process led to the qualitative and some of the quantitative data that we cite in this report. In some cases, we qualify the reliability of data where we determined through interviews that an inconsistent basis or some other factor meant the information banks provided was not comparable.

We also conducted interviews with key regulators including the PA and the FSCA. We interviewed the SARB's Financial Stability and Bank Resolution departments and conducted a written question and answer process with the PA.

Data analysis includes analysis of data provided in the bank's questionnaires, BA900 statutory returns, Basel 3 disclosures and bank financial results.

4. Prudential regulation

Prudential regulation is split between microprudential, being the regulation of risks at individual institution level, and macroprudential, being the management of risk across the financial system. The overall prudential framework also includes bank resolution, which is a separate competency focused on managing the resolution of distressed institutions. These have been the focus of regulatory development since the GFC. Global development has been driven by the BCBS predominantly through the Basel 3 Capital Accord. In this section we assess proportionality issues that arise in macro- and microprudential regulation and supervision.

Microprudential regulation

Background: development of Basel

Until 1988, the requirements governing regulatory capital were country specific. In the mid-1980s it became apparent that international convergence of regulatory capital standards was appropriate given the increasingly global activities of many banks and the need to level regulatory playing fields and ensure global systemic stability (BCBS, 2021).

This led to the Basel Capital Accord (referred to as Basel I) in 1988, followed by the Basel 2 Framework in 2006 and Basel 3 in 2010. The scope of application of the Basel capital framework is internationally active banks on a consolidated basis.

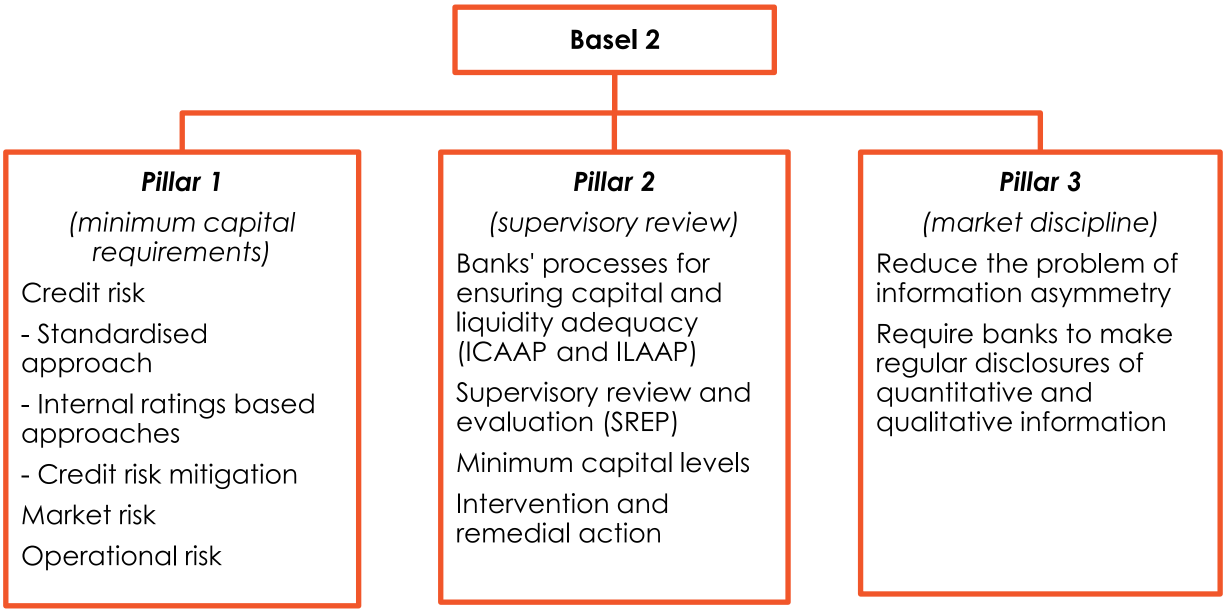
The Basel I capital framework set out minimum regulatory capital requirements made up of three components:

- Definition of regulatory capital:
    - Tier 1 capital primarily comprises equity and disclosed reserves and has the highest capacity to absorb losses,
    - Tier 2 capital comprises a mix of capital elements that have some ability to absorb losses,
    - Tier 3 capital (short-term subordinated debt) was introduced by the 1996 amendment to Basel I to meet part of the capital requirements for banks' market risks. Tier 3 capital is no longer recognised under Basel III.
- Risk-weighted assets: all credit risk exposures, including off-balance sheet items converted into on-balance sheet equivalents, are risk-weighted using weights based on the degree of risk.
- Minimum capital adequacy ratios:
    - Total regulatory capital divided by the risk-weighted assets must be at least 8%,
    - Tier 1 capital divided by risk-weighted assets must be at least 4%.

Basel I was a "one size fits all" with limited scope for proportionality.

In 2004, Basel 2 was introduced with its three pillars approach shown in Figure 1. Basel 2 was a development over Basel 1 in that it is significantly more risk sensitive. The standard aimed to align capital levels with the riskiness of the bank, however by 2008 it was still to be implemented in several major economies. Basel II was the starting point for Basel 3 developed in response to the GFC.

Figure 1: Basel II's three pillars



Pillar 2 is principles-based and bank-specific so there is no "one size fits all". Thus, a range of practices is possible across jurisdictions – from strong supervisor leadership to full reliance on banks' internal methods and processes.

Pillar 3 imposes disclosure requirements on all banks without distinction. Under Pillar 3, banks are all required to report key Basel 3 information including risk-weighted assets, liquidity and leverage ratios and compliance with Pillar 1 minimum capital levels.

Basel 3 attempts to address the weaknesses revealed by the financial crisis and enhances Basel 1 and Basel 2, including strengthening of the definition of qualifying regulatory capital, improving risk coverage and introducing a leverage ratio. Basel 3 also introduced liquidity prudential requirements – the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). The LCR attempts to ensure banks hold enough high-quality liquid assets (HQLAs) to survive a period of major liquidity stress lasting 30 calendar days. The NSFR aims to reduce banks' funding risk over the longer term by creating incentives for them to fund their activities with more stable funding sources.

The Basel Framework was last fully updated in December 2019 and is maintained on the Bank for International Settlement's website but includes several changes that will come into effect in 2023 (and a few in 2028). The framework includes 14 different standards that are broken down into 117 chapters. These are extensive and detailed, providing clear guidance to banks on the specific application of capital calculations and liquidity requirements, but are founded on a set of core principles that ultimately have sway in interpretations.

A degree of proportionality is embedded in the Basel capital framework. The risk-weighted capital requirements of Basel II and III provide a range of standardised and internal model-based approaches for calculating regulatory capital requirements. The framework also requires higher capital requirements from systemically important banks: both G-SIBs and D-SIBs. Various components also allow for country-level discretion to be applied.

Application of Basel 3 in South Africa

In June 2015, the results of South Africa's Regulatory Consistency Assessment Programme, undertaken by regulatory specialists from other BCBS member countries, were published. It addressed the local implementation of Basel 3 and Basel LCR standards (BCBS, 2015). South Africa was found to be compliant with both standards. The reports also indicated the areas where SARB requirements are stricter than Basel minimum standards including:

- The Basel framework is applied to every bank and bank controlling company whereas the Basel framework requires it be applied on a consolidated basis only to internationally active banks. In principle, South Africa could opt not to apply Basel 3 to all banks that are not internationally active.
- The PA's minimum capital levels for Pillar 1 are higher at all levels compared to Basel 3 (see Table 2 below). Excluding capital conservation, countercyclical and D-SIB buffers by 2022 common equity tier 1 (CET1) is 5% (Basel minimum 4.5%), additional Tier 1 (AT1) is 6.75% (Basel minimum 6%) and total capital is 9% (Basel minimum 8%).
- No dividends may be declared out of CET1, which means banks may have retained earnings excluded in CET1.
- CET1 point of non-viability trigger is 5.875% (Basel minimum 5.125%).
- Credit risk (standardised approach) – A €1m threshold was converted to R7.5 (relevant, in respect of the definition of SMEs that can be included in retail portfolios, among others, which attract less capital). The threshold was subsequently lifted to R12.5m in 2016 (SARB, 2016).

South Africa's next Regulatory Consistency Assessment Programme began in March 2021 and is underway at the time of writing.

Some relaxations were made to capital buffers at the start of the Covid-19 pandemic in 2020, but these and other capital buffers will be fully implemented by 2022 (SARB, 2021). Table 2 shows the capital buffers in place, including those that were adjusted in response to the Covid-19 crisis in April 2020. Those levels that are higher than Basel 3 requirements are shown in bold.

Table 2: Capital buffers in force in South Africa

		South African implementation		
	Basel 3	2019	6 April 2020	2022
Common Equity Tier 1 requirements (CET1)				
Minimum CET1 Ratio (per Basel 3)	4.5%	4.5%	4.5%	4.5%
Pillar 2A for CET1		0.5%	0.0%	0.5%
Minimum CET1 plus Pillar 2A		**5.0%**	4.5%	**5.0%**
Phasing in of D-SIB requirements at CET1 level[1]		100.0%	100.0%	100.0%
Capital Conservation Buffer[2]	2.5%	2.5%	2.5%	2.5%
Countercyclical buffer (maximum %, if imposed) [2]	2.5%	2.5%	2.5%	2.5%
Tier 1 requirements (T1)				
Minimum Tier 1 Ratio (per Basel 3)	6.0%	6.0%	6.0%	6.0%
Pillar 2A for T1		0.75%	0.00%	0.75%
Minimum T1 plus Pillar 2A		**6.75%**	6.00%	**6.75%**
Phasing in of D-SIB requirements at Tier 1 level[1]		100.0%	100.0%	100.0%
Total capital requirements				
Minimum Total Capital Ratio (per Basel 3)	8.0%	8.0%	8.0%	8.0%
Pillar 2A for Total Capital (maximum 2.0%)		1.0%	0.0%	1.0%
Minimum Total Capital plus Pillar 2A		**9.0%**	8.0%	**9.0%**
Phasing in of specified D-SIB charge at Total Capital level[1]		100.0%	100.0%	100.0%

[1] The aggregate requirement for Pillar 2A and D-SIB will not exceed 2.0% for CET1, 2.5% for Tier 1 and 3.5% in respect of the capital adequacy ratio.
[2] The capital conservation buffer together with the countercyclical buffer will be applied at CET1 level and will also be required to be met at both a Tier 1 and total capital level.

Excluding capital conservation, countercyclical and D-SIB buffers, by 2022 common equity tier 1 (CET1) is 5% (Basel minimum 4.5%), additional Tier 1 (AT1) is 6.75% (Basel minimum 6%) and total capital is 9% (Basel minimum 8%). A number of jurisdictions, for example Australia and India, have implemented capital levels higher than Basel 3 minimum levels. However, the PA points out that it could be argued (correspondence) that there is no net difference between Basel requirements and South Africa's Pillar 1 capital requirements because its D-SIB buffers are reduced from Basel's 3.5% to 2.5%. However, the Basel buffer applies to G-SIBs that are assessed to be at the highest of five levels of risk and currently there are no banks in this bucket. The most populated G-SIB bucket has a buffer of 2.5%. Given that in South Africa most banks are not DSIBs, the higher Pillar 2A requirement is a material margin of additional capital over Basel minimum levels. This is a shift in the proportional allocation of capital requirements to non-D-SIBs relative to Basel standards.

Eligible capital

Definitions of eligible capital can be another material factor in capital costs. While the Basel 1 capital categories of CET1, AT1 and Tier 2 listed above provide the basis for definitions, there can be "regulatory adjustments" to this capital which have evolved and a level of country discretion applies in some respects, although this has been narrowed over time. For example, goodwill is always excluded from capital calculations but significant investments in unconsolidated financial institutions can be included only to a cap of 10%, with the definition of "financial institution" determined by national regulation (BCPS, 2019). This can have material effects in the case of conglomerates that hold financial services subsidiaries which could form a substantial part of the balance sheet of the conglomerate. While the PA does apply specialist regulation to conglomerates in line with international principles, we did not further investigate the national treatment of the capital eligibility of financial services subsidiaries. National authorities can also make exemptions, for example, exposure to other financial institutions can be included in capital without caps temporarily if such exposure arises from resolving a distressed institution.

Determination of risk-weighted assets

All capital requirements are specified as a percentage of risk-weighted assets (RWA). The method of calculation of RWA, and definitions of assets, are therefore material factors in determining the resulting quantum of regulatory capital a bank must hold. There are various methods that can be used, which broadly divide between standardised and internally modelled estimates. These can be applied in any of the three main categories of credit risk, operational risk and market risk, of which the most material for most banks is credit risk.

The standardised credit risk approach uses weights derived from globally agreed measures of their perceived riskiness. For example, central government own-currency paper is weighted 0% while high-risk assets such as sub-investment grade corporate paper is weighted 150%. Definitions can have a material impact. For example, small business loans can be included as retail exposures provided that the total exposure of the banking group to the small business is less than €1m (BCPS, 2019). In the South African context, this threshold was converted to R7.5m and subsequently lifted to R12.5m in 2016 (SARB, 2016). Those treated as retail exposures have a risk-weighting of 75% whereas unrated corporate exposures are risk-weighted at 100%. Given that, at the time of writing, the €1m Basel threshold was equivalent to R17.8m, the current SARB definition of small business exposures is more onerous in terms of capital requirements than the Basel requirement. In our engagement with banks, several smaller banks cited this restriction on small business exposures as a driver of higher capital costs for them.

Internal ratings-based (IRB) approaches involve determining various components of risk internally, subject to supervisory review. The components include:

- probability of default (PD),
- loss given default (LGD),
- exposure at default (EAD), and
- effective maturity (EM).

Compared with the standardised approach, IRB approaches are far more resource-intensive given the systems requirements to determine risk components across portfolios. IRB approaches therefore tend to be more common in larger banks. Supervisors also tend to only allow IRB approaches for larger banks given the resource intensive nature of supervising IRBs. Because they allow for fine-grained risk assessment at the asset level, they should be a more accurate measure of risk.

Banks' internal estimates can be mixed with supervisory estimates where supervisors determine it to be preferable. Under the foundation IRB approach, banks generally provide their own estimate of PD and rely on supervisory estimates for other components. Under the advanced IRB approach, banks also provide estimates for the other risk components internally. Once a bank adopts an internal approach for part of its holdings, it is expected to adopt it across its group and should only reverse to a standardised approach under exceptional circumstances such as the disposal of most of its business (BCPS, 2019). However, Basel recognises it may not be feasible for all banks and accepts a rollout must be agreed with regulators. In practice, in South Africa only the five largest banks use internal approaches on any of the risk categories, and none do so exclusively but use a combination of standardised and internal ratings approaches including, in most cases, for credit risk. The rest of the 13 banks we studied use standardised approaches for all risk categories.

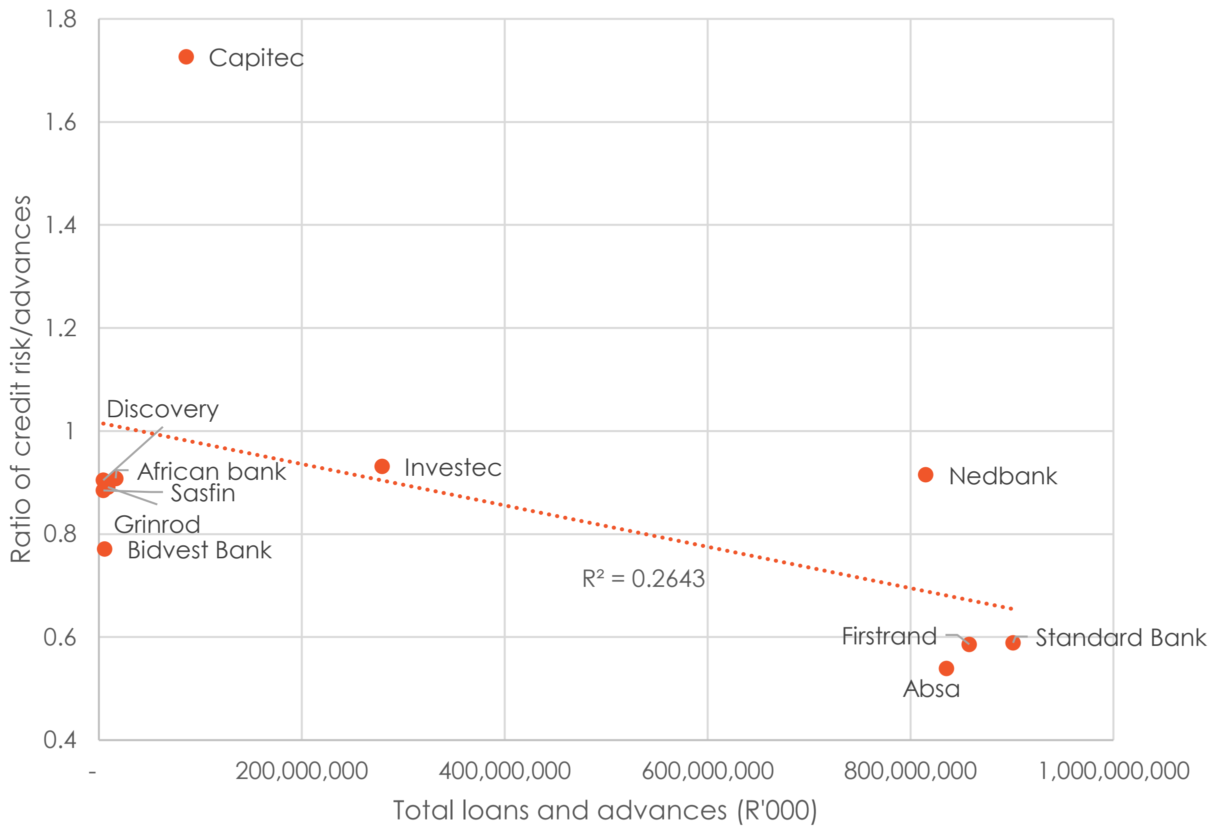
Basel is cautious that banks should not choose risk approaches with the intention of minimising RWA and therefore calls on supervisors to prevent practices like shifting credit between different entities to reduce capital charges. However, in practice, supervisors must manage the reality of banks with limited resources. This means a level of pragmatism with banks using internal approaches where the improvement in risk insight justifies it, and standardised approaches otherwise.

The PA currently imposes more stringent requirements in some aspects of the IRB approach in that it sets minimum PD and LGDs for specific types of exposures, which are higher than those of banks. In the standardised approach, the PA also requires banks to use the loan splitting approach rather than the whole-loan approach to mortgages specified by Basel 3. The loan splitting approach requires banks to assess mortgage credit risk by reference not only to the features of the property being financed, but also to the credit features of the borrower[2]. This effectively means that banks in SA hold higher RWA for mortgages than the 35% specified by Basel.

In our interviews, some executives at smaller banks expressed a view that RWA approaches are a source of disproportional impact as internal approaches tend to reduce RWA compared with standardised approaches, such that smaller banks were prejudiced with systematically higher RWA (see below). We conducted a limited test for this by comparing banks' credit RWA as a function of advances. This provides weak support for the view that banks using internal models report lower RWA with smaller banks generally holding higher credit RWA as a proportion of total advances (see Figure 2), although we did not control for the structure of credit books. Further research is necessary to confirm whether this is a reliable finding. It would be a disproportional outcome if IRB approaches systematically reduce RWA relative to standardised approaches as it would systematically reduce the capital costs of large banks relative to small ones, all else being equal.

[2] Effectively, under the loan splitting approach, collateral is always recognised only up to 55% of the property value. Any loan that exceeds 55% of the property value must be risk-weighted as a comparable exposure to the same obligor, not secured by mortgages on real estate (EBA, 2019).

Figure 2: Credit RWA/advances against size of book



Outside of credit risk, there are similar differences between internal and external approaches to operational risk and market risk. Globally, internal approaches to operational risk are being phased out with a single standardised approach to be adopted worldwide from 2023. Our survey found that South African banks do not expect this change to amount to a material long-run increase in costs beyond the short-term costs of managing the changeover (although about half of respondents had not yet estimated the cost impact).

Market risk is faced by banks that have balance sheet exposure to traded instruments so tends to be incurred by larger banks which are engaged in trading activities. Supervisors have wide latitude to decide which methods banks should use to assess market risk and have discretion in allowing for offsetting of long and short exposures. There are several options across different asset classes including equity, debt, commodities and foreign exchange. These divide broadly into standardised approaches and internal risk management model approaches. There is scope for a mix of approaches indefinitely, although Basel guidelines expect banks that use internal models to extend these to their entire portfolio, such that there is a consolidated view of risk factors (BCPS, 2019). The standardised approach uses "building blocks" with general market risk and specific risk (per issuer) calculated separately for debt and equity positions and then summed. Internal approaches require banks to determine all risk factors that affect the value of positions in portfolios and assess these qualitatively, and then to create value-at-risk (VaR) models and stress tests ("stressed VaR"). VaR is determined at the 99th percentile, one-tailed confidence interval, with a holding period of 10 days based on a minimum one-year observation period. The resulting VaR is then multiplied by 12.5 to obtain market RWA, such that the 8% minimum capital requirement will be an amount equivalent to VaR. Supervisors can add to the basic multiplication factor of 12.5 if they determine that the bank faces risks beyond those reflected in its internal models.

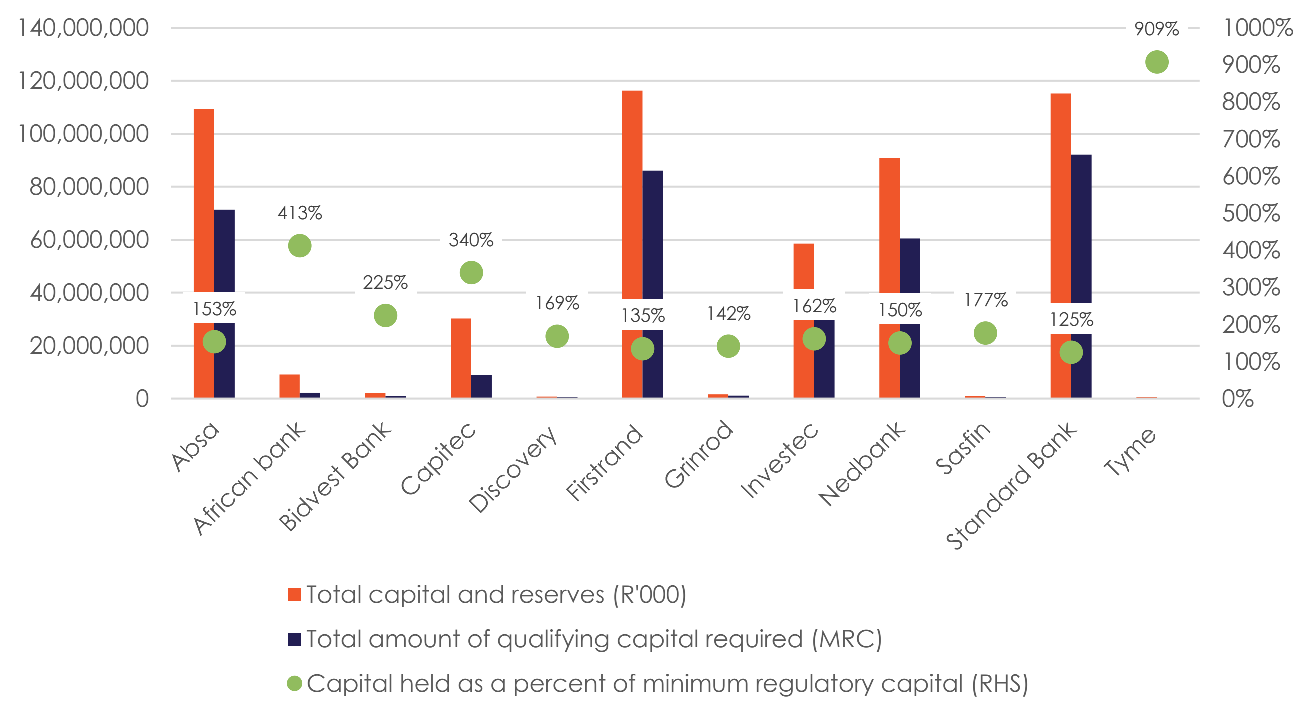
While banks apply a variety of approaches to assessing market risk, our study did not identify proportionality issues in the determination of market risk. Smaller banks that do face market risk tend to use the standardised approach, while larger banks use a mix of standardised and internal models approaches, with equity risk generally determined through the standardised approach and interest rate, credit, foreign exchange and commodities risks using internal models. The different approaches reflect that extent of underlying market activity so impact on banks tracks exposure in a proportional way.

Pillar 2B capital

A significant component of smaller banks' regulatory capital requirements stems from Pillar 2 of Basel, under which regulators set capital requirements for banks following supervisory review. This element of capital requirements is difficult to analyse as the specific requirements of each bank are not publicly disclosed. Conceptually, the minimum regulatory capital requirement imposes minimums for the industry but, apart from the D-SIB buffer, does not vary between banks. The D-SIB buffer and any countercyclical buffer is a macroprudential requirement. Pillar 2B reflects the specific risks of the individual bank's business model and exposures. It may be that these risks do not require any additional capital or liquidity beyond regulated minimums but more often there will be additional Pillar 2 capital requirements.

In Figure 3 we show all banks' minimum regulatory capital (Pillar 1 plus Pillar 2A) against total capital (based on publicly available information). Banks hold capital in excess of minimum requirements, ranging from 125% of minimum to 909%. This excess capital will in some part consist of Pillar 2B capital.

Figure 3: Total capital held vs minimum regulatory capital requirement (R'000, LHS, and ratio, RHS)



The supervisory review evaluation process (SREP) assesses banks' internal processes for ensuring capital and liquidity adequacy. These are determined through banks' internal capital adequacy assessment process (ICAAP) and internal liquidity adequacy assessment process (ILAAP). The expectations for ICAAP and ILAAP are set out by Basel through a set of detailed principles, but there is limited prescription of the calculations that banks should undertake to determine capital requirements. The ICAAP should consider all relevant risks, ranging from interest risk in the banking book to compensation practices and the likely impact on risk management. ICAAP covers the full internal risk management and governance framework and the allocation of capital to meet the risks being managed. The Basel Framework imposes a significant responsibility on supervisors to review and evaluate banks' internal assessments and strategies and holds as a core principle that supervisors should have the ability to require banks to hold capital in excess of the minimum (BCPS, 2019).

Conceptually, the regulatory capital that banks are required to hold may be less than the "economic capital" they are required to hold (so the excess capital shown in Figure 3 could consist of economic capital as well as Pillar 2B). Economic capital is distinct from regulatory capital in that it should capture all risks and other requirements that a bank seeks to manage through its capitalisation. As we detail below, certain banks do hold capital in excess of their regulatory minimum, and this is often to satisfy the expectations of ratings agencies or funders. Where such counterparts require banks to hold additional capital, it suggests they have determined a bank presents higher risk than regulators have, or that they require a higher margin for error. Given that these third parties do not have the same access to information that regulators do, a margin for error may be an appropriate response to the information gap. However, given that such third parties do not know specifically what the regulator's view on Pillar 2B capital is, the margin for error may well be higher than they would require if they had specific knowledge of Pillar 2B requirements.

As we detail in the next section, banks state the "total capital" that they are required to hold has a significant impact on their overall costs. Several smaller banks disclosed that they hold additional capital beyond that indicated by their ICAAP in line with requirements from regulators following SREP. Others indicated that they hold capital in excess of requirements to support future growth plans, to meet ratings agency expectations or to support a funding strategy. More than one bank also said that reviews of Pillar 2B requirements were too infrequent and that fundamental changes in their business models over the last several years had not been reflected in Pillar 2B capital requirements.

The ICAAP should be inherently proportional. By reflecting risks at an idiosyncratic level of each institution, smaller, less complex banks should have lower Pillar 2 capital requirements in the normal course. The PA notes that "the ICAAP produced by each bank will be reflective of the nature, size and complexity of that bank" (correspondence). The PA conducts on-site reviews of selected ICAAPs following a risk-based process that involves all risk specialists in the banks. These reviews may lead to further capital requirements based on the PA's assessment of risk relative to the capital held in the form of a Pillar 2 capital add-on.

We did not find that Pillar 2B capital is consistently seen as disproportionate among smaller banks, though it does emerge as the single most important factor driving compliance costs for banks. A concern expressed by some bank interviewees was that Pillar 2 capital add ons are an indirect mechanism used for wider systemic risk management rather than narrowly reflecting the risks at institution level. This may reflect some concern that Pillar 2A is used in South Africa as a systemic risk tool while 2B is used for idiosyncratic institution-level risk. This practice differs to elsewhere, for example the Bank of England uses Pillar 2A to reflect a bank's ICAAP while Pillar 2B is an additional buffer determined by the prudential authority based on stress testing and scenario analysis based on the forward-looking planning horizon (PRA, 2015). This differentiation makes it straightforward to understand the distinction between the regulators' view and a bank's view, although the Pillar 2A is also subject to the SREP and add-ons can be determined.

The PA expressly notes that the Pillar 2 capital add-ons "are based on the riskiness of individual banks and not on categories of banks. However, the PA does peer comparisons to ensure consistency in application within peer groups". These peer comparisons are discussed with banks so that banks have some ability to benchmark themselves. However, the lack of transparency around individual banks' Pillar 2B outcomes makes it difficult for banks to have high confidence that their capital levels are proportionate, especially when they are in excess of their internally determined ICAAP levels.

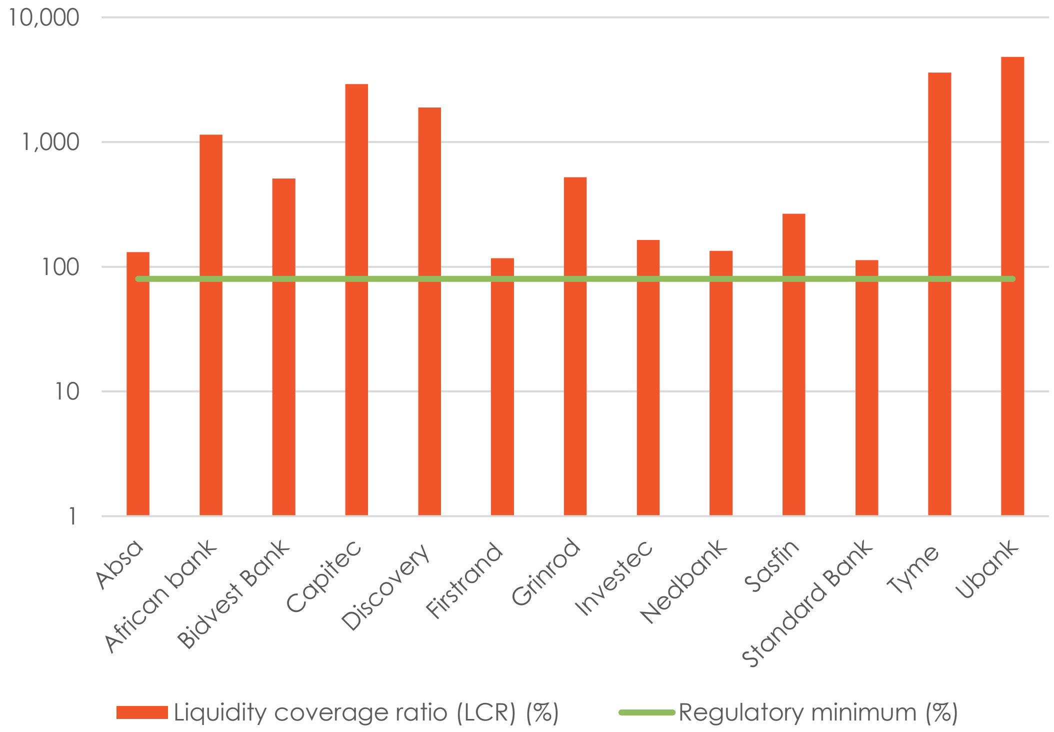
Further, the use of Pillar 2A in a South African context to capture systemic risk is different to international practice and leads to the impression that Pillar 2 capital is excessive for institution-level risk. The PA reports that Pillar 2A is not a "buffer" but a fixed amount and that the percentage was deducted from the DSIB buffer (i.e. the D-SIB buffer is 2.5% instead of the 3.5% required by Basel 3 of the highest risk category of G-SIBs). This would not be the case were the function of Pillar 2A replaced by the use of dynamic buffers under macroprudential risk management (discussed further below) with Pillar 2B divided into ICAAP-derived capital requirement and a separate category to reflect the PA's views on additional risks in a stress scenario.

Liquidity coverage ratio and net stable funding ratio

Basel 3 introduced liquidity prudential requirements, the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). The LCR attempts to ensure banks hold enough high-quality liquid assets (HQLAs) to survive a period of major liquidity stress lasting 30 calendar days. The NSFR aims to reduce banks' funding risk over the longer term by creating incentives for them to fund their activities from more stable funding sources.

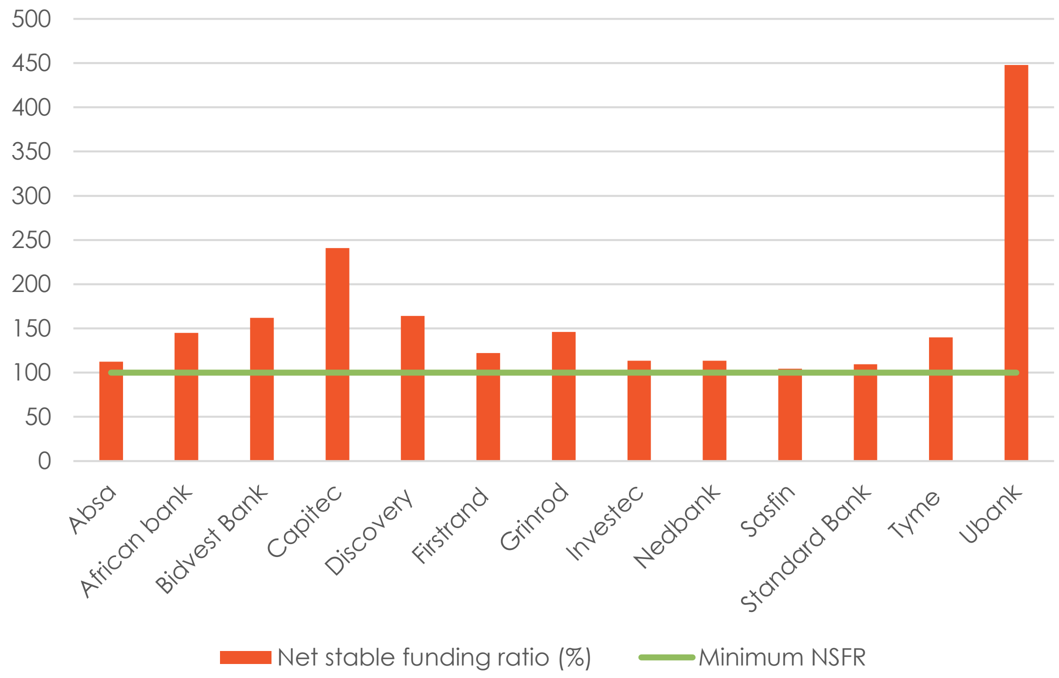
As Figure 4 shows, South Africa's smaller banks all hold significantly more liquidity than regulatory minimums. Indeed, smaller banks hold LCRs several fold higher than minimum requirements. Based on feedback in interviews, this reflects smaller banks' views that strong liquidity is essential to counter market apprehension about liquidity mismatches on bank balance sheets among smaller banks, a legacy of the small banks crisis of the early 2000s in which liquidity mismatches played a prominent role. This behaviour in the market suggests that LCR regulations themselves do not impose any disproportional impact on smaller banks.

Figure 4: Liquidity ratios (%) of South African banks vs minimum (note Y axis is log 10)



Banks are closer to NSFR thresholds, though there is significant variation in the market as shown in Figure 5. The NSFR aims to manage maturity mismatches between banks' funding and assets and reflects a ratio of banks' available stable funding and required stable funding, which should be at least 100%. The NSFR encourages banks to hold long-term funding instruments and to make shorter-term loans and can have a disproportional impact on banks that are less able to attract longer-term funding. As discussed in Section 7 below, certain jurisdictions have implemented less onerous liquidity regimes including dropping the NSFR while continuing to apply the LCR.

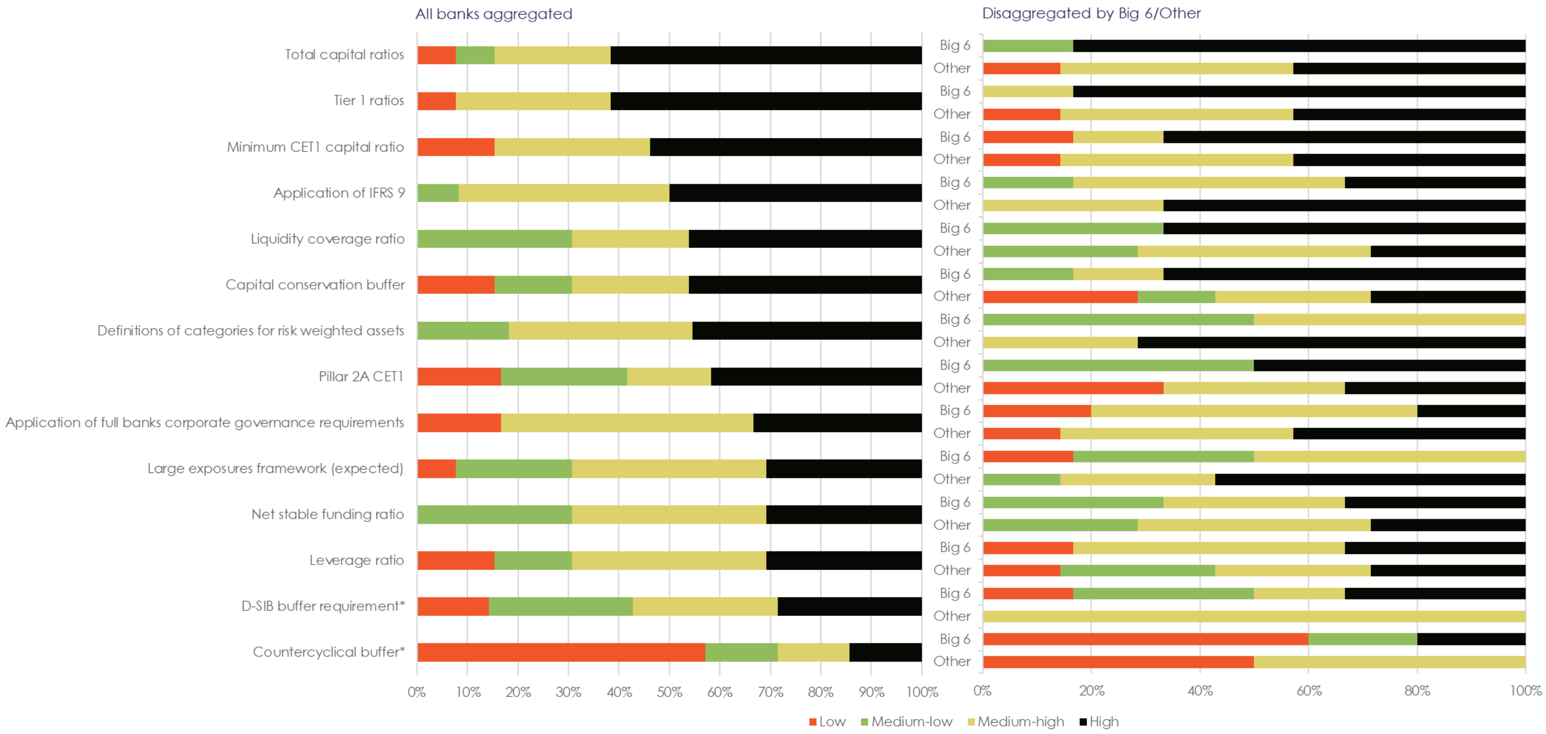
Figure 5: Net stable funding ratios of South African banks



Bank qualitative views on prudential regulation in South Africa

Our questionnaire solicited views from banks on the contribution to capital or funding costs of banks of various elements of prudential regulation. In Figure 6 we show the results at an aggregate level and then split between small and large banks. Minimum capital ratios clearly stand out as the most important contributor to capital costs for banks in aggregate, but it is instructive that this is considered a greater factor for the big 6 banks relative to smaller banks. In interviews, smaller banks told us that capital levels were often in excess of minimum capital levels because of the expectations of ratings agencies and funders, rather than regulated minimums. A similar pattern is seen in the liquidity coverage ratio, with larger banks seeing it as having a higher impact on costs than smaller banks, for whom high liquidity ratios are a requirement of doing business.

Figure 6: Qualitative views on the contribution to the capital/funding costs of banks. All banks (LHS) and banks broken down between large and small (RHS)

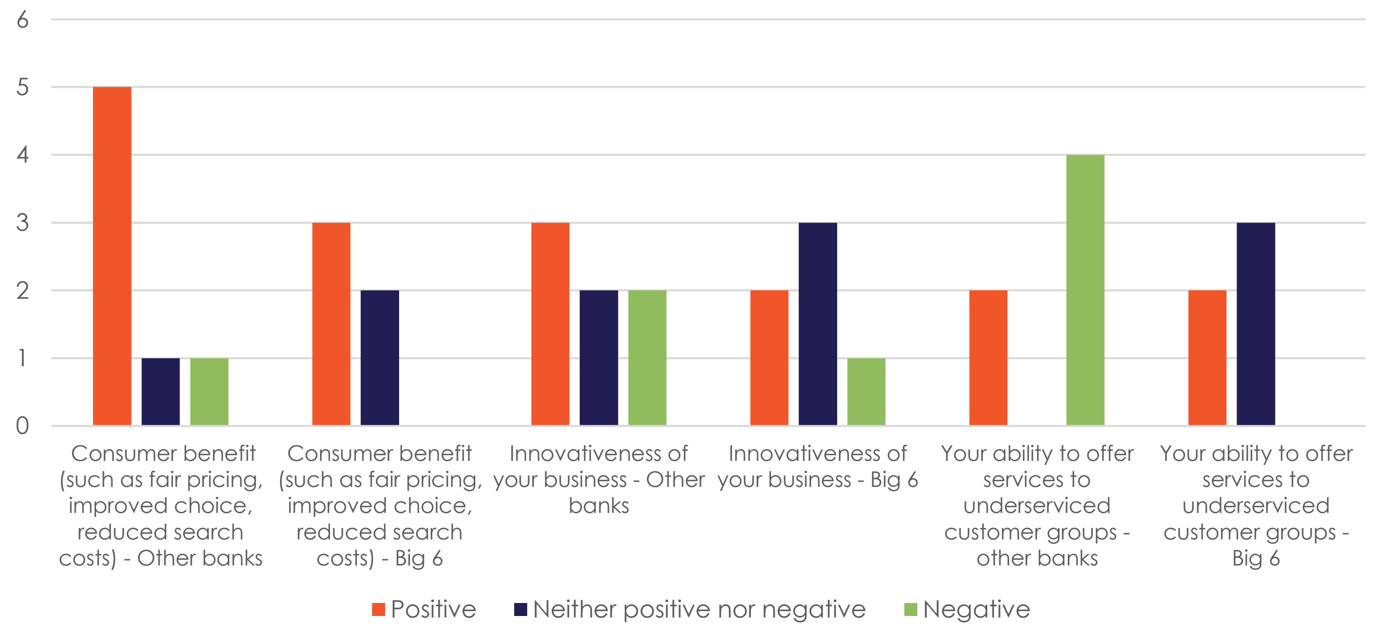


There is a sharp distinction in views between large and small banks in two other factors: definitions of categories for risk-weighted assets and the large exposures framework, which is in the process of being finalised. In both cases, smaller banks cited these elements as having a much higher cost impact than the large banks. As discussed above, we found weak evidence that banks that use internal rather than standardised models have systematically lower RWA totals which may be one factor contributing to this view. In respect of definitions, in our view the material issue is the threshold for small business exposures to quality as retail assets, given that several of the smaller banks are focused on the small business segment. The large exposures framework similarly has a larger impact on smaller banks, for whom small balance sheets mean single exposures could relatively quickly approach the applicable limits (25% of Tier 1 capital). There is in this regard a clearly disproportional impact on the business models of smaller vs larger banks, with smaller banks constrained to relatively lower absolute amounts of exposure. The large exposures framework under Basel applies to internationally active banks and jurisdictions have the option to develop alternative approaches for other banks. The Bank of England, for example, allows banks with less than €600m in capital to apply higher exposure limits in relation to exposures to other banks of 100% of eligible capital (but non-bank exposures remain limited to 25%) in part to recognise that smaller banks have limited access to money market funds and so rely more heavily on larger banks for funding (Chapman, et al., 2020).

The DSIB and countercyclical buffers ranked low in terms of cost impact, which is to be expected given that the countercyclical buffer is currently set at zero and D-SIB buffers do not apply to smaller banks (though interestingly larger banks did not rate it a high-cost factor on aggregate).

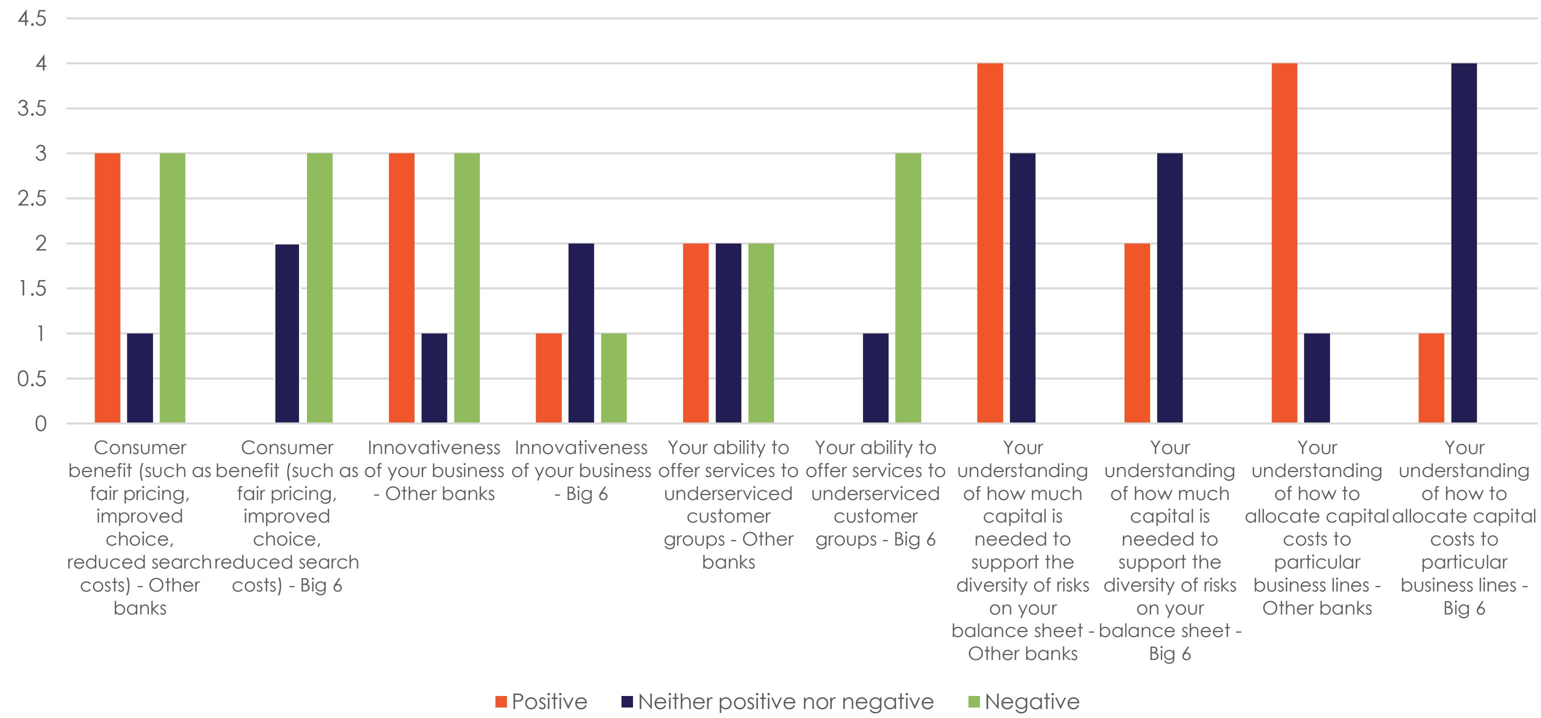
In the survey, respondent banks were asked to provide qualitative views on the impact of regulation. The key aspects the survey focused on were consumer benefit, innovation and financial inclusion. In Figure 7 we show banks' views on overall PA supervision requirements (which will also reflect views on supervisory practices, discussed more in the next section).

Figure 7: Bank views on impact of overall PA Supervision (number of banks, responses split between Big 6 and other banks)



Banks generally see PA supervision as highly beneficial to their businesses and the market in general. PA supervision is seen by most large and small banks as having a positive consumer benefit. There are more mixed results in perceptions of impact on innovativeness and financial inclusion. Smaller banks in particular see PA supervision as negative for financial inclusion, while there is a balance of positive and neutral views on the impact on innovation.

Figure 8: Bank views on benefits of Basel 3 capital requirements (number of banks, responses split between big 6 and other banks)



Supervisory practices

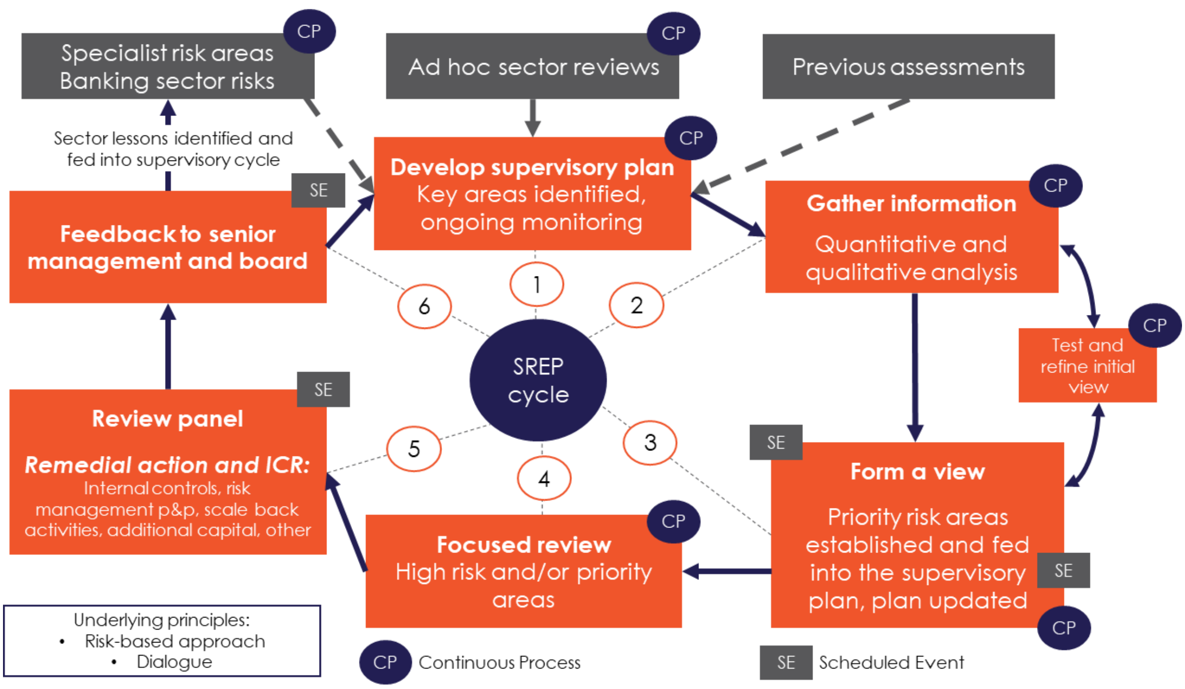
Supervisory practices refer to the activities undertaken by regulators and banks in the process of supervision. This can refer to statutory returns, meetings, ad hoc information requests, forms and other engagements. Supervisory practices also have clear proportionality consequences. Highly risky banks should be subject to more onerous supervision than low-risk banks. Appropriate and proportional supervisory practices improve efficiencies both for regulators and for the market. Supervisory practices are resource intensive for regulators as well as banks and appropriate supervision ensures costs match the risk benefits of supervisory practices.

The PA's supervisory practices are based on an annual supervisory plan informed by the PA's key priorities, risk assessments and emerging trends in the banking industry. The PA implements its supervisory plan by:

- Holding prudential meetings with, among others, the chairpersons of boards, boards of directors and their committee members, executive management, heads of control functions and the auditors of the banks;
- Carrying out assessments on each bank's governance and culture frameworks, structures, and practices;
- Instituting an independent review if the PA is concerned about governance matters or the principles, methods and assumptions used for the calculation of the value of assets, liabilities, capital requirements and/or capital resources of a bank;
- Accessing statutory returns and all relevant information from banks, their controlling companies and subsidiaries including the ICAAPs and ILAAPs; and
- Qualitatively and quantitatively analysing information submitted by the bank through off-site and on-site supervisory tools.

These practices are informed by the SREP (discussed above) process that is depicted in Figure 9.

Figure 9: Supervisory Review and Evaluation Process



Source: (BCBS, 2015)

In the case of microprudential regulation, engagements between the regulator and banks are extensive given the need to assess and supervise idiosyncratic institutional-level risks and practices. This supervision is applied on a consolidated basis (in line with Core Principles for Effective Banking Supervision issued by BCBS) so assesses all the businesses of a banking group worldwide. The supervision approach, guided by the Core Principles, uses a methodology for determining and assessing the nature, impact and scope of risks which a) banks or banking groups are exposed to, including risks posed by entities in the wider group; and b) which banks or banking groups present risk to the safety and soundness of the banking system (PA, correspondence).

Bank categorisation

Bank categorisation can be a key driver of proportionality, by separating risky and less risky banks for appropriately matched supervisory intensity. For macroprudential regulation, a key category distinction is between D-SIBS and other banks (discussed further below). For microprudential supervision, the PA divides banks into three levels (PA, correspondence):

- Level 1: Supervision of a licensed entity on a standalone basis, which is often referred to as solo supervision;
- Level 2: Specialist group supervision where the supervised group operates primarily in one industry, such as, for example, banking or insurance, which is often referred to as consolidated supervision;
- Level 3: Supervision of a financial conglomerate, where the group of companies operates in one or more sectors, such as, for example, insurance, banking or financial market infrastructure.

Functionally, the PA divides the banks into two different frontline supervision departments. Larger banks are supervised by the Financial Conglomerate Supervision department and smaller banks and foreign branches are supervised by the Banking, Insurance and Financial Market Infrastructures Supervision department. In addition, banks are grouped into peer groupings based on their size, nature and complexity and considering their business models (so, for example, a peer group might consist of small banks). This peer grouping forms a reference point in the supervision process, allowing for comparisons rather than to tailor supervision for specific peer groups.

The material categories in the PA's approach are between financial conglomerates on one hand and Levels 1 and 2 on the other. This is reflected in the internal structuring of the PA in dividing the banks between its conglomerates and the banking supervision departments. The specialist treatment of conglomerates is a development following the GFC which brought out that supervision of conglomerates had not fully captured all their activities or fully considered the impact and cost that these activities posed to the financial system (BCPS, 2012). Conglomerates often have intra-group exposures each of which may have been regulated separately while capital could be used by multiple component businesses leading to gearing of capital. As a result, consolidated risks or leveraged risks between component entities was sometimes missed.

A premise of such an approach is that conglomerates are more risky than narrowly focused banks. This was an assumption that seemed borne out by the financial crisis where dependencies between a conglomerate's bank and insurance subsidiaries, for example, contributed to the crisis. Basel guidance is provided by the Joint Forum's Principles for the Supervision of Financial Conglomerates which was substantially amended after the financial crisis (BCBS, 2012). These "should be applied in a proportionate manner to the risks posed and at least be applied to large internally active financial conglomerates", according to the Joint Forum (ibid. pg 2). The current practice of the PA was adapted after the GFC in the creation of the twin peaks regulation approach which consolidated prudential supervision of banks, insurers and market infrastructures in the PA allowing for consolidated supervision of conglomerates.

The categorisation between conglomerates and solo banks does have proportionality consequences. Conglomerates are supervised with a view to ensure consistent capital management across a group including in respect of its unregulated activities. This would ordinarily mean that conglomerates are subject to higher capital requirements than the sum of the parts of a conglomerate would imply. Arguably, therefore, the unregulated components of a conglomerate suffer a competitive disadvantage to unregulated competitors that are not part of a conglomerate. A conglomerate is also subject to specific regulatory supervision practices to detect potential "blind spots" in the group's activities implying weightier supervisory practices that a conglomerate must face, unlike unregulated competitors. The Joint Forum's principles provide significant scope for national discretion particularly given that multiple approaches are likely to be taken in different countries, depending on the background supervision structure before consolidated supervision was introduced. For example, many jurisdictions regulate insurers outside of a central bank and may have quite decentralised approaches to different components of a conglomerate. The principles require only that a single "group-level supervisor" with appropriate cooperation agreements with other relevant supervisors. South Africa took the approach of consolidating all financial microprudential supervision into the PA, removing much of the coordination risk that might otherwise arise.

However, while the cost of a crisis in a conglomerate may be large, it is not always clear that the risk of a crisis is higher than in narrower financial businesses. Portfolio effects may arise in conglomerates which provide some level of earnings stability, although there are also risks of leveraged risks if the conglomerate has concentrated internal cross-exposures. The focus of regulators on ensuring a single view of conglomerates that eliminates blind spots and determines consolidated risks should tilt the net effects in favour of benefits rather than harms. However, to the extent that a net risk benefit may arise, this is not reflected in capitalisation requirements which do not fall below requirements for any individual regulated entity within the conglomerate.

Scheduled meetings and returns

The PA's supervisory practices are set out following the SREP process each year. Apart from a set of standardised returns that banks are required to submit to the PA, a series of annual meeting are also held. These include (PA, correspondence):

- **Chairperson/board/CEO.** Three meetings are held to discuss the strategy, resources to achieve the strategy, financial performance, board (chairman meeting) and senior management (board and CEO prudential meetings) performance and any other risk areas.
- **Trilateral.** The external auditors, audit committee and internal auditors discuss the audit findings, i.e. internal audits and the statutory audit, and trends, residual and emerging risks as well as plans for the next audit reviews.
- **Risk management/compliance/internal audit.** These meetings cover the views of the assurance providers on the entity, their concerns, plans and alignment to the Basel requirements, governance standards and the resources necessary to assist the bank in its risk mitigation efforts.
- **Bilateral (with auditor).** The views of the auditor on the bank's performance, the emerging and inherent risks facing the bank, the bank's risk mitigation efforts and the statutory audit plan are discussed between the external auditors and the supervisor.

This series of meetings is held as standard with all registered banks. Our survey of banks, however, found significant variation in the number of such prudential meetings, ranging from one to 38 formal prudential meetings over the course of the banks' last financial year. In addition to the meetings themselves, banks are required to compose information packs for the supervisors that must be submitted several weeks in advance. Smaller banks reported to us that the preparation time for the information packs was particularly burdensome in terms of executive and compliance staff time. We did not detect any meaningful bias in time for meetings or preparation between large or small banks.

Further regular meetings take place, including monthly management information reviews and biannual risk reviews. Additionally, ad hoc reviews can be scheduled at any time to consider market risk, credit risk, asset and liability management, operational risk and reviews of a bank's ICAAP, as well as other matters that may arise.

However, in interviews smaller banks did repeatedly raise the nature of many standardised returns which often ask for information relevant only to larger banks and conglomerates. The returns that banks are required to submit in terms of Banks Act regulations range from daily (BA 325 concerning daily liquidity positions) to six-monthly (BA 600 concerning credit risk) though most are monthly or quarterly (including the publicly disclosed BA900s). There are 33 such periodic returns that are required to be submitted. Many of these can be populated through electronic accounting systems and much of the information submitted reconciles across forms. Banks had different approaches to managing the completion of information requests. Some had no dedicated PA regulation team, instead consolidating input from various other departments such as finance, risk, compliance, audit, etc.

South African banks are subject to BCPS 239, the Risk Data Aggregation and Risk Reporting (RDARR) standard of Basel implemented in 2017 (with a roadmap for full compliance extending into 2022). This set of principles was designed for G-SIBs, but with BCBS recommending they be applied to D-SIBs in member countries. In South Africa RDARR was adopted for all Banks Act registered banks with the intention of improving the ease and speed of reporting of data. Banks reported that because of RDARR, the PA had been shortening deadlines for information requests but that often some information required laborious manual processes to collect. The PA has noted though that some banks have struggled to comply with RDARR and have struggled to define how proportionality should apply to their regulatory compliance approach and strategy (PA, 2021).

The required forms are standard for all Banks Act registered banks, irrespective of the types of activities such banks may be involved in. The PA reports that banks can systematically leave blank any data fields so the presence of these fields should not be a concern. Nevertheless, certain banks report that their systems must be designed to track all fields of forms and they must understand, interpret and operationalise all requests, even if it results in a null response. Some small banks may have exposure in several areas that would be incidental and short-lived if they ever arose, requiring them to track those. There was a general sense among smaller banks that the forms are all designed for large, complex banks, creating a disproportional cost burden on small banks with no comparable benefit. This is particularly acute for new entrants which must set up systems to manage all information flows to the PA, even if many line items do not apply to them.

One option for proportionality approaches is to simplify and/or reduce the frequency of standardised reporting required of lower-risk banks. We consider this option further under recommendations, below.

Informal meetings and information requests

In addition to the formal requirements discussed above, there are frequent unscheduled meetings and requests for information. Many of these are routine, such as when a bank requires permission to appoint an executive officer or auditor or pay a licence fee (these permission requests are standardised in forms BA001 to BA023) and can be initiated by the bank or the PA. Additionally, however, the PA may request information from banks as part of ongoing research activities. There was a consistent view among the banks that we interviewed that the volume and resources absorbed by such requests have been increasing. Banks report that the type of engagements include clarity seeking queries about specific exposures, questions about information provided in returns and discussions about new products being planned. Additionally, discussions may arise in relation to any forms or returns submitted where the PA may want to obtain additional information. Further ad hoc meetings may be occasioned by financial results releases or specific corporate activities, or on request by banks to obtain clarity on matters.

The PA may request information from the whole industry in response to specific events or issues, such as climate change or the impact of the violence experienced in KwaZulu-Natal in July 2021. Several banks, both large and small, reported that such requests have a substantial impact on resources particularly where information is simply unknown at the time of the requests. Other banks pointed out that they are often asked for information that clearly is not relevant to them (for example banks with narrow geographical exposures being asked about exposures in KwaZulu-Natal). However, the PA does confirm that it does send questionnaires to subsets of banks based on their nature, size, complexity and risk profile.

There are efficiencies that can be generated around ad hoc requests, such as combining meetings and focusing thematic reviews with selected banks based on particular exposures such banks may have. However, our research suggests that most engagements are undertaken industry-wide with no risk-based assessment of which banks to engage with. In our view it should be possible to apply a risk basis to ad hoc information requests, excluding banks which have no material effect on the particular risk being assessed. Of course, it is the information itself that may be necessary to determine this, but there are likely to be occasions where the existing information set available to the PA provides a sufficient basis to direct information requests informed by a risk-based assessment of which banks will provide pertinent information.

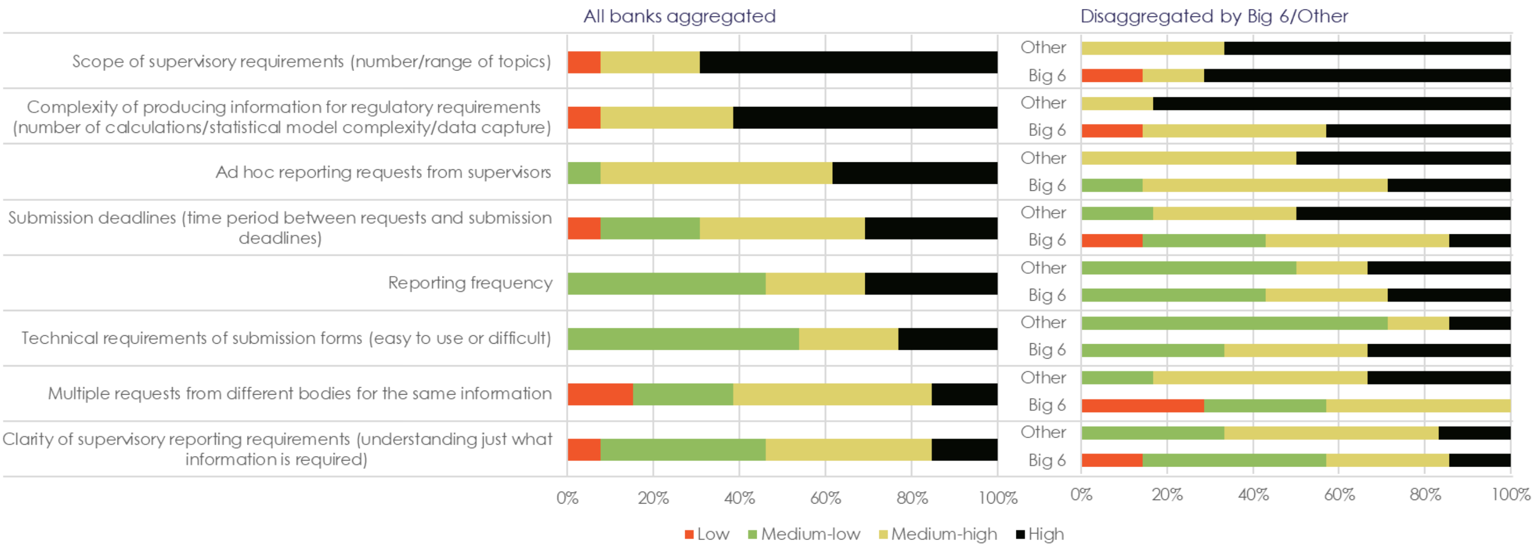
Bank qualitative views

We have described our findings drawn from interviews with bank executives above, save for two further areas of feedback we received. There is some frustration on the submissions and approvals process regarding new products. These can get in the way of strategy and innovation due to the stringent and onerous nature as well as lengthiness of the process. Bank executives told us that they need to be agile and quite quick in introducing a new product to the market and this impacts innovation. Secondly, the approval process required for acquisitions, including very small ones, is costly and timely. Banks have to almost think twice before embarking on acquisitions above a certain threshold. In both of these areas there may be scope to finetune processes for quicker consideration based on a risk-weighted view.

Below we report findings from our survey of banks pertinent to the impact of various supervisory practices.

Banks were consistent in seeing the scope of supervisory requirements as having a high impact. Smaller banks were more likely to cite the complexity of producing information as having a high impact as well as ad hoc requests and submission deadlines. Interestingly, large and small banks were fairly consistent on the impact of reporting frequency and the contribution it has to the cost of compliance which suggests that reporting frequency does not have a disproportionate impact.

Figure 10: How much do these factors contribute to the cost of compliance with PA requirements



Banks did not generally consider multiple requests from different regulators for the same information to be a cost contributor. They also generally considered the clarity of supervisory requirements to be good.

Governance

The GFC has been attributed in part to failures and weaknesses in corporate governance. Board oversight and risk governance did not safeguard against excessive risk in several financial institutions in many countries, the United States particularly. In response, the Basel Committee issued a set of principles to assist national banking supervisors to promote the adoption of sound corporate governance practices by banks (BCBS, 2015) .

Given the significant difference in legislative and regulative frameworks across countries, the Basel Committee expects national authorities to implement the principles commensurate with the size, complexity, economic significance, risk profile and business model of banks, making reasonable adjustments where appropriate for banks with lower risk profiles (BCBS, 2015).

In South Africa, Chapter 3 of the regulations to the Banks Act is dedicated to corporate governance. Provision is made for proportionality. For example Regulation 39 (process of corporate governance) requires a bank's governance to "(i) be consistent with the nature, complexity and risk inherent in the banks' on- and off-balance sheet activities; and (ii) include effective risk management and capital management processes, practices, procedures and policies that are adequate for the size and nature of the activities of the bank". Furthermore, Regulation 40 (guidelines relating to conduct of directors) requires that the competence of directors be "commensurate with the nature and scale of business conducted by the bank or banks in the group (controlling company)". It is evident that the PA considers corporate governance to be critical to the proper functioning of banks: in February 2019 the PA imposed the first administrative penalty in terms of the FSR Act for R10m on a bank arising from a breach of required governance standards. In this case the penalty was for the non-disclosure of the bank's key management personnel's compensation in its annual financial statements (SARB, 2019).

However, the PA is not the only regulator with jurisdiction over banks' corporate governance processes. This was emphasised in the 2020 Financial Markets Review (NT, 2020), which recommended that regulators consider developing a central source of information (as envisaged in section 256 of the FSR Act) relating to corporate governance standards applicable to financial institutions, both listed and unlisted. The review suggested regulators explore legislative governance requirements that establish equivalent but proportional regulatory regimes for all market participants and to remove gaps or inconsistencies. The review further highlighted that South Africa has several well-established governance frameworks set out in various regulatory arrangements, including:

- Primary legislation such as the Companies Act 71 of 2008 (South Africa's overarching legal framework for all firms that contains basic corporate governance requirements), the Banks Act 94 of 1990 (Banks Act), and the Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS Act);
- Secondary legislation such as regulations issued in terms of the Banks Act (see Chapter III of the Banks Act regulations issued December 2012). Regulations are also envisaged in terms of the Conduct of Financial Institutions Bill;
- Stock exchange listing rules issued in terms of the Financial Markets Act 19 of 2012; and
- Governance codes such as King IV, certain provisions of which are incorporated into the exchanges' listing requirements.

The impact of these legislative and regulatory arrangements on banks and their boards is evident in the committees required to assist the board with its responsibilities – see Table 3.

Table 3: Committees required by law and good (best) practice

Committees	Banks Act	Companies Act	King IV
Audit committee	Yes	Yes	Yes
Risk (and capital management) committee	Yes		Yes
Directors' Affairs Committee	Yes		
Remuneration committee	Yes		Yes
Social and ethics committee		Yes	Yes
Nomination committee	Yes		Yes

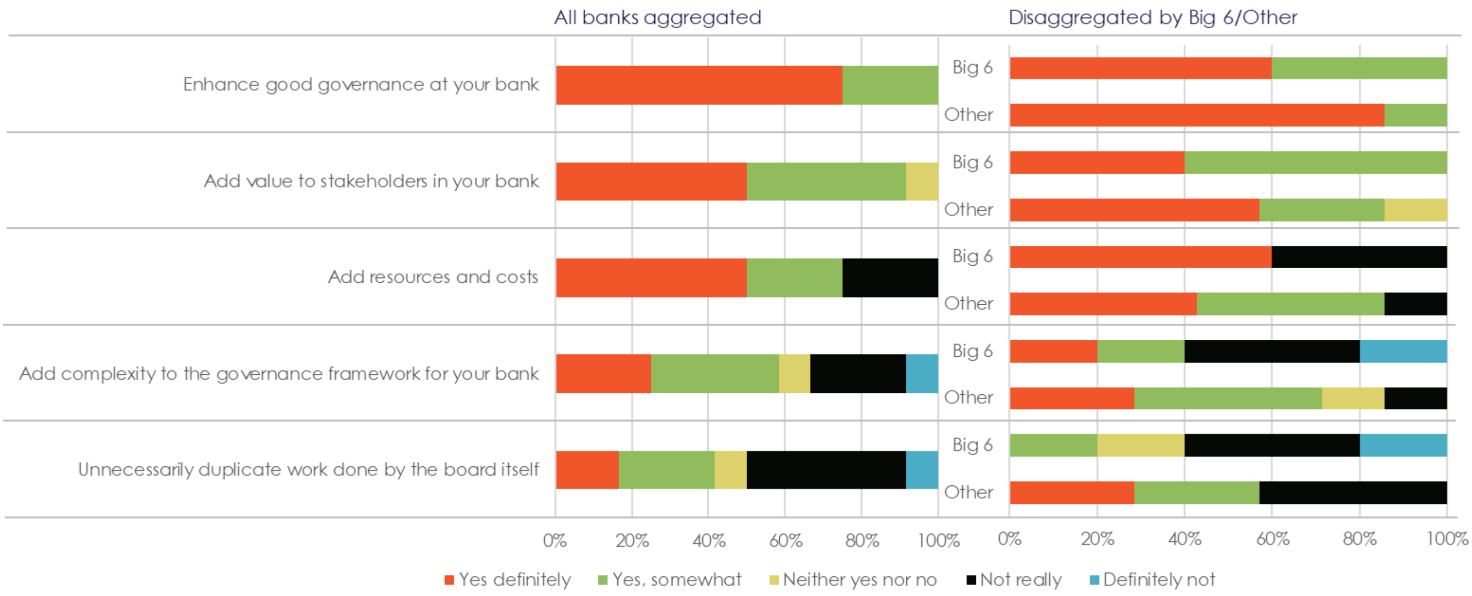
The responsibility for monitoring and enforcing governance requirements is allocated to different regulatory agencies: the PA uses its prudential powers to ensure that banks adhere to appropriate corporate governance standards and the JSE uses its delegated regulatory powers to ensure compliance with its rules. No doubt the FSCA will also enforce its corporate governance requirements issued under FAIS, the FSR Act or the future COFI Act. Governance codes such as King IV, where not incorporated into regulation, are enforced, in essence, through moral suasion having become accepted by shareholders, funders and other stakeholders as de facto good governance practice.

Having corporate governance requirements embedded in various regulatory sources has the potential to increase complexity and compliance costs for banks – particularly smaller listed banks. This was confirmed in the OECD reviews on flexibility and proportionality in corporate governance. Key developments identified in the financial and corporate sectors included fewer company listings and an increase in institutional ownership. The OECD report (OECD, 2018) stressed that flexibility and proportionality is not about accepting inferior governance standards but about ensuring the corporate governance framework meets the needs of corporations that operate under widely different environments and conditions, increasing efficiency and avoiding over-regulation. The report found that all 39 of the jurisdictions reviewed allowed flexibility and proportionality with respect to board composition, board committees and board member qualifications.

Bank qualitative views on governance

In our survey of banks, we assessed views on the impact of governance requirements under Banks Act regulations, given the proportionality impact identified in the literature. However, we did not find any clear distinction in views between large and small banks on the impact of governance requirements. Generally

Figure 11: Bank views on whether board committees required in terms of Banks Act regulations...



banks see such requirements as being positive for governance and adding value to stakeholders. While they acknowledge that governance requirements add resources and costs, there is no definitive view that these add complexity or unnecessarily duplicate work of the board.

In our view, therefore, governance requirements currently do not impose a disproportional impact on banks in SA and we do not make further recommendations in this regard.

Macroprudential

Macroprudential regulation is a post-GFC development that aims to detect and manage systemwide risks. The primary tools used in macroprudential regulation are G-SIB and D-SIB buffers and countercyclical buffers, though macroprudential regulation also can draw on several other instruments in the prudential framework including dynamic institution-level provisions. In South Africa, macroprudential regulation is managed by the SARB's Financial Stability Department.

South Africa has no G-SIBs but does have D-SIBs. A degree of proportionality is built into macroprudential policy (and similarly microprudential policy) through the demarcation of D-SIBs, which are required to hold a D-SIB capital buffer under macroprudential regulation, currently set at 2.5%. The South African approach to categorising D-SIBs is broadly based on Basel Committee guidance and uses similar indicators, however there have been enhancements for domestic use through the addition of indicators and criteria that better reflect the South African conditions. The approach used is summarised in Table 4 (SARB, 2019).

Table 4: SARB approach to determining D-SIBs in South Africa

Indicator	Weighting
Size	40%
Interconnectedness and substitutability	40%
Global activity	10%
Complexity	10%

On this basis, South Africa has six D-SIBs. These are not formally identified but are assumed to be the six largest banks, FirstRand, Absa, Standard Bank, Nedbank, Capitec and Investec. Macroprudential stability focuses on these and other financial institutions including insurance and financial infrastructures, but also considers smaller institutions in conducting stress tests to test the resilience of the system under different economic scenarios.

There are three main capital- based instruments used in the South African macroprudential framework – countercyclical capital buffers, sectoral capital requirements and dynamic provisions (SARB, 2016), but to date SARB has focused on the countercyclical capital buffer. This is applied when credit growth in the private sector is excessive and stimulating the build-up of systemwide risk. In such instances, banks would be required to hold an additional capital buffer. Where exposure to a specific sector or segment is assessed by the prudential regulator as contributing to the risk, additional capital may need to be held against these exposures. To mitigate risks arising from inadequate provisioning, dynamic provisions may be imposed to cover expected losses. Macroprudential provisioning requirements could be rules-based, for example, the Bank of Spain sets general provisions as a fixed percentage of credit growth and specific provisions are made for delinquent assets. This is imposed based on indications that a bank tends to make inadequate provisions in good times relative to historical experience. Provisioning could be applied to specific sector exposures or across the board.

The main criteria that guide selection and implementation of macroprudential instruments are effectiveness, efficiency and transparency of the instruments. SARB (2016) found econometric evidence that macroprudential policies have limited effectiveness. Other countries that use ex post assessments and back-testing of historical periods of excessive growth in credit show better results.

In South Africa's context, Pillar 2A is also used as an additional amount of capital that provides a macroprudential function. For example, banks were permitted to use Pillar 2A capital at the outbreak of the Covid-19 pandemic. As discussed above, this approach reduces the proportionality embedded in Basel 3's G-SIB buffer by dividing it between D-SIB buffer and Pillar 2A.

We did not query banks on the impact of macroprudential instruments as, apart from the D-SIB buffer, they are not currently being used. Bank views on the D-SIB buffer were provided as part of the general questions on prudential regulation outlined above.

Macroprudential management is focused on reducing the probability of default, while bank resolution, which we discuss in the next section, focuses on reducing the loss given default.

Bank resolution

The capital adequacy approach embeds an implicit acceptance that there is a non-zero probability of a bank failing as all banks face risk. A critical task in regulating banks is ensuring there is an explicit framework to manage the exit of banks with minimal cost to the rest of the system. South Africa has several examples of costly exits, most recently that of VBS Mutual Bank, whose collapse had significant political consequences despite being non-systemic.

South Africa is still in the process of establishing its bank resolution framework. This will principally include a deposit insurance scheme, allowing for the orderly payout to small depositors in the event of a bank failure. It will also impose living wills on banks and ensure capital structures include loss-absorbing instruments that convert to capital in the event of distress of a bank.

In September 2018 National Treasury published the Financial Sector Laws Amendment Bill (FSLAB) of 2018, which gave effect to proposals in the discussion document "Strengthening South Africa's resolution framework for financial institutions" first published in 2015 (National Treasury, 2015);and "Designing a deposit insurance scheme for South Africa" published in 2017 (National Treasury, 2017). The resolution framework aims to make the financial sector safer for the economy and customers by (i) improving the resolvability of designated resolution institutions (DRIs) – mainly banks which are most likely to be designated systemically important financial institutions, (ii) giving SARB (the resolution authority) additional powers to minimise disruption to the financial sector, (iii) minimising costs to the fiscus (and general public) in the event of bank failure and (iv) introducing a deposit insurance scheme.

In assessing the loss-absorbing capacity (LAC) of DRIs, an element of both supervision and resolution, the framework identifies two dimensions of LAC – regulatory capital and total loss-absorbing capacity (TLAC). Basel III determines the amount and composition of regulatory capital for banks. Where this capital is insufficient, TLAC can be applied to G-SIBs, or in South Africa's case, D-SIBs. The TLAC includes instruments (bail-in liabilities), over and above regulatory capital requirements, that are identified and available for loss absorption during resolution. While the FSLAB provides the SARB with the powers to write off equity and convert other LAC instruments, the introduction of such instruments is still under discussion. The SARB does not currently expect that smaller banks will make use of LAC instruments (personal communication, 2021) as it will be difficult for small banks to issue such instruments in the market, and rather rely on closed bail-ins. LAC instruments are still being developed and the pricing that they find in the market will be a key determinant of proportionality in the application of the resolution framework.

The SARB, with the assistance of the PA, will develop institution-specific resolution plans for all DRIs. These plans will set out the cheapest and least disruptive resolution strategy in the event of a crisis. The plans will be proportionate to the systemic significance of the bank. Its systemic importance depends on its size, complexity, interconnectedness, as well as the lack of readily available substitutes for the financial products, services or infrastructure it provides, and its global (cross-jurisdictional) activity and, in the context of resolution the likely impact of a disorderly failure of the financial institution on the financial system and the real economy. Smaller banks that are substantially savings banks may be largely resolvable within the deposit insurance framework, which in South Africa will cover the first R100,000 of each client's deposits. Larger banks will require more complex resolution plans as their assets and liabilities are more deeply exposed to the wider economy and financial system. Resolution planning therefore allows for a high level of proportionality with the complexity of the resolution plan directly related to the risk and complexity of the institution.

The resolution framework also provides for recovery plans (similar to living wills) which are compiled by the bank itself and approved by the board of directors. Recovery plans set out possible strategies that the bank can implement to recover from severe stress scenarios. The PA will ensure recovery plans are developed and adhere to sound minimum standards (see Directive 1 /2015) (Bank Supervision Department, 2015). Again, some degree of proportionality is built in as recovery plans must be consistent with the bank's risk profile, business model and complexity.

The resolution framework will also provide a safety net for vulnerable depositors in the form of a deposit insurance scheme. The scheme is one-size-fits-all and covers the first R100,000 of depositors' exposure. A risk-weighted premium for banks is not currently applied; the premium is a flat rate and equal for all banks. The risk-weighting of premiums will be reconsidered at a future time. To some extent, a deposit insurance scheme should be positive for small bank market entry as it immediately provides a risk guarantee for smaller depositors that does not currently exist.

The proposed framework takes proportionality considerations seriously. As it is developed and implemented, attention will need to be paid to ensuring this proportionality leads to appropriate outcomes in practice.

5. Conduct regulation

Conduct regulation is the second peak of South Africa's twin peaks architecture. Conduct regulation has lagged the development of prudential regulation for various reasons, but the restructuring of the Financial Services Board into the Financial Sector Conduct Authority (FSCA) and the development of the Conduct of Financial Institutions (COFI) bill mean that conduct regulation is now evolving to its envisaged end state. As of writing, this remains a work in progress, with the COFI bill providing a consolidated framework that cuts across the entire financial services sector.

COFI requires licensed financial institutions to have governance arrangements proportionate to the nature, size, scale and complexity of its conduct risks or business model and activities performed. The Bill also emphasises proportionality in consequential changes to the Financial Sector Regulation Act. For example, subsection 5A added to section 58 requires the FSCA to undertake its functions in a manner that is proportionate to the nature, size, scale or complexity of an institution's conduct risks, business model or activities performed. Also, when drafting conduct standards (section 106), FSCA may consider the nature, size, scale or complexity of the conduct risks or business model and activities performed by institutions (National Treasury, 2020).

This universal approach to all financial services providers prevents regulatory arbitrage and consistent conduct outcomes can be achieved across industry subsectors. However, this wide scope, from big banks through to sole-proprietor financial advisors, requires an outcomes- and principles-based approach. The intended outcomes are based on positive consumer experiences, including the six Treating Customers Fairly outcomes (FSCA, undated) augmented with further outcomes relevant to conduct for business clients.

The FSCA is developing frameworks to apply proportionality that will consider the size and risks of a business, with a graduated supervisory regime that balances the conduct risk against the level of supervisory intensity. Such a framework has been developed for insurers (FSCA, 2021). The approach will be "data driven" with data being used to identify the conduct risk profile of insurers – high, medium or low risk. If an insurer is assessed as high risk, it will be monitored more closely from a conduct perspective. Data to be collected includes type of insurer (traditional, cell captive, niche or commercial), distribution model (intermediated, direct or hybrid), outsourcing agreements (including binder agreements), quarterly conduct of business returns (CBRs), which include conduct risk indicators, on-site and thematic inspections and complaints (to insurer and ombuds). In addition, FSCA will hold meetings with insurers to observe their culture and with the PA to establish any areas of conduct-risk interest.

This indicates the general approach that can be expected to apply to banks too. A lighter version of return has been developed for co-op banks, for example, reflecting recognition by FSCA that the capacity of co-ops is limited and the risks are different to traditional banks. Traditional banks and mutual banks will have more detailed returns, with size in terms of assets and customers being a key indicator.

The outcomes focus means that the priority for the FSCA is to assess the effect on the customer, following the customer journey. Indicators are focused on whether the customer was treated fairly and on the culture of the entity. The returns for banks are still being drafted (FSCA, personal communication). In addition, FSCA will conduct onsite monitoring on a quarterly basis, and engagements based on a risk rating of the entity that looks at the type of customer, vulnerability of the customer, size of the entity, impact it would have on the customer and economy and how advanced the entity is in terms of digital applications. Business model features are also considered, including the number of outsourced partners which increases conduct risks, as well as the vulnerability and sophistication of customers. The FSCA is still in the process of developing the framework and categories of banks, but expects to divide banks into large, medium and small and then have thematic categories such as digital banks, where specific conduct risks arise.

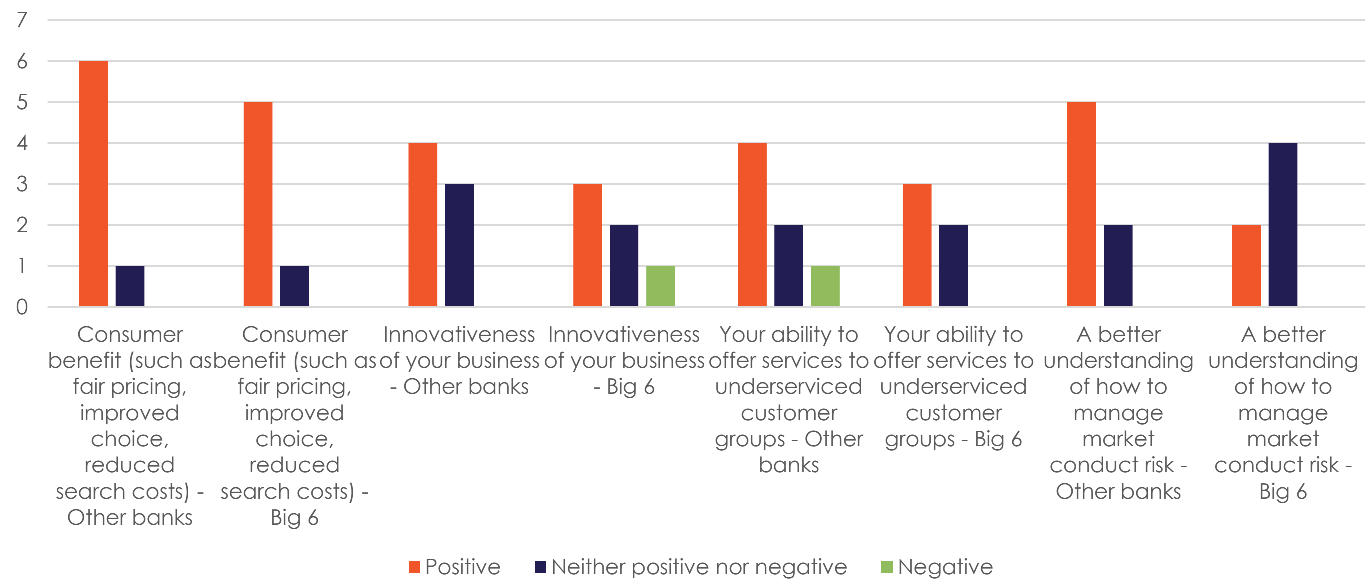
To date, banks have primarily faced conduct regulation incidentally through the Financial Advisors and Intermediary Services (FAIS) Act in that most banks will have a FAIS license, while also engaging with the FSCA TCF process over the last several years. The FSCA has also developed Conduct Standard 3 in terms of the FSR Act specifically for banks, as a forerunner to COFI. In the FSCA's responses to the comments to its conduct standard 3 of 2020, which is a conduct standard for banks under the Financial Sector Regulation Act (FSCA, 2020), it acknowledges that there may be additional costs incurred for banks to comply with the standard, however it believes the standard is flexible and principle-based enough to ensure that the requirements are adaptable to the complexity and size of the banks. FSCA believes that measures of cost need to be viewed considering the bigger interest of the customer.

Our research found that most banks in South Africa have not yet estimated the cost impact of the full implementation of COFI. Larger banks indicated that they do not foresee a significant cost impact from COFI over and above their existing conduct compliance. Smaller banks, however, are anticipating a variable cost impact in the range of up to R5m a year. This suggests that conduct regulation may have a larger proportional impact on smaller banks as full COFI implementation evolves.

Bank qualitative views on conduct regulation

There is generally a positive view on the benefits of conduct regulation as it has been implemented so far. Banks, both large and small, see it as providing consumer benefits and there is a balance of positive views regarding innovativeness, conduct risk and financial inclusion. This was fairly consistent between large and small banks.

Figure 12: Bank views on benefits of conduct compliance (TCF/COFI)



In our view, conduct regulation and supervision has not been a significant factor for banks from a proportionality perspective to date. However, this is likely to be tested as the new requirements of COFI come into full application. We anticipate that proportionality will become a more substantial issue in conduct regulation in future.

6. Integrity regulation

Integrity regulation aims to ensure the financial system is not used in criminal activities. South Africa is a signatory to the Financial Action Task Force (FATF) which leads global coordination of regulation to deal with anti-money laundering (AML) and combating the financing of terrorism (CFT). South Africa is largely a regulation taker in that compliance with FATF is important for the country to have access to the global financial system.

In 1990, FATF issued a set of 40 recommendations intended to combat money laundering. In 2001 it developed eight special recommendations to deal with terrorist financing, expanded to nine in 2004. In 2012 FATF reviewed its 40+9 recommendations and issued a stronger and clearer set of standards – the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation. FATF comprises 39 members, including South Africa, representing most financial centres across the world (FATF, 2021).

National discretion in FATF standards

Nominally, jurisdictions have discretion to implement FATF standards. However, FATF publicly lists countries with weak AML/CFT regimes. For countries identified as high risk, FATF calls on all members and urges all jurisdictions to apply enhanced due diligence and countermeasures to protect the international financial system from the ongoing money laundering and terrorist financing originating from the country (FATF, 2021). Countries that find themselves identified as high risk are essentially cut off from the international financial system. Therefore, while discretionary in theory, compliance with FATF is critical for countries that wish to participate in the international financial system.

During the research for this report, FATF released a mutual evaluation report on South Africa based on site visits conducted in 2019 (FATF, 2021). Among findings was that the risk-based approach as required under the FATF standard is inadequately implemented

Proportionality considerations

Scope for proportionality in FATF standards is embodied in its guidance on risk-based supervision (FATF, 2021) A risk-based approach is seen as less burdensome on lower-risk sectors or activities, which is essential if global financial inclusion objectives are to be achieved. Thus, FATF encourages supervisors to move from rules-based to risk-based supervision.

FATF's guidance to its risk-based approach (FATF, 2014) requires bank supervisors to understand the AML/CFT risks that the banking sector as well as individual banks (and/or banking groups) are exposed to. For individual banks, this requires an assessment of the exposure of the bank based on a number of characteristics. These are similar to the proportionality categories suggested by the FSB and Basel Committee (FATF's requirements are aligned to a number of the Basel Core Principles):

- Size
- Geographic location and countries of operation
- Business model and AML/CTF risk profile, which includes the nature and complexity of the bank's products and services associated with at least four business lines (compared to the eight business lines of the Basel Committee), namely retail banking, corporate and investment banking, investment services or wealth management and correspondent services. In addition, supervisors should consider the bank's financial and accounting information, delivery channels and customer profiles
- Corporate governance arrangements including control environment, risk management policies, internal audit oversight and fitness and propriety of management and compliance function.

To implement FATF's guidance on risk-based supervision in South Africa, the FIC Amendment Act was tabled in 2017. The Amendment Act incorporates a risk-based approach to the South African AML regulatory framework to compliance elements such as customer due diligence (KYC). The risk-based approach aims to be a more customer-friendly and less costly approach to implementing AML/CTF in line with the Treating Customers Fairly initiative.

In terms of the Financial Intelligence Centre Act (FICA), the PA is a supervisory body for banks and is thus responsible for the AML/CFT supervision of banks as accountable institutions. The PA applies a risk-based supervisory framework to identify, assess and understand money laundering and terrorist financing risks in the banking sector. The application of the risk-based approach to AML/CFT supervision means the PA changes the intensity and frequency of its supervisory interactions depending on the ML/TF risk profile of an accountable institution (FIC, 2017). Since 2014, the PA has imposed 25 administrative sanctions on banks ranging from a fine of R75m to a caution not to repeat the conduct which led to non-compliance (SARB, 2021) .

Bank qualitative views on integrity regulation

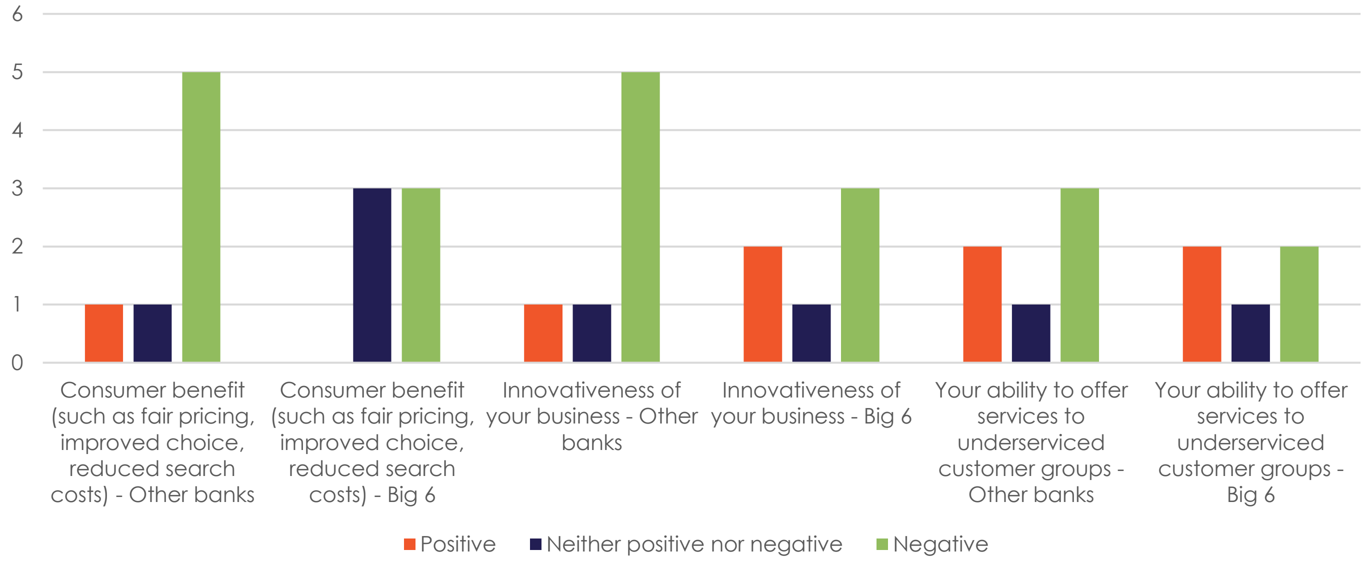
Integrity supervision in the form of know your client (KYC) and FICA was the most consistently negative area of feedback we received from banks in both interviews and survey responses. The costs of compliance with KYC/FICA mean there are additional costs incurred to service customer groups. As such, banks prefer to service customer groups where costs can be recouped without going higher up in the risk curve. This has financial inclusion consequences. Costs to service underserviced clients are high and the FICA process has become more onerous. While the risk-based approach adopted through the 2017 FICA amendments should mean a lighter burden in respect of low-risk clients, banks reported to us that the systems costs of introducing variation in processes for low-value clients were too high for the risk-based approach to have any practical impact, particularly for smaller banks. Banks also reported a lack of maturity, guidance and framework from a regulatory perspective when it comes to risk-rating of clients.

The cost of complying with AML requirements has been punitive, especially among smaller banks, and there was a universal feeling that the cost vs benefit balance is tilted inappropriately when it comes to AML. Banks feel costs to comply are high yet the system does not lead to any notable increase in successful prosecutions for criminal conduct and it therefore has no corresponding return in public benefit.

Banks also cited the onerous nature of AML reviews undertaken by the PA which can last six months and absorb considerable amounts of time. More than one interviewee said the management and resource drain of the reviews means that resources are taken off the primary task of monitoring transactions and systems in order to meet compliance requirements, which is counterproductive.

While the risk-based approach created by the 2017 amendments theoretically implies a level of proportionality in the application of AML regulations, feedback from institutions was that there was no corresponding proportionality in the assessment of risk presented by institutions themselves. Institutions suggested that factors like the tenor of client relationships, the depth of personal interaction with clients and the types of services provided give a good basis to determine whether a bank, overall, presents low or high AML risks, with supervision tailored proportionally. In our engagement with the PA, it was pointed out that a risk-based perspective on institutions was being developed, which may address this concern from the market.

Figure 13: Bank views on KYC/FICA/AML compliance



Based on input to the survey we conducted, banks view integrity regulation negatively, with smaller banks somewhat more negative than large banks. This finding was clearly supported in our interviews with banks. Those who provided positive feedback on the questionnaire explained that they saw the regulation as creating opportunity to innovate in managing the regulation, rather than that it supports the innovativeness of their businesses per se.

Over 50% of respondents felt that FICA/AML compliance had a negative impact on consumer benefit and innovation. In the follow-up interviews, there was a widely held view that the costs for complying with AML were disproportionate to the overall benefit to consumers as the system was not seen as being safer from a money laundering point of view. Several expressed frustration that despite the large investment in AML systems and reporting, it did not seem to lead to any investigations or prosecutions.

7. International comparisons

In this section we consider how other jurisdictions have applied proportionality in their regulations and supervisory approaches, particularly in respect of prudential regulation. As is clear, many have been concerned to ensure that they allow for proportional application to maximise the benefit of regulation and supervision.

In 2021 the World Bank and the Basel Consultative Group (BCG), the outreach arm of the Basel Committee (World Bank & BIS, 2021), undertook a joint global survey of 94 jurisdictions to understand proportionality practices in different jurisdictions. The survey defined proportionality as the implementation of a set of Basel Committee standards that is (a) limited or simplified, (b) more comprehensive or conservative or (c) a combination of limited and conservative. Implementation of locally developed standards is not considered to be a proportionate implementation as these standards are significantly different from the Basel Committee standards. (So, for example, South Africa's cooperative banks framework would not be considered an example of proportionality in a Basel context.) Interestingly, a jurisdiction's implementation of the standardised approaches in Basel 3 for all material risks was deemed to be full implementation.

Basel Committee standards include standards, guidance and sound practices or principles issued by the Basel Committee and the FSB including Basel I, Basel II, Basel III, leverage ratio, liquidity coverage ratio, net stable funding ratio, large exposures, interest rate risk in the banking book, prudential treatment of assets, corporate governance, and recovery and resolution planning.

We summarise the results as follows:

- Proportionate implementation is widespread (80%) and growing but challenging for many jurisdictions. The challenges include:
  - During the design phase: how to define the tiering criteria, how to maintain a level playing field and how to avoid opportunities for regulatory arbitrage;
  - After implementation: how to ensure financial positions are still comparable across banks and how to achieve net reduction in compliance costs and stress on supervisory resources.
- Respondents recognise that proportionality results in improved bank stability, reduced regulatory burden and compliance costs and effective use of scarce supervisory resources.
- Most respondents preferred the implementation of a limited set of standards (85%).
- Approximately 50% of jurisdictions with proportionate regulation adopted a tiered approach, that is, different sets of prudential regulatory and supervisory requirements simultaneously for different segments of regulated entities. For example, implementing the full Basel standards for one set of regulated entities and proportionate approaches and locally developed non-Basel standards for other sets of regulated entities. The tiering criteria used by such jurisdictions are systemic importance (89%); complexity or risk profile (87%); business model or permitted activities (74%); supervisory judgment (71%); market share (66%); and supervisory rating (53%).
- To ensure consistency in exercising supervisory judgment when allocating a regulated entity to a tiered segment, supervisors rely on experience, guiding principles (qualitative and quantitative), and quality assurance.
- Proportionate implementation at the level of individual standards differs: governance and large exposures at 25% of respondents, net stable funding ratio, SREP and ICAAP are used by less than 15% of respondents and other standards between 15% and 25%. Some of the standards have not been implemented by many jurisdictions. The reasons given for not implementing a given standard instead of implementing it in full or proportionately include complexity of standards, lack of flexibility (e.g., in the form of standardised or simplified approaches and national discretion), the absence of key pre-requisites for implementing the standards (e.g., lack of high-quality liquid assets for implementation of LCR), lack of adequate technical skills and resources in banks or supervisory authorities, a desire to avoid an increase in compliance costs, limited cross-border activity by banks in that jurisdiction, the presence of simple and non-complex banks or banking products, underdeveloped domestic financial markets and stability, and the resilience of the banks and banking system

In terms of the effectiveness of proportionality implementation the survey found that:

- Less than 25% of jurisdictions have self-assessed the effectiveness of their proportionality implementation ranging from 50% in South Asia to 11% in Americas and Middle East and Northern Africa
- Just 16% of surveyed institutions indicated that their implementation is either fully or adequately effective with 14% to 16% effectiveness at the level of individual standards, except the leverage ratio, NSFR and IRBB, which 5% to 7% of respondents said was effective.

Most participants implementing or planning to implement proportionality indicated their work would be enhanced by global guiding principles, case studies of effective implementation, support of external experts and post-implementation reviews and assessments.

A prior survey In February 2018 conducted by the Basel Committee (BCBS, 2019) of 45 jurisdictions (24 from the Basel Committee and 21 from non-member countries) attempted to find out whether jurisdictions applied proportionality as part of their regulatory framework. The survey focused on:

- The approaches taken to establish the segments or thresholds of banks subject to different proportional requirements
- The regulatory and supervisory requirements across these segments

- The challenges and obstacles encountered with proportionality practices

The survey found that most respondents apply proportionality measures. Generally, such measures are applied to banks that represent a relatively small share of total banking assets.

Jurisdictions rely on several determinants in identifying proportionality thresholds / segments. These include balance sheet metrics and banks' business models. In most cases, supervisory judgment is a further dimension to determine which banks should be subject to different requirements.

Most jurisdictions apply some form of proportionality related to capital and liquidity requirements, generally through amended or simpler versions of Basel standards, particularly for more complex risk categories, or an exemption from such requirements for certain banks. Jurisdictions similarly apply proportionate reporting and disclosure requirements, mainly less onerous reporting obligations and submission frequencies. Most jurisdictions apply a proportionate approach to supervisory practices such as less intense on- and off-site examinations, risk management controls and governance requirements, and supervisory stress tests.

Challenges relating to the proportionality of frameworks include:

- Balancing the benefits of tailoring requirements for different types of banks and the preserving of comparability in banks' regulatory information and ratios;
- Balancing the appropriate differentiation of requirements to reflect the diversity of banks without introducing competitive inequalities e.g., capital neutral simpler approaches for smaller banks is not always possible in practice;
- Determining appropriate contributing factors e.g., quantitative and qualitative measures for proportionality tiers or categories of banks;
- Ensuring banks do not arbitrage proportionality thresholds / segments to benefit from less onerous regulatory and supervisory requirements;
- Supervisors keeping track of changes in banks' risk profiles and business activities.

In a 2021 discussion paper on a proportional prudential framework, the Bank of England's Prudential Regulatory Authority (BoE Prudential Regulatory Authority, 2021) analysed the prudential regulation of smaller banks in other jurisdictions. It determined the main characteristics used to identify banks subjecte to proportional prudential requirements as well as what those simpler requirements are (shown Table 5 and Table 6).

Table 5: Determinants for simpler prudential requirements applied to banks

	Scope metrics	Graduated regime
Australia	• Total assets; trading activities • Level of non-centrally cleared derivative exposures • Provision of purchased payment facilities; offshore funding	No
Canada	• Total assets • Total loans	Yes
Switzerland	• Total assets; assets under management • Privileged deposits	No
United States	• Total assets; off balance sheet exposure • Short-term wholesale funding • Cross-jurisdictional activity; non-bank assets	Yes

Table 6: Simpler prudential requirements

	Capital	Liquidity	Disclosure/reporting	Risk management control
Australia	• Simplified capital requirements for operational risk; flat rate capital add-on of 10% of RWAs • Exemption from capital requirements for counterparty credit risk • Exemption from a leverage ratio requirement		• Reduced disclosure requirement	
Canada	• A gradually simplifying approach for calculating capital requirements for credit risk and operational risk approaches • Smallest banks subject to a simplified risk-based total regulatory capital requirement of 10.5%	• Smallest banks exempted from the LCR and NSFR but subject to a simpler liquidity requirement		
Switzerland	• Exemption from risk-weighted capital requirements • No capital buffer and sectoral countercyclical capital buffer requirements • Simplified leverage ratio of at least 8%	• Average (12 month) LCR of at least 110% • Exemption from NSFR	• Reduced disclosure obligations	• Reduced risk control requirements • Lower frequency of comprehensive risk assessment by internal audit
United States	• A gradually simplifying risk-based capital requirement • Exemption from the countercyclical capital buffer requirements • Smallest banks subject to a leverage ratio of	• Gradual introduction and increase in the LCR and NSFR		• Reduced frequency of company-run and supervisory testing

	9% and exempted from other capital requirements.	

EU

Proportionality as a general principle of EU law (EBA Banking Stakeholder Group, 2015) was first developed by the European Court of Justice and requires:

- Suitability in that the regulation does not exceed what is appropriate and necessary to achieve the objectives aspired to;
- Necessity in that there is a lack of less intrusive alternatives i.e., in the event of a choice between several appropriate measures, recourse is to the least onerous alternative;
- Proportionality in the strict sense is that the disadvantages caused must not be disproportionate to the objectives i.e., proportionality should balance aims and disadvantages.

The EU's Capital Requirements Regulation and Directive (CRR/CRD IV) recognises the principle of proportionality (FSI , 2017) in that it provides for smaller, less risky institutions i.e., regulatory requirements are commensurate with the bank's business model and riskiness (e.g., in terms of size, complexity, cross-border activity and interconnectedness):

- the calculation of capital ratios makes an exemption for banks with a small trading book business never exceeding 6% of total assets and €20m;
- the supervisory reporting framework alleviates the reporting burden on smaller banks by requiring a more limited set of templates to be reported and at less frequent intervals.

The European Banking Authority undertook a study in 2021 (EBA, 2021) to determine the costs (see Table 7) and challenges faced by small and non-complex institutions with supervisory reporting requirements and processes.

Table 7: EBA supervisory reporting cost as a proportion (%) of the total compliance cost for a sample of institutions (average 2018 -2020)

	Number of banks	**Average**	**Median**	**Min**	**Max**
Small and non-complex institutions	91	38.38%	36.88%	3.14%	83.27%
Medium	28	25.53%	17.04%	4.30%	66.53%
Large	26	23.72%	17.54%	3.52%	68.46%
All institutions	145	33.48%	29.82%	3.14%	83.27%

The challenges faced by banks regarding supervisory reporting arrangements were summarised as:

- Complexity of reporting requirements,
- The voluminous amount of information to be reported,
- Internal data extraction and calculations, and
- Stability of the supervisory reporting framework.

The report sets out 25 recommendations to further improve proportionality in supervisory reporting requirements and reporting processes. The EBA is targeting a cost reduction of 10% to 20% in supervisory reporting costs at least for small and non-complex institutions (SNCI). The recommendations address:

- Improvements to supervisory reporting requirements in respect of liquidity and NSFR, large exposures, leverage ratio, group and consolidated reporting, asset encumbrance;
- Improvements to the supervisory reporting process including better explanations, more examples, clearer instructions and greater stability in requirements with longer implementation periods for changes;
- Increased use of technology; and
- Coordination and integration of data requests and reporting requirements.

UK

The Bank of England has sought comment on measures to simplify the prudential regulatory framework for smaller, non-systemic banks and building societies (BoE Prudential Regulatory Authority, 2021). The PRA says that smaller banks and building societies face prudential regulatory requirements and expectations that are overly complex given what is needed to ensure their safety and soundness. This complexity may negatively affect their costs and operational resilience and thus competition in the UK banking sector.

The Bank's proposed strong and simple prudential framework would apply to firms that are:

- Not systemically important
- Not internationally active
- Not involved in trading activities
- Not approved to execute an internal model for capital requirements.

The PRA is considering two approaches to implement its strong and simple prudential framework: streamlined and focused. Table 8 summarises them:

Table 8: Summary of streamlined and focused approaches

	Possible "focused" approach	Possible "streamlined" approach
Capital	• A single capital requirement • No buffer requirement, or a single buffer set at the same level for all firms	• Simpler versions of current Pillar 1 and Pillar 2A risk-weighted capital requirements • Single buffer requirement set on a firm-by-firm basis
Liquidity	• A single liquidity requirement	• Simpler versions of current liquidity requirements
Other key requirements (e.g. on governance)	• Unlikely to vary according to approach	

Switzerland

The Swiss banking industry is divided into five supervisory categories which facilitates proportionality in its supervision (IMF, 2019).

- Category 1 comprises the two large and complex Swiss G-SIBs (Credit Suisse and UBS) that represent 52% of Swiss market share in terms of deposits. Their total global assets represent 260% of Swiss GDP;
- Category 2 comprises three banks designated as D-SIBs (Raiffeisen Swiss cooperative bank, Zurich Cantonal Bank, and PostFinance) that operate almost exclusively on activities within Switzerland. Their total assets are about 80% of Swiss GDP;

- Category 3 consists of 24 middle-size cantonal banks and larger regional commercial banks that although significant, are not individually systemically important;
- Categories 4 and 5 comprise 259 small regional banks that focus on traditional retail activities such as mortgage financing and private banking and wealth management activities.

The commitment of FINMA, Switzerland's banking supervisor, to proportionality is demonstrated by its intensive supervision of G-SIBs and D-SIBs relative to smaller banks. In 2020 a regulatory regime for small banks (category 4 and 5) was introduced with an easy-to-compute leverage ratio (broadly comparable to the Basel 3 leverage ratio) of at least 8%, a liquidity buffer of 20% over and above the 100% LCR Basel 3 requirements and reduced regulatory audit frequency from annual to every two or three years on request. Other planned relief measures to be implemented include:

- Simplified capital planning requirements in respect of stress testing and key supporting risk measurement, management and control practices;
- The Basel 3 NSFR not implemented;
- Focused simplifications in corporate governance, outsourcing and operational risk management requirements; and
- No regulatory disclosures beyond publication of a few key metrics.

8. Conclusions

South Africa has incorporated proportionality widely in financial sector regulation and supervision. The legislative instruments in place all support proportionality considerations and secondary regulations largely encode these successfully. The scope for more appropriate proportionality in practice exists in the detail of supervision practices and regulation. The recommendations we have made in this report will, we believe, lead to improvements in the overall public benefit that regulation offers in South Africa by improving the ability particularly of smaller banks to compete.

We also, however, make more profound recommendations that would require legislative change, particularly to implement a two-tier market structure for mainstream banks. South Africa, like many other mature banking markets that have fully complied with Basel developments, needs to reckon with the proportionality impact of the significant evolution of prudential regulation in the past decade. It is increasingly clear worldwide that a one-size fits all approach to regulated banks means a blunt approach to the application particularly of prudential requirements from both micro and macro perspectives. A two-tiered approach can allow for a nuanced proportional application of prudential requirements, both at the level of capital and liquidity, and in the various practices of supervision. Such an approach can have the important public benefits that proportionality should provide: making entry into the market easier and allowing for greater innovation and competition in the banking sector. It can also facilitate financial inclusion particularly of lower income groups, who are often underserviced because the regulatory and compliance costs to do so are too high.

Such changes to the structure of the South African market may take years to develop. To some extent, the ground has already been covered in previous market development ranging from the Dedicated Banks Bill to more recent analysis of the scope for specific regimes for digital banks or narrow banks. A purpose-designed second tier could be fine-tuned to make entry easier with a scale up of supervision intensity as banks grow and become more risky. It could fine tune supervision for specific operating models, particularly digital banks with no physical architecture. Such second-tier banks could be limited in the risks they take, facing no market risk, for example, and limited in geographic exposures and the complexity of products. Such restrictions would ensure that the market is appropriately tiered, with larger complex banks able to develop wider business models with appropriate returns, commensurate with the risks and supervisory intensity they would face.

The set of recommendations we make outside of market structure, however, would be more straightforward to implement. They exist at the level of regulation and practice rather than laws. And no point should these proposed changes introduce heightened risks for the sector, one which has so ably demonstrated its resilience through the Covid crisis. An improvement in proportionality must occur while the risk of the system are appropriately managed.

The existing supervisory approach is in a state of development in several respects. The bank resolution regime that will introduce deposit insurance is soon to be implemented and will be positive for competitiveness in the market by reducing the perceived risks of small banks. Conduct regulation is another significant area of development that may bring a range of proportionality issues into the system as it evolves toward its envisaged end state. In these, as well as evolving approaches to macroprudential supervision, the balance between regulation and benefit must be constantly maintained. We expect, therefore, that proportionality issues will remain important in the overall debate on regulation, although not to the extent occasioned by the rapid evolution of microprudential regulation since the financial crisis. We trust that this report will support a reckoning by policymakers, regulators, and the industry with this rapid evolution, to recalibrate regulation to optimise the overall public benefit.

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