GOVERNMENT NOTICE NO. 56

FINANCIAL SERVICES ACT

(CAP 44:05)

FINANCIAL SERVICES (CONSOLIDATED SUPERVISION OF BANKS) DIRECTIVE, 2018

ARRANGEMENT OF PARAGRAPHS

PARAGRAPH

PART I—PRELIMINARY

1. Citation
2. Interpretation

PART II—OBJECTIVES

3. Objectives

PART III—REGULATORY REQUIREMENTS

4. Board oversight
5. Reporting requirements
6. Consolidated financial statements
7. Capital requirements
8. Bank holding company not to engage in excessive leveraging
9. Double and multiple gearing practices
10. Single borrowers and large exposure limits
11. Intra-group transactions and exposures
12. Liquidity requirements
13. Group restructuring
14. Examination of banking group
15. Risk management processes
16. Corporate governance
17. Fit and proper requirements

PART IV—ENFORCEMENT

18. Monetary penalties
19. Administrative penalties

IN EXERCISE of the powers conferred by section 34 of the Financial Services Act, I, DR. DALITSO KABAMBE, Registrar of Financial Institutions, make the following Directive—

PART I—PRELIMINARY

Citation

1. This Directive may be cited as the Financial Services (Consolidated Supervision of Banks) Directive, 2018.

Interpretation

2. In this Directive, unless the context otherwise requires—

"associate" has the meaning ascribed to that term in section 2(1) of the Act;

"affiliate" means any entity, corporate or unincorporated where 5 % or more of any class of its voting shares or other voting participation is directly or indirectly owned or controlled by that financial institution or is held by the financial institution with power to vote;

"bank holding company" means a body corporate that owns or controls at least two financial institutions one of which is a bank, being

its subsidiaries or significant minority investment or interest;

"banking group" means a group of two or more companies, one of which is a bank domiciled in Malawi where the holding company is either a bank, financial institution or a non-financial company;

"consolidated supervision" means an overall evaluation both qualitative and quantitative aspects of a bank and the banking group to which the bank belongs, taking into account the risks which may affect entities within the group, regardless of whether these risks are carried in the books of the bank or related entities within the group;

"consolidation" means a process of adjusting and combining financial statements of a parent entity, its subsidiaries and affiliates to produce regulatory consolidated financial statements prepared in accordance with the regulatory reporting standards;

"control" has the meaning ascribed to it in International Accounting Standards and includes the power to govern the financial and operating policies of an entity to obtain benefits from its activities. The existence of control is generally evidenced by either of the following—

(*a*) direct or indirect ownership of more than 50% of voting power;

(*b*) power over more than 50% of voting rights or power to cast the majority votes at meetings of the board of directors or shareholders;

(*c*) power to govern the financial and operating policies of the entity; and

(*d*) power to appoint or remove the majority of the members of the board of directors;

"(50/50) deduction approach" means an approach whereby capital is reduced by 50% from core capital (tier 1) and 50% from supplement capital (tier 2);

"double gearing" occurs whenever one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet, in that situation, capital of the group is geared up twice; first by the issuer, and then a second time by the dependent;

"encumbered assets" means property owned by the banking group but subject to the legal claims of another party;

"financial institution" has the same meaning ascribed to that term in the Act;

"group capital" means the aggregate capital of the consolidated entities in a banking group subject to adjustments as set out in this Directive;

"intra-group transactions and exposures (ITEs)" means transactions between entities in the same banking group which must be removed from

the regulatory consolidated accounts, so as not to inflate the net income or capital of the parent entity and other entities within the group;

"lending of a capital nature" means long term loans with a maturity period of more than one year and subordinated loans;

"minority interest" means that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not controlled, directly or indirectly through subsidiaries, by the parent entity;

"parent entity" means an entity that has majority ownership or control of another entity (subsidiary) or exercises a dominant influence over another entity;

"reciprocal investments" means a crossholding of capital between a bank or bank holding company and any other entity;

"related party" has the same meaning ascribed to that term in the Cap. 44:01 Banking Act ;

"significant minority investment or interest" means any ownership interest of at least 20% but less than 50% of the voting rights or capital held by the reporting bank or bank holding company in the relevant entity;

PART II—OBJECTIVES

Objectives

3. The objectives of this Directive are to—

(*a*) provide for the scope and methodology for consolidated supervision of banks;

(*b*) facilitate the understanding of a banking group, so as to enable the Registrar to fully and effectively evaluate the structure, business and risks of the entire group, its affiliates, associates and subsidiaries;

(*c*) provide for prudential limits and standards for banks and bank holding companies on a consolidated basis;

(*d*) provide reporting requirements for financial institutions and entities within banking groups; and

(*e*) enable the Registrar to provide oversight over financial institutions that conduct part of their business through the unregulated entities in a banking group whose activities have the potential to affect the principal objectives of supervision of financial institutions as set out Cap. 44:05 in section 3 of the Act;

PART III—REGULATORY REQUIREMENTS OF CONSOLIDATED SUPERVISION

Board oversight

4. The Board of a bank holding company shall be responsible for—

(*a*) ensuring that policies are in place for the business of the bank holding company, its subsidiaries and affiliates;

(*b*) supervising all activities engaged in by entities within a banking group;

(*c*) ensuring existence of clear organizational structures, management reporting lines, internal information systems and controls appropriate to its size, complexity and risk profile;

(*d*) establishing robust risk management system over all entities in the banking group; and

(*e*) ensuring that the bank maintains a separate corporate and functional existence from its affiliates.

Reporting requirements

5.—(1) A bank holding company shall submit to the Registrar, qualitative information as set out in the First Schedule hereto, as at 31st December of each year for all entities within the banking group, not later than the 31st January of the following year.

(2) A bank holding company shall submit to the Registrar, consolidated returns containing the following quantitative information not later than 30 days after the end of each quarter—

(*a*) statement of financial position;

(*b*) statement of comprehensive income;

(*c*) capital adequacy ratios;

(*d*) credit concentration;

(*e*) related party transactions; and

(*f*) such other prudential requirements as may be specified by the Registrar.

(3) In addition to the reporting requirements specified in this paragraph, the Registrar may request the bank holding company in writing, to submit any additional information that may be required from the bank holding company and any entities within the banking group, in order to satisfy himself that the operations and affairs of such entities are not detrimental to the objectives of supervision of financial institutions as set out in the Act. Cap. 44: 05

(4) The Registrar shall specify the reporting format, frequency, submission dates for the additional information in subparagraph (3).

(5) Notwithstanding the consolidated reporting requirements set out in this paragraph, a bank that is part of the banking group shall submit returns and other information to the Registrar in accordance with the Financial Services (Submission of Information by Banks) Directive, 2018.

Consolidated financial statements

6.—(1) A bank or a bank holding company with more than 50% ownership investment in a financial entity shall, based on the requirements set out in the regulatory reporting framework returns, fully consolidate all financial subsidiaries unless specifically otherwise provided for in this Directive:

Provided that the following entities shall be excluded from consolidation—

(*a*) dormant companies;

(*b*) companies acquired in settlement of a debt;

(*c*) entities whose individual or aggregate assets that are not more than 1% of assets of the parent company; and

(*d*) insurance companies.

(2) A bank or bank holding company which has a significant minority ownership investment, of at least 20% and less than 50% in a financial entity, but does not exercise control, shall apply *pro-rata* or proportionate consolidation.

(3) A bank or bank holding company shall use a deduction approach for investments in financial entities below 20%.

(4) Investments in non-bank financial entities below 20%of the voting rights or capital held by the reporting bank or bank holding company in the relevant entity shall not be consolidated. The investments shall be risk-weighted using the relevant risk-weights.

(5) For significant investments in commercial entities which exceed certain materiality levels, the amount to be deducted shall be that portion of the investment that exceeds the materiality levels and shall be applied as follows—

(*a*) the excess amount of capital shall be deducted if the investments exceed a materiality level of 10% of the bank or bank holding company's capital on an individual basis; and

(*b*) the excess amount of capital shall be deducted if the aggregate amount of all investments of 10% or more of the concerned bank or bank holding company exceeds the 60% threshold of the bank or bank holding company's capital.

(6) Investments in commercial entities below the materiality levels stipulated above shall be risk weighted using the applicable weights.

(7) The regulatory consolidation techniques to be used shall be as set out in the Second Schedule hereto.

(8) The consolidation technique to be used in subparagraph (7) shall be based on the percentage of ownership or control and type of business.

(9) Ownership or control in insurance companies shall be calculated using the deduction approach due to dissimilarity with banks.

Capital requirements

7.—(1) A bank holding company shall—

(*a*) have in place a Board approved policy on banking group capital adequacy to ensure that the banking group is adequately capitalized to cover risks that it faces, as well as to meet regulatory, market and strategic needs; and

(*b*) upon request, provide the Registrar with a copy of its Board approved policy with regard to group capital adequacy, including the methodology used to measure group capital adequacy.

(2) The minimum capital of a bank holding company shall not, on a

consolidated basis, be less than the total regulatory capital requirements for entities within the banking group.

(3) A bank holding company shall, on a consolidated basis, also comply with a minimum core capital (tier 1) and total capital ratios as prescribed in the Financial Services (Capital Adequacy for Banks) Directive, 2018 or such higher ratios as may be determined by the Registrar.

(4) A bank holding company shall ensure that the capital of any regulated entity within the banking group does not at any time amount to less than the prescribed regulatory capital requirements for the regulated entity.

(5) (*a*) An unregulated entity within a banking group shall be subject to a proxy capital requirement provided that the unregulated entity shall not comply with the capital adequacy requirement on an individual basis.

(*b*) The requirement shall be for the purposes of calculating regulatory capital requirements on a consolidated basis.

(6) The qualifying capital for an unregulated entity shall—

(*a*) comprise only of core capital (tier 1) elements;

(*b*) a be calculated using the following formula—

(*Total assets of unregulated entity + off-balance sheet activities*) - *exposures to group entities*) x10

100; and

(*c*) the results from the calculation be compared with the core capital (tier 1) of a regulated entity.

(7) In calculating the consolidated amount of qualifying capital, a bank holding company shall deduct from its consolidated capital and reserve funds the following—

(*a*) goodwill;

(*b*) investments in significant minority owned financial entities;

(*c*) investments in commercial entities exceeding materiality levels;

(*d*) reciprocal investments;

(*e*) intra-group holdings of shares among consolidated entities; and

(*f*) non-performing loans to related entities within the group.

(8) Deduction of Investments shall be treated as follows—

(*a*) where deductions of investments are made as set out in paragraph 7 (7), the deductions shall be 50% from core capital (tier 1) and 50% from supplementary capital (tier 2) (50/50 approach), unless specified otherwise in this Directive;

(*b*) if the amount deductible from supplementary capital (tier 2) exceeds the consolidated group's actual supplementary capital (tier 2), the group shall deduct the shortfall amount (balance) from core capital (tier 1); and

(*c*) The qualifying amount of supplementary capital (tier 2) shall be limited to hundred 100% of core capita (tier 1).

(9) A bank holding company shall—

(*a*) ensure that entities which are not consolidated, and for which capital investments are deducted, are themselves adequately capitalized to reduce the possibility of future potential losses to the banking group and the bank; and

(*b*) deduct any shortfalls in the capital for such entities from the group's total consolidated capital.

(10) The amount of shortfall to be deducted from the group consolidated capital shall be proportionate to the bank holding company's equity stake in such unconsolidated entities:

Provided that where the bank holding company has control over the entity, a *pro rata* attribution of any deficit may understate a parent's de facto responsibility to provide additional capital and in that regard any solo deficits in such dependants shall be attributed in full.

(11) A bank holding company shall, in the case of any minority interest arising from the consolidation, include in its consolidated group capital such percentage of or amount relating to the said minority interest subject to—

(*a*) the ability to absorb losses; and

(*b*) the availability of the amount arising from the minority interest to the bank holding company and the members of the relevant banking group.

(12) Where the conditions in subparagraph (11) (*a*) and (*b*) are not met, then the capital shall not be eligible for inclusion in the group's consolidated capital.

(13) Any shortfalls in the regulatory capital of the regulated consolidated financial entities shall be deducted from the group's total consolidated capital.

(14) The following shall also be deducted from the group's total consolidated capital—

(*a*) lending of a capital nature to subsidiaries and significant minority investment.;

(*b*) encumbered assets; and

(*c*) the portion of unsecured loans and advances in excess of prudential limits such as single borrowers,large exposures limit and related party lending limit.

(15) When the Registrar determines that a bank or bank holding company has insufficient capital arising from its group relationships, the Registrar shall direct the bank or bank holding company to increase its capital above the minimum requirements to a level that the Registrar may determine.

Bank holding company not to engage in excessive leveraging

8.—(1) Where a bank holding company issues debt to fund equity capital in banking subsidiaries (double leveraging), the bank holding company shall not exert excessive financial pressure on its subsidiary bank by any method including—

(*a*) payment of excessive dividends. For the purposes of this Directive, excessive dividend payment shall occur when such payment will—

(i) impact the ability of the bank or bank holding company to maintain adequate capital or to support its business expansion; or

(ii) exceed current audited profits;

(*b*) pressure subsidiary banks to invest in high risk assets to increase asset yields;

(*c*) urchase or trade its high quality assets for the other affiliate's lower quality assets;

(*d*) purchase of unnecessary services from affiliates; and

(*e*) payment of unjustifiable management or other fees to related entities.

Cap. 44: 01

(2) The provisions of section 12 of the Banking Act on restriction of dividends, shall apply *mutatis mutandis* to a bank holding company with respect to dividends from a bank.

Double and multiple gearing practices

9. A bank holding company shall not engage in double or multiple gearing. Shareholdings in subsidiaries or associates shall therefore be deducted to avoid double counting of capital.

Single borrowers and large exposure limits

10.—(1) A bank holding company's maximum exposure to a single person shall not exceed 10% of its core capital.

(2) A bank holding company's maximum exposure to a group of related persons shall not exceed 25% of its core capital.

(3) In addition, the limit on large exposures in relation to the consoli-dated group's core capital shall be limited to a maximum of 400%.

(4) A bank holding company shall report to the Registrar all large exposures of 10% and above in line with the reporting requirements specified under the Financial Services (Large Exposures and Concentration Limits for Banks) Directive, 2014.

Intra-group transactions and exposures

11.—(1) The Board and senior management of a bank or bank holding company shall have an adequate understanding of the incurred risks and any subsequent changes in the risk profile due to an intra-group transaction or exposure.

(2) A bank holding company shall have in place Board approved policies and risk management processes and procedures relating to intra-group transactions or exposures and these policies shall—

(*a*) duly address matters set out in Third Schedule;

(*b*) ensure that intra-group transactions or exposures are duly documented, reported and accounted for;

(*c*) ensure that intra-group transactions or exposures are subject to appropriate oversight by the Board and senior management of the relevant bank or bank holding company; and

(*d*) ensure adequate control in respect of any transfer mechanism adopted within the relevant banking group, including any transfer mechanism relating to capital, funding, risk or income.

(3) A bank holding company shall report to the Registrar all intra-group transactions and exposures within the group of equal to or more than 5% of the total amount of consolidated group capital.

(4) When the Registrar is of the opinion that the bank holding company's board approved policies, processes, procedures and systems relating to intra-group transactions or exposures are inadequate, the Registrar shall—

(*a*) require the bank holding company to deduct from its capital the amount relating to such transactions or exposure as may be specified in writing by the Registrar;

(*b*) require the bank or bank holding company to obtain adequate collateral in respect of the relevant exposure; and

(*c*) specify limits in respect of intra-group transactions or exposures, as considered appropriate by the Registrar.

Liquidity requirements

12.—(1) A bank holding company shall comply with the liquidity requirements prescribed by the Financial Services (Prudential Liquidity Requirements for Banks) Directive, 2018.

(2) A bank holding company shall design an adequate contingency liquidity plan for its consolidated position and for each prudentially regulated entity in the group.

(3) The Board of a bank holding company shall exercise adequate oversight over liquidity issues of the group.

Group restructuring

13.—(1) A bank holding company shall establish ownership and management corporate structures that are transparent and which do not hinder effective banking supervision or endanger the stability of the banking sector.

(2) The Registrar may require any banking group to amend its existing organizational structure if the Registrar considers that the structure may hinder effective consolidated supervision.

(3) A structure may be considered to hinder the conduct of effective consolidated supervision if the structure impairs or may impair the Registrar's capacity to access information or determine the nature and extent of any relationships or transaction with the bank that may impact on the bank's safety and soundness.

(4) A bank holding company shall not restructure regulated institutions within a banking group without the prior written approval of the Registrar.

(5) The Registrar shall ring fence the operations of a bank where the Registrar determines that there is inadequate access to information about material parts of a banking group. The ring fencing may involve limiting or prohibiting transactions of the bank with other members of the banking group and its related entities, and *vice-versa*.

(6) A bank holding company shall seek approval from the Registrar prior to the acquisition, disposal or closure of a subsidiary or of any interest in any other undertaking.

Examination of banking group
Cap. 44: 01

14.—(1) Pursuant to section 14 (2) of the Banking Act, the Registrar shall conduct examinations of a banking group on a consolidated basis.

(2) Where applicable, the examination may be carried out in coordination with the relevant authority or body which exercises supervision or regulation over such affiliates, associates, or subsidiary companies.

Risk management processes

15. A bank holding company shall comply with the guidelines on risk management issued by the Registrar.

Corporate governance

16. A bank holding company shall comply with the corporate governance guidelines issued by the Registrar.

Fit and proper requirements

17. A bank holding company shall comply with the Financial Services (Fit and Proper Requirements for Directors, Shareholders, and Senior Management Officials of Banks) Directive, 2018.

PART IV—ENFORCEMENT

Monetary penalties

18.—(1) The Registrar shall impose the following monetary penalties for violations of this Directive—

(*a*) for regulated institutions that are members of a banking group, up to K50,000,000; and

(*b*) for a natural person who is a member of the Board, senior management or shareholders in regulated institutions within a banking group, up to K10,000,000

(2) With respect to banks, the Registrar shall—

(*a*) debit the penalty in subparagraph (1) (*a*) from the main account of the bank maintained at the Reserve Bank of Malawi; and

(*b*) notify the bank in writing prior to debiting the account.

(3) With respect to any person who does not maintain an account with the Reserve Bank of Malawi, the person concerned shall pay the penalty through a bank certified cheque or electronic transfer payable to the Reserve Bank of Malawi within ten working days after being notified by the Registrar.

Administrative penalties
Cap. 44: 01

19. In addition to the monetary penalties imposed in paragraph 18 (1), the Registrar may impose directions, administrative penalties and enforcement actions as provided for under the Act and the Banking Act.

FIRST SCHEDULE (para. 5 (1))

INFORMATION REQUIREMENTS

A bank holding company shall submit to the Registrar the following qualitative information—

(*a*) chart or series of charts which shows the relationship among the group entities and the extent of outside shareholders' interests;

(*b*) chart of the group management structure which clearly indicates the way in which group senior management responsibilities (including the names and job titles) are allocated;

(*c*) brief outline of the nature of each of the above mentioned entities business, types of products or range of services being offered and locations of principal places of business;

(*d*) list of shareholders, directors and officers of each of such entities or bank holding company;

(*e*) name and contact details of the authority or body responsible for regulation and supervision of each of such entities or bank holding company if any; and

(*f*) name and contact details of the external auditors for each of such entities or bank holding company.

SECOND SCHEDULE (para. 6 (7))

CONSOLIDATION TECHNIQUES

A bank or a bank holding company shall use the following techniques—

(1) Full Consolidation

In the regulatory consolidated returns of the relevant reporting bank or bank holding company, line by line all the relevant assets and liabilities of the entity should be consolidated.

(2) *Pro-rata* orProportionate Consolidation

In the regulatory consolidated returns of the relevant reporting bank or bank holding company, only the relevant shares of the assets and liabilities of the entity in which the bank or bank holding company and any of its related person can be included. It reflects the fact that the bank or bank holding company has an interest in an entity in which a significant shareholder other than the bank or bank holding company has the means and will to provide parental support and also has participation.

(3) Deduction Approach

(*a*) The assets of an entity are not fully or pro-rata consolidated with the risk-weighted exposure amount of a bank or bank holding company in accordance with the relevant requirements set out in this Directive, but instead as a minimum, the amounts specified below are deducted from the capital of the reporting bank or bank holding company—

(i) in the case of a majority owned or controlled entity, the investment by the bank or bank holding company in the equity or other regulatory capital instruments of the relevant entity, plus any shortfall in the capital requirement of the entity,

calculated in accordance with the rules and regulations of the relevant supervisor responsible for the supervision of the entity; and

(ii) in the case of a significant minority owned or controlled financial entity, the investment by the bank or bank holding company in the equity or other regulatory capital instrument of the relevant entityand

(*b*) The investments referred to under (3) (*a*) (i) and (ii) are recorded using the equity basis of accounting and are risk-weighted at 0%.

MATRIX SHOWING TREATMENT OF ENTITIES IN BANKING GROUP

	Financial Institution	*Non- Financial Company*	*Insurance Company*
Above 50% Control	Full consolidation	Deduct investment amount above materiality levels : Risk weight amount below the materiality levels	Deduction approach
20% to 50%	*Pro-rata* consolidation	Deduct amount above materiality levels: Risk weight amount below materiality levels	Deduction approach
Below 20%	Deduct and weight as risk asset	Deduct amount above materiality levels: Risk weight amount below materiality levels	Deduction approach

THIRD SCHEDULE (para. 11 (2)(*a*))

INFORMATION REQUIREMENTS FOR POLICIES AND RISK MANAGEMENT PROCESSES AND PROCEDURES RELATING TO INTRA-GROUP TRANSACTIONS OR EXPOSURES

(*a*) cross -shareholding;

(*b*) trading activities in terms of which one entity within the banking group deals with or on behalf of another member of the banking group;

(*c*) central management function in respect of the liquidity structure or requirements within the relevant banking group;

(*d*) guarantees, loans or commitments provided to or received from any entity within the banking group;

(*e*) material exposure exceeding 5% of the banking institution's capital to a major shareholder of the banking institution or bank holding company, including any guarantee, loan or commitment;

(*f*) provision of services or support functions, such as internal audit or back office services, provided to or received from any entity within the banking group;

(*g*) exposure arising from the placement of funds or assets of clients with any other entity within the banking group;

(*h*) purchase or sale of assets between entities within the banking group;

(*i*) risk transfers between entities within the banking group, such as reinsurance or securitisations; and

(*j*) relevant risk arising from double or multiple gearing of funds.

Made this 29th day of June 2018.

D. KABAMBE, PhD
Registrar of Financial Institutions

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