The Bank Supervision Department

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Introduction

The South African Reserve Bank (the Bank) is the central bank of the Republic of South Africa (RSA). The mission of the Bank is the achievement and maintenance of financial stability.

This fact sheet focuses on one of the functions of the Bank, namely:

- To regulate and supervise the South African banking system with a view to achieving an efficient and sound banking system in the interest of depositors and the economy as a whole.

Why are banks important?

Banks are important to the economy of a country for several reasons. Firstly, they act as intermediaries through which the funds of surplus units (savers) can be made available to shortage units (borrowers) in order to finance productive activities. This is crucial to the functioning of the economy. Secondly, banks provide a whole range of financial services to the public, such as the payment services that are an everyday fact of life and without which the economy cannot function smoothly. A third reason for banks being important is that they are able to increase the available supply of money through credit extension, which impacts directly on the monetary policy of a country.

Why do banks need to be supervised?

Having established that banks are important, let us examine why they have to be regulated and supervised by the authorities. A logical first reason is that a strong and adaptable banking system helps the monetary authorities to carry out monetary policy, that is, to implement decisions about money supply and interest rates. In this sense, regulation is a "public good", because everyone benefits from an effective monetary policy.

A second more practical reason relates to the unique nature of the business of a bank. The business of a bank can for argument's sake be reduced to, on the one hand, the taking of deposits from the public and, on the other hand, the lending of those same funds to others at a profit. The liabilities of banks, namely the deposits held on behalf of clients, are generally short term and certain in amount – the bank must repay the full amount from its resources. The assets of a bank, namely the loans made, are generally longer term in nature, but actually uncertain in value – the bank can never be sure that the debtor will repay the loan over the specified period. The nature of a bank's business is therefore inherently highly risky, and poor decisions can easily lead to the demise of a bank and the loss of depositors' funds. When this happens, often the confidence in the banking system is harmed, and, in order to avoid this, public funds are sometimes used to save an ailing bank. Either way, the cost of a bank failure to society as a whole is often higher than the private cost (that is, shareholder losses), which is a compelling reason for supervising banks to ensure that they are always prudently managed by competent, experienced and ethical individuals.

Another reason why banks are usually regulated is the asymmetry of information – that is, the unequal availability of information to all interested parties. Depositors do not have sufficient information about the true risks that a particular bank faces, and whether the risk they take in placing their money with the bank is commensurate with the interest to be earned on the deposit. A final reason for the regulation and supervision of banks is to protect depositors against unscrupulous organisations that misrepresent themselves as banks and unlawfully collect "deposits" before absconding.

All developed countries, and most less developed countries, have a banking supervisory authority. Although the principles are largely the same, supervisory authorities may differ regarding their degree of autonomy, relationships with other financial regulators, and supervisory approaches or methods employed.

What are regulation and supervision?

Regulation refers to the creation and maintenance of a legal framework within which institutions are licensed to operate as banks and are subject to prudential rules and practices. Supervision generally refers to the process of monitoring the control systems, activities and financial condition of banks in order to ensure that these are always within the limits of prudent banking practice, as set out in the prudential regulations referred to previously.

Regulation and supervision have three logical objectives, namely ensuring systemic stability, enhancing efficiency and protecting investors and depositors. Because of the inter-relationship between these objectives, the same authority normally performs both regulation and supervision. Because of banks' role in the monetary system and the risk of systemic failure, bank regulation and supervision are often performed by the central bank of a country.

History of the Bank Supervision Department

In 1985, a department for bank supervision was created in the South African Reserve Bank to monitor the foreign activities of South African banks. The functions of the department were expanded in 1986 to include supervision of domestic activities of all banks, a task previously performed by the Registrar of Financial Institutions, who was part of the Ministry of Finance. The Bank Supervision Department began its work on 1 October 1986, and the responsibility for the supervision of banks and building societies (the latter have since been transformed into either banks or mutual banks) was officially transferred from the Department of Finance to the South African Reserve Bank on 24 April 1987.

The Department remains accountable to the Minister of Finance in that it is legally required to submit an annual report on its activities, which is tabled in Parliament by the Minister. Some of the Department's decisions are also subject to the approval of the Minister of Finance.

Bank supervisory framework

The Banks Act, 1965, was rewritten in 1990 in order to place banks and building societies on an equal competitive basis, and to bring our legislation more in line with international banking and bank supervisory practice. Specifically, the regulatory emphasis of the new Banks Act is on the function of deposit-taking, (that is, every entity taking deposits as defined in the Banks Act is regarded as a bank and must be licensed as such), and the supervisory emphasis is on the promotion of adequate risk management in banks. The Banks Act, 1990

(Act No 94 of 1990), was enacted on 1 February 1991. A number of amendments to the Banks Act have since been proposed and it is hoped that these amendments will be tabled in Parliament during 2002. The purpose of these amendments was to bring the banking legal framework in line with international regulatory and market developments.

A second act, the Mutual Banks Act, 1993 (Act No 124 of 1993), aims to fill the gap between the formal and the informal financial sectors. Mutual banks are subject to the same principles of accountability and risk management as are banks, and differ from banks only as regards the nature of capital and the minimum capital requirement. Required capital does not have to be in the form of equity. At the level of informal banking services, provision has been made for structures such as credit unions, stokvels, and village financial services co-operatives to operate under specified conditions. These measures ensure that the legal framework allows banking services to be brought within reach of even the poorest and most remote communities.

The Bank Supervision Department and the Financial Services Board (FSB), which is the regulator of all other financial institutions such as insurance companies, pension funds, unit trusts and the financial markets, are both represented on a statutory body called the Policy Board for Financial Services and Regulation. The Policy Board is responsible for formulating and co-ordinating policy relating to the continuing development of the financial services sector and financial regulation, and for advising the Minister of Finance on these matters. An increasingly important aspect of the Policy Board's role is to help ensure that a holistic approach to supervision is followed in cases where financial conglomerates are involved in banking as well as other financial services.

What does the Bank Supervision Department do?

An important function of the Bank Supervision Department is the licensing of banks. Legally, no person may accept deposits from the public or operate as a bank without the express authorisation of the Department, also known as the Office of the Registrar of Banks. Such authorisation is not given lightly and follows only after a rigorous application process, in which the Registrar has been satisfied that the four main criteria for the licensing of banks have been and will be met. These criteria are as follows:

- Capital is adequate, given the nature and risks of the intended business, to serve as a buffer in order to protect depositors against losses.
- Management is fit and proper in terms of competence and integrity.
- The proposed bank's business plans are viable and the bank is likely to be sustainable.
- The bank's existence is deemed to be in the public interest.

Another function of the Department is the prudential supervision of banks. Because the supervisor cannot take over the management of a bank, the approach adopted is to conduct the Department's activities in a way that promotes sound risk-management practices by all key players in the risk-management process. The key players include banks' shareholders and boards of directors, managements, internal and external auditors, the general public and, of course, the supervisor. The approach taken consists primarily of two types of activity: qualitative assessment and quantitative analysis.

On-site and off-site supervision

The qualitative aspects of supervisory work are undertaken mainly on-site at the premises of banks, and consist of assessing the adequacy and effectiveness of the corporate governance and internal control systems of a bank. In view of the daily volumes of transactions in the banking system, it stands to reason that great reliance is placed on the ability of the system to ensure automatically that good risk-management principles are always applied. The Department's on-site work is aimed at forming a high-level opinion about the adequacy of a bank's risk management and controls. The more detailed evaluation of the quality of a bank's systems is formally delegated to the bank's external auditors.

The quantitative analysis of a bank's ongoing financial condition is performed off-site at the Department's offices. This quantitative analysis is based on comprehensive statutory data provided by banks on a monthly basis. The data, certified as correct by the external auditors of a bank, are electronically entered into a database and converted into meaningful information by means of various techniques, such as ratio analysis, time series analysis, peer and sector comparisons, and graphic analysis. Relevant information from other sources, such as published annual financial statements, the media, and rating agencies, is also considered. The bulk of the analysis process consists of the Department's analysts monitoring the information that is available on their allocated banks to ensure that these banks comply with the stated prudential requirements. Any deviation from what is expected would be the subject of specific discussions held on-site at the premises of the particular bank. Apart from frequent informal contacts between analysts and their allocated banks, formal interaction includes, as a minimum, a quarterly prudential meeting with the executive management and various risk managers of each bank, a pre-audit planning meeting with the external auditors of each bank, annual trilateral discussions with the management and auditors of a bank, and annual presentations to a bank's entire board of directors.

How are foreign banks supervised?

In South Africa, foreign-owned banks, whether they are subsidiaries or branches of the foreign parent, are subject to the same standards of licensing and prudential supervision as domestic banks. Branches are not permitted to accept retail deposits, and representative offices, the third form of foreign banking activity, may not accept deposits at all.

Since South African banks also operate in overseas countries in similar forms as foreign banks do in this country, the Bank Supervision Department has committed itself to conducting consolidated supervision of banking groups and their cross-border establishments. Such supervision is in line with the minimum standards set by the Basle Committee on Banking Supervision. These standards are aimed at ensuring that the cross-border operations of banks can be supervised effectively by the supervisory authorities in both the home country and the host country, and that there is an adequate flow of information between these authorities.

International standards, regional co-operation and other initiatives

The international nature of the South African banking sector requires that the best international standards of banking regulation and supervision should be applied. No country will allow a South African bank to operate in its jurisdiction if it is not satisfied with our standard of supervision. Similarly, a foreign bank will not be interested in establishing an operation here if the market is poorly regulated. The Bank Supervision Department is therefore fully committed to compliance with the Basle Committee's Core Principles on Banking Supervision; the internationally accepted benchmark for supervisory standards. Each year, the Department assesses its strategies and methods as regards their continued relevance and adherence to international best practice.

This commitment to high standards also extends to co-operation with and assistance to other bank supervisors in the Southern African Development Community. Matters of common interest include harmonisation of supervisory and accounting standards, education and training of supervisors, development of technology-based systems, and measures to combat money laundering.

Additionally, recently initiated projects include an investor-awareness campaign, focusing on illegal money schemes, and a possible legal dispensation for the informal micro-finance sector.

What happens if a bank fails?

It is understandable that people who have money deposited in a bank are concerned about the safety of their money. Unfortunately, the Bank Supervision Department cannot guarantee that a bank will not fail, since banking would become entirely non-competitive and too expensive if prudential ratios and supervisory measures were designed in a way that would prevent the possibility of failure. Since banks are allowed to enter the system freely provided that they meet the licensing criteria, they should also be allowed to exit the system freely.

In this way, the market can decide which banks are managed best and which have no place in the system because they are uncompetitive. Distress in a bank can be caused by many factors, but often manifests itself in liquidity problems, that is, insufficient readily available cash to pay current commitments such as deposit withdrawals. Because the panic that may ensue could spread to other banks, the South African Reserve Bank will often act as a lender of last resort by providing liquidity assistance against the security of financial assets. This of course implies that the bank in distress should be solvent, in other words, its assets (fairly valued) must still exceed its liabilities, even though some of these assets may not be sufficiently liquid. If this is not the case, and the South African Reserve Bank will usually ascertain this by means of an independent due diligence investigation, then there is no option but to allow the bank to fail. A curator is usually appointed and will try to ensure that depositors' funds are not lost. Whatever happens to the bank after that, whether management is replaced or whether it is liquidated or merged with another bank, the shareholders' risk capital is likely to be lost to the extent of the short-fall in assets to cover liabilities. If the extent of the short-fall is so large that depositors' funds are also lost, a deposit-insurance scheme is the usual way of repaying depositors' monies. This ensures that there is always confidence in the banking system. At present, South Africa has no deposit-insurance scheme. So far, however, in all circumstances in which depositors' funds were lost or were likely to be lost, the Reserve Bank, with the concurrence of the Government, has stepped in to ensure that depositors were repaid a substantial part of their deposits. If recent history is anything to go by, this means that, to all intents and purposes, South Africa already has a form of implicit deposit insurance.

What can I do if I have a problem with my bank?

The Bank Supervision Department focuses on systemic risk and prudential matters, and does not handle problems relating to individual bank/client relationships. Complaints should be directed, in writing, to the managing director of your bank. If the matter is not resolved satisfactorily in that way, it can be referred to the Banking Ombudsman at the following address: P O Box 61674, Marshalltown, 2107. For more information on the Bank Supervision Department and its activities, including the contents of its latest annual report, please consult the South African Reserve Bank's website on the Internet.

This is the tenth in a series of fact sheets on the South African Reserve Bank, compiled by the Research Department: Information Division and distributed by the Executive Management Department: Communications Unit.

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