# Chapter 1

# Registrar of Banks' review

Throughout 2007 the South African banking system remained stable and banks were adequately capitalised. However, adverse economic developments both in South Africa and internationally have had a negative impact on the banking sector's operating environment. During the year under review the impact on consumers could be clearly observed by the sharp increase in non-performing loans and overdue ratios.

banking system remained stable

This overview therefore discusses, *inter alia*, asset growth, capital adequacy, profitability and asset quality in the South African banking system. It, furthermore, reviews the South African banking sector's exposure to the sub-prime mortgage market, compliance with anti-money laundering (AML) legislation, securitisation, the high-level meeting arranged for African banking supervisors, and the Companies Bill. Finally, the Bank Supervision Department's (the Department) human resources-related developments are discussed.

## Overview of the South African banking system

The South African banking system remained stable and banks were sound during 2007. Banks maintained capital-adequacy ratios above the minimum requirement of 10 per cent. The capital-adequacy ratio for the banking sector amounted to 12,78 per cent at the end of December 2007 (December 2006: 12,29 per cent).

adequate capital maintained

Banking-sector assets increased from R2 075,3 billion at the end of December 2006 to R2 547,0 billion at the end of December 2007, representing an annual growth rate of 22,7 per cent (December 2006: 23,7 per cent). The growth rate slowed down during the first two quarters of 2007, reaching 17,8 per cent at the end of June 2007 before recovering in the remaining two quarters of 2007. Loans and advances, and investment and trading positions were the main contributors to the increase in banking-sector assets during 2007.

banking-sector assets increased

Non-bank deposits remained the primary source of funding for the banking sector throughout 2007, and represented 65,1 per cent of total liabilities and capital at the end of December 2007 (December 2006: 65,2 per cent). Total non-bank deposits increased from R1 353,2 billion at the end of December 2006 to R1 657,8 billion at the end of December 2007.

non-bank deposits remained primary source of funding

Profitability ratios remained strong throughout 2007. The return on regulatory capital amounted to 18,1 per cent at the end of December 2007, compared with 18,3 per cent at the end of December 2006, while the return on assets equalled 1,4 per cent at the end of both December 2006 and December 2007. The efficiency ratio (also referred to as the 'cost-to-income ratio') improved from 58,8 per cent at the end of December 2006 to 56,9 per cent at the end of December 2007.

profitability ratios remained strong

The liquid assets held exceeded the statutory liquid-asset requirement throughout 2007. The average daily amount of liquid assets held in December 2007 represented 112,5 per cent of the statutory liquid-asset requirement (December 2006: 111,2 per cent).

Credit risk ratios deteriorated during 2007. Non-performing loans increased from R18,8 billion at the end of December 2006 to R29,4 billion at the end of December 2007, representing an annual growth rate of 56,4 per cent. Expressed as a percentage of total

credit risk ratios deteriorated

loans and advances, non-performing loans deteriorated from 1,1 per cent at the end of December 2006 to 1,4 per cent at the end of December 2007. The increase in interest rates, together with other adverse developments in the South African and international economic environments, contributed to the deterioration of the credit risk ratios.

## Concentration in the South African banking system

The Herfindahl–Hirschman index (H-index) is a commonly accepted measure of market concentration in a banking system. The index is calculated by squaring the market share of each bank in the system and subsequently summing the squares. The higher the index, the less competition exists in the market and vice versa.

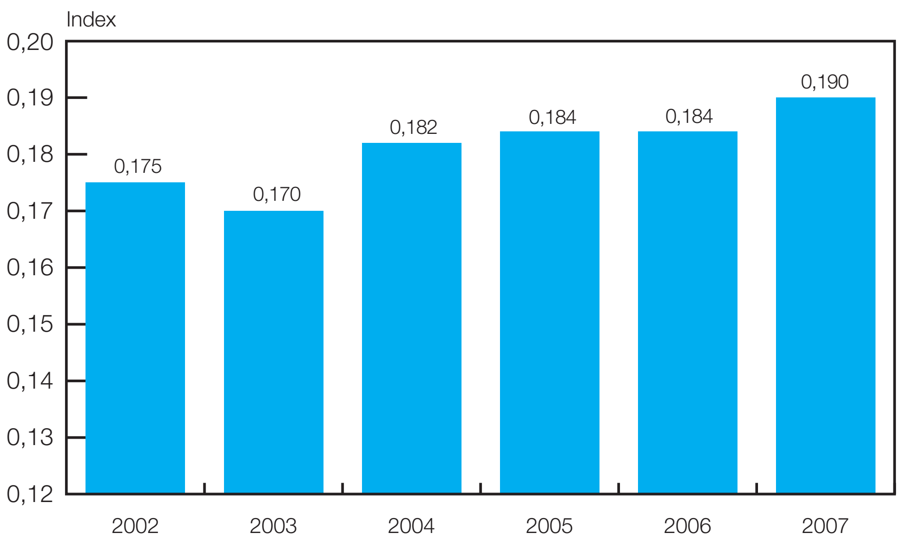
An H-index below 0,1 indicates that there is no concentration in an industry, while an H-index between 0,1 and 0,18 is an indication of moderate concentration. However, an H-index above 0,18 represents a highly concentrated industry.

H-index deteriorated

As portrayed in Figure 1, the level of concentration in the South African banking system increased from 0,184 in December 2006 to 0,190 in December 2007. The increase in concentration can be attributed to a rise in market share of the four largest banks. The total balance sheet of these banks amounted to R2 167,8 billion and represented 85,1 per cent of banking-sector assets in December 2007, compared with 84,1 per cent in December 2006. Three of the four largest banks reported a balance-sheet annual growth percentage exceeding 24 per cent in December 2007.

At the end of December 2007 there were 33 banking institutions reporting data to the Department (excluding two mutual banks; however, including one institution conducting banking business in terms of an exemption from the provisions of the Banks Act, 1990 (Act No. 94 of 1990), namely Ithala Limited).

Figure 1 H-index for the South African banking system (2002–2007)



## The South African banking-sector exposure to the sub-prime mortgage market and the impact of the turmoil in the international markets on the South African banking groups

turmoil in financial markets

The turmoil caused by the sub-prime mortgage market was undoubtedly the major development in financial markets during 2007. What began as credit concerns in the United States (US) sub-prime mortgage market developed into concerns in global credit markets as the extent of exposures and potential losses from the sub-prime market were not known. The resultant uncertainty made financial market participants exceedingly risk-averse, that is, they were unwilling to invest in any markets or financial instruments that were not regarded as a 'safe haven', which led to severely reduced levels of liquidity in the global financial system.

### Background

favourable conditions globally preceded turmoil

In the years preceding the financial market turmoil, the global economy was characterised by favourable annual growth, lower interest rates, buoyant financial markets and increasing asset prices. The US was no exception to this phenomenon.

growing US housing prices

Since the early 1990s, housing prices in the US have been growing at an unprecedented pace. The favourable housing market developments resulted in an increased demand for housing from both an investment and occupational perspective. The continuous boom in this market attracted clients who would not normally have qualified for loans. These were clients with a poor or non-documented credit history, no or negligible assets and in most instances no steady income. Loans granted to these clients are what are commonly known as 'sub-prime mortgage loans'. The assumption was that the growth in equity of these clients would allow them to refinance their loans as housing prices continued to increase.

Institutions granting these sub-prime mortgage loans became creative by offering these loans at initial low 'teaser' rates, which reset to higher rates after a few years. As these loans began to reset and the housing market began to cool off during 2006, that is, growth in house prices decreased, these clients found themselves unable to meet the higher payment obligations and were not able to refinance their loans. It was during this period that non-performing sub-prime mortgage loans increased rapidly. In 2007 concerns regarding the level of non-performing sub-prime mortgage loans became more pronounced. Institutions that granted these loans and maintained them on their books faced major losses.

loans securitised

Concurrent with the granting of sub-prime mortgage loans, certain institutions securitised their loans in special-purpose institutions (SPIs) that issued mortgage-backed securities. These securities offered high yields and the high levels of liquidity in the global financial system attracted large numbers of investors to these products. To complicate matters, various tranches of lower-grade mortgage-backed securities were repackaged, assigned ratings and sold off to conduits (structured investment vehicles (SIVs)) as collaterised debt obligations (CDOs). The SIVs were mainly attracted to investing in the CDOs due to the higher yields offered by these products. Severe liquidity mismatches developed in the SIVs as a result of the CDOs acquired by SIVs being long-dated financial instruments (e.g. five years), while the SIVs were dependent on short-term funding that needed to be rolled over continuously. This structure posed significant liquidity risk to the SIVs, that is, the risk of short-term funding not being rolled over.

Mortgage-backed securities were sold in tranches, namely equity (high-risk), mezzanine (medium-risk) and low-risk tranches. However, many investors were of the view that the housing prices would continue to increase and therefore did not expect high levels of default, that is, investors were attracted to the higher-risk tranches.

credit crunch experienced

With the increased levels of default on sub-prime mortgage loans in 2007, financial institutions and regulators became concerned about these institutions' exposure, either directly or indirectly, to the sub-prime mortgage market, resulting in the so-called market turmoil or credit crunch experienced in the global markets during the second half of 2007.

## Methodology used by the Bank Supervision Department

Department requested information from banks

Given the developments in the international markets, broadly insofar as off-balance-sheet activities were concerned, a selection of South African banks was requested to provide the Department with a detailed document setting out the results of the work undertaken to assess the banks' own position vis-à-vis any potential contagion (or other) risks, together with an indication of the action taken by both the board risk subcommittee and the chief risk officer of the banks to mitigate such risks. Furthermore, the following information was requested:

- Full details of any direct and/or indirect exposure that the bank or banking group may have had to the so-called sub-prime market.
- A full list and value of securitisation schemes undertaken (and capacity), with funding details and recent reviews of these schemes that had been conducted.
- A review of off-balance-sheet activities, including any conduits or so-called SIVs. Such review had to include the size and nature of the underlying assets, and the degree to which any funding mismatch existed.
- A detailed quantification of any liquidity support that the bank or banking group provided to either its own or third-party conduits and, if so, whether such facilities were effectively integrated into the bank's/group's asset and liability committee (ALCO) process, including stress testing.
- Whether the bank or banking group managed or participated in any portfolios on a geared/leveraged basis, where small movements in the value of the underlying assets could cause a (significant) loss to the holders of the equity/units. If so, relevant details of such portfolios had to be provided.
- In respect of any foreign funding that the bank or banking group may have had:
  - the extent of its reliance thereon
  - any indication of change in behaviour in roll-overs having been granted
  - any change in pricing
  - any roll-overs due in the next six months and the contingency plans in place should such roll-overs not occur.

The Department held meetings with the chairpersons of the board risk subcommittees and the chief risk officers to discuss the information presented.

## Overview of the findings

local banks had no direct exposure

Local banks had no direct exposure to the sub-prime mortgage market, while the banks' international franchises had very limited exposure. The securitisation schemes of local banks in South Africa are traditionally cash-backed securitisation schemes, and are used mainly as part of banks' liquidity and capital management strategies. In a traditional securitisation scheme, the legal and economic transfer of assets to a special-purpose vehicle (SPV) takes place. All rights and obligations of the referenced assets are transferred to the SPV.

offshore-listed operations exposed minimally

One of the banks selected for assessment, to a limited extent through its separately offshore-listed operations, was exposed minimally to the sub-prime mortgage market.

This resulted in a negative mark-to-market adjustment to its portfolio. The offshore operations of another local bank had structured transactions using off-balance-sheet entities for bankruptcy-remote purposes, but these exposures were on-balance sheet.

participated in securitisation schemes

The banks had also participated in various capacities in the securitisation schemes of external parties. In those instances where banks had acted as liquidity providers for external parties, such contingent liabilities were included in the banks' ALCO processes. Banks implemented plans to lengthen the duration of the liabilities. The programmes involved rolling maturing commercial paper into longer-term floating rate notes. In some instances, banks had capped the undrawn portion of the facilities and steps were under way to restructure some of the facilities. In one case, a bank had included its cash reserves and statutory liquid assets in its contingency planning. The Department is therefore of the opinion that in most cases stress testing in respect of liquidity contingency planning is still rudimentary and further enhancements are required.

use of foreign funding

The use of foreign funding by the banks selected for assessment differed widely. It ranged from the use of longer-term foreign funding to lengthening their funding structure, and thereby managing liquidity mismatches, to overnight facilities and to the management of their offshore operations.

The banks had not been exposed to any change in the behaviour of providers of foreign funding towards roll-overs, since at that stage most of them did not have facilities maturing within the following six months. In those limited cases where funding had to be rolled over, the credit spreads widened; reflecting the reassessment of risk by fund providers.

South African banks have mostly been isolated from the turmoil in the international markets. As the South African banking sector has had no direct exposure to the sub-prime mortgage market, the impact has been minimal. The wider impact of the global crisis on the local banking sector is still uncertain, but it is expected that as credit spreads widen and pricing for risky assets increases, the borrowing costs of banks will increase. Although there is no immediate concern for the South African banking sector, the second-round effects of the markets will invariably impact on the earnings of banks.

further deterioration of asset quality expected

Internationally, further deterioration of asset quality is expected as more borrowers fail to meet their repayments as the lending rates continue to reset. This uncertainty will continue as long as banks continue to write off exposures. Furthermore, counterparty risk is expected to increase during 2008.

## Compliance with anti-money laundering legislation

Department committed to co-operating with FIC

The Department's endorsement of the revised Core Principles for Effective Banking Supervision (Core Principles), released by the Basel Committee on Banking Supervision (the Basel Committee) in October 2006, signalled an increase in the bank supervisor's duties and the strengthening of supervisory systems in a wide range of aspects, including the areas of anti-money laundering and the combating of the financing of terrorism (AML/CFT). In endorsing the Core Principles, the Department committed itself to co-operating with the Financial Intelligence Centre (FIC), the primary authority responsible for assessing compliance with laws and regulations against the abuse of financial services by criminal elements, to achieve compliance with the criteria mentioned in revised Core Principle 18. A key criterion for assessing compliance with Core Principle 18, which was not present in the previous Core Principle 15, is to have laws or regulations that clarify the duties, responsibilities and powers of the banking supervisor regarding the supervision of banks' internal controls.

## Financial Intelligence Centre Amendment Bill, 2007

Bill aims to adhere to international standards

The Financial Intelligence Centre Amendment Bill, 2007was released for comment in November 2006. The Bill primarily aims to adhere to international standards for regulation and supervision with regard to compliance with AML measures and measures to combat the financing of terrorism as contained in the recommendations of the Financial Action Task Force on Money Laundering (FATF). While the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001) (FICA) provides for the enforcement of its provisions only through criminal sanctions, the proposed amendments seek to introduce an administrative enforcement framework to FICA. Some of the changes to be introduced include the following:

- Co-ordinating and integrating the FIC's powers with supervisory bodies in the supervision of accountable institutions
- Detailing the mandate of supervisory bodies when supervising and enforcing compliance with FICA
- Empowering the FIC and supervisory bodies, *inter alia*, to undertake inspections, issue directives, request information and impose administrative sanctions
- Enhancing co-operation between the FIC, the supervisory bodies and law enforcement agencies.

## Ongoing supervision

pre-emptive steps in supervising compliance with FICA

In 2007, in keeping with current global expectations to optimise banks' compliance with AML/CFT, the Department took pre-emptive steps in supervising compliance with FICA. The flavour-of-the-year topic for trilateral discussions between the Department, banks' audit committees and banks' external auditors during the 2007 calendar year focused on the activities of the internal audit function vis-à-vis AML/CFT. To satisfy itself of the effectiveness of the internal audit functions in banks and that AML/CFT was being implemented, the Department requested banks to report on the following:

- A high-level overview of internal audit functions in respect of the implementation of AML/CFT measures
- Key internal audit findings in respect of the previous financial year (2006) as well as the current financial year (2007) to date
- An overview of internal audit AML/CFT reports issued, actions taken and their timing, in order to address the key findings
- Interaction between internal audit, the audit committee and the AML control officer
- An overview of the internal audit AML/CFT plan for the forthcoming 12 months (2007/08), including adequacy of resources
- An overview of the current compliance status with AML/CFT requirements.

As part of the ongoing co-operation between the Department and the FIC, Mr Murray Michell, Director of the FIC, attended a number of the above-mentioned trilateral discussions.

The steps set out above are in addition to the following supervisory steps taken by the Department to ensure that banks had implemented measures to comply with FICA, the Core Principles and FATF processes since 2002:

- Banks were required to provide the Department with the following:
  - the name of the person responsible for ensuring compliance with the provisions of FICA

  - a completed questionnaire, signed by the chief executive officer and compliance officer, to enable the Department to assess the status of AML measures already taken by banks
  - detailed plans on how the bank intended to achieve full implementation of, and compliance with, FICA and FIC regulations.

- As part of its ongoing supervisory process, the Department met with banks to monitor progress made with the implementation of FICA.
- The Department visited banks on-site to inspect the AML measures taken by them.
- In co-operation with the FIC, the Department enforced deadlines for banks' identification and verification of their clients. The Department monitored compliance on a quarterly basis.

## Mutual evaluation

FATF mutual evaluation in 2008

As a member of FATF, South Africa will undergo a mutual evaluation in 2008 to assess whether the necessary laws, regulations or other measures required under the new standards are in force and effective; that there has been full and proper implementation of all necessary measures; and that the systems in place are effective. These evaluations are based on the 40 Recommendations of 2003 and the 9 Special Recommendations of 2001 (40 + 9 FATF Recommendations), and use the AML/CFT Methodology of 2004.

key feature of process is on-site visit

This is the third round of mutual evaluations for members of FATF, which began in January 2005. A key feature of the process is an on-site visit to the jurisdiction by a team of FATF experts in legal, law enforcement and financial regulatory issues (drawn from institutions in FATF member countries) and the FATF Secretariat, during which they will conduct comprehensive meetings with government officials, supervisory authorities and the private sector over a two-week period.

The team is expected to visit South Africa during August 2008. All participants are expected to be equipped with the *Handbook for Countries and Assessors*, published in June 2006, which provides procedural information and detailed instructions for performing a proper and fair evaluation. Among financial-sector bodies that will be visited in South Africa are

- the Department
- the FIC
- The Banking Association South Africa
- senior executives, compliance officers and internal auditors from a representative sample of financial institutions, including banks
- a representative sample of external auditors.

Mutual Evaluation Report

The findings of the FATF assessment team will be compiled in a *Mutual Evaluation Report*, which will describe in detail the system in place, and assess and rate its effectiveness. A summary of each report will be published on the FATF website.

## The latest work of the Basel Committee on AML/CFT

AML/CFT Expert Group

In June 2007 the Basel Committee established a dedicated AML/CFT Expert Group. Previously, AML/CFT matters were overseen by the Basel Committee's Working Group on Cross-border Banking, consisting of members of the Basel Committee and the Offshore Group of Banking Supervisors (OGBS). In addition to representatives of the Basel Committee and the OGBS, the AML/CFT Expert Group is open to representatives of the Basel Committee's International Liaison Group (ILG). The Department is a member of the AML/CFT Group and the ILG.

tasks of Expert Group

The tasks of the AML/CFT Expert Group are to
- monitor AML/CFT issues that have a bearing on banking supervision;
- serve as a forum for AML/CFT experts from banking supervisory agencies;
- act as interlocutor for FATF and industry groups active in AML/CFT matters; and
- provide guidance, where appropriate.

Basel Committee supports implementation of FATF recommendations

The Basel Committee recognises the FATF as the cross-sectoral standard setter for AML/CFT matters. To this end, the Basel Committee contributes to FATF efforts and supports the implementation of FATF recommendations. However, its perspective differs. From a sectoral perspective, the Basel Committee focuses on banks and banking supervisory issues. From a prudential perspective, it recognises the importance of know your customer (KYC) as not exclusive to AML, but for the management of other risks.

FATF work on risk-based supervision

FATF has undertaken work on the issue of the risk-based approach to combating money laundering and terrorist financing under the auspices of the Electronic Advisory Group (EAG), established by FATF in December 2005. The Department and The Banking Association South Africa were among the participants who volunteered to be part of this initiative. Other participants included FATF members and observers, and members from the banking and securities industries. The work of the EAG followed a number of steps that culminated in the adoption, in June 2007, of high-level principles and procedures in a paper titled “Guidance on the Risk-based Approach to Combating Money Laundering and Terrorist” (the Guidance paper). This is the first time that FATF has developed guidance using a public–private sector partnership approach.

Guidance paper

The purpose of the Guidance paper is to
- support the development of a common understanding of what the risk-based approach involves;
- outline the high-level principles involved in applying the risk-based approach; and
- indicate good public- and private-sector practice in the design and implementation of an effective risk-based approach.

It is hoped that by adopting the risk-based approach, competent authorities and financial institutions will be able to ensure that the measures to prevent or mitigate money-laundering and terrorist financing are commensurate with the risks identified.

The Department has adopted the risk-based approach as outlined in the Guidance paper as the benchmark for assessing the ongoing effectiveness of its supervisory processes, and intends to address the recommendations in this regard by means of scheduled action plans in 2008 and beyond.

## Securitisation

### Background

review of securitisation regulatory framework

During 2007 extensive work was undertaken to review the existing securitisation regulatory framework. This culminated in the finalisation of the proposed amended Exemption Notice relating to Securitisation Schemes (the proposed amended Exemption Notice), which was due to be published on 1 January 2008. This would replace Government Notice No. R. 681 published in *Government Gazette* No. 26415 on 4 June 2004. Further regulatory amendments are discussed elsewhere in this report. The proposed amended Exemption Notice provides for both traditional and synthetic securitisation schemes. It also provides for various roles that may be performed in respect of such securitisation schemes. Where banks are a party to securitisation schemes, it is important to distinguish between the type of securitisation scheme (traditional versus synthetic) and the role(s) that the banks are required to play in respect of the scheme (originator versus liquidity provider or credit enhancement provider).

A typical securitisation scheme involves the creation of a bankruptcy remote SPV. Traditionally, an originator transfers assets to the SPV that funds the purchase price by issuing multiple classes of equity and debt securities to be taken up by investors. These securities are usually listed on the Bond Exchange of South Africa (BESA).

Securitisation can achieve four objectives for the asset originator:

objectives of securitisation

1. Removal of the applicable financial assets and related indebtedness (financing costs) from the originator's balance sheet.
2. Attainment of funding at a lower cost than available through other means of financing as a result of isolating the assets from the potential bankruptcy risk of the originator.
3. Improvement of the originator's liquidity.
4. Matching maturing assets and liabilities.

Securitisation curtails balance-sheet growth and eases the regulatory capital charge by moving assets off the books of the originating bank or by reducing the cost of capital as a proportion of asset exposure. The benefits derived from such activities are, however, not without risk.

## Risks associated with securitisation

### Interest rate risk

price fluctuations

As with all fixed-income securities, the pricing of asset-backed securities (ABSs) fluctuates in response to changing interest rates. When interest rates decline, prices rise and vice versa. The prices of ABSs with floating rates are, however, much less affected. Some ABSs, especially mortgage loans, are also subject to the risk that a change in interest rates may influence the pace of repayments of the underlying loans which, in turn, affects yields.

### Default risk

borrower fails to meet obligations

The risk of default is generally when a borrower fails to make timely payments. It may, however, also occur when a borrower fails to meet other obligations, such as the obligation to maintain a required amount or quality of financial assets as specified in the agreement.

### Liquidity risk

liquidity depends on variety of factors

Liquidity risk relates to the relative ease with which a particular ABS can be traded and sold at any point at a price that reasonably approximates its intrinsic value. The level of liquidity depends on a variety of factors, including the supply and demand characteristics of the broader market and the interest rate environment. For investors who plan to hold a particular ABS until maturity, liquidity risk is less important. Liquidity risk is also relevant when banks become too reliant on funding from SPVs in a securitisation scheme.

### Funding risk

difference in maturities

Funding risk occurs when an SPV issues securities with maturities that are shorter than the maturities of the underlying assets. In such a case, there is a risk that the bank will be required to fund some or all the underlying assets when the securities mature.

### Servicer risk

The risks for a bank acting as servicer are principally operational. The number of loans in the portfolio and the number of parties involved in a securitisation scheme increase the risk of a malfunction for which the servicer could be liable.

### Retention of credit risk

credit enhancement is expensive

Third-party credit enhancement is expensive. Banks will therefore often provide credit enhancement to a securitisation scheme themselves. In some cases, this results in the bank being exposed to as much credit risk as it would have had had it retained the loans on-balance sheet.

### Reduction in asset quality

best assets for securitisation purposes

The risk is always that a bank originates its best assets for purposes of securitisation, thereby reducing the overall quality of assets on-balance sheet. The issue for supervisors is whether the level of capital requirements is still appropriate on the riskier assets remaining on the books.

### Reputational risk

banks have multiple roles

Although the assets of a bank are transferred to a so-called bankruptcy remote SPV in terms of a securitisation scheme, the risk remains that, in cases where the securitisation scheme encounters problems, the bank will be approached to make good any losses. This is not only because of the fact that the assets were originally those of the bank, but also because of a variety of other roles that the bank might have in terms of the securitisation scheme, such as the promoter, arranger, servicer, liquidity provider or credit-enhancement provider.

### Market size

The total value of assets securitised by securitisation schemes, involving banks directly (as originator) and indirectly (in performing a secondary role), that have been approved by the Department since 2001, is approximately R223 billion. This amount is the amount to which the seven participating banks are potentially exposed. This should be seen against the backdrop, at 31 December 2007, of the total balance-sheet size of the banking sector of R2 547 billion and total loans and advances of some R2 124 billion.

## High-level meeting for African banking supervisors

FSI held high-level meeting in Cape Town

On 5 and 6 February 2007 the Financial Stability Institute (FSI) of the Bank for International Settlements (BIS) held a high-level meeting in Cape Town, South Africa, on the Implementation of Basel II in Africa and other regional supervisory priorities. The focus of the meeting was on Basel II preparation and implementation, the revised Core Principles and AML/CFT. Among the attendees were four members of the Basel Committee, including its Chairperson, Dr Nout Wellink. The proceedings were chaired by Mr Josef Tošovský, Chairperson of the FSI. Supervisors from central and southern Africa attended the meeting.

introductory remarks

The first day's proceedings commenced with introductory remarks by the chairperson of the meeting, Mr Josef Tošovský. Thereafter, Mr Errol Kruger, Registrar of Banks and Executive General Manager of the South African Reserve Bank (the Bank), described the South African Basel II implementation process and its progress. He also described how

South Africa had benchmarked its supervisory processes against the revised Core Principles and, in areas where gaps had been identified, was in the process of rectifying such gaps. On AML/CFT, he gave some history relating to South Africa's admittance as a member of the FATF and the importance of such continued membership to the country. He also explained the work undertaken by the Department to ensure that banks complied with the 40 + 9 FATF Recommendations.

implementation of Basel II

Deliberations on the first day continued with brief comments made by Dr Nout Wellink, Chaiperson of the Basel Committee and President of the Netherlands Bank, setting out the way forward with regard to the implementation of Basel II. This was followed by Thomas Hoenig, President of the Federal Reserve Bank of Kansas City, who addressed the topic "Ensuring Adequate and Competitive Capital Levels in a Rapidly Changing Banking Environment". He described the vast array of new activities that banks had become involved in and the rapid pace of innovation by banks, all of which presented challenges to regulators worldwide. He also described the Basel II implementation process in the US.

Mr Karl Cordewener, Deputy Secretary General of the Basel Committee, touched on select Basel II implementation issues. His overview included an exploration of the context underpinning the development and release of the Basel II Framework: what was sought to be achieved; some implementation issues, including consideration of timing by countries to implement Basel II; and the relationship of Basel II implementation with the Core Principles. Furthermore, he highlighted the need for more co-operation between supervisors to enable an effective and efficient implementation.

information sharing in Basel II

Mr Rudi Bonte, a member of the Basel Committee and Management Committee member of Banking Supervision at the Banking, Finance and Insurance Commission in Belgium, dealt with cross-border issues and information sharing in Basel II. He discussed cross-border challenges with respect to Basel II implementation and how to address the home-host supervisory co-operation, and proposed a practical approach to supervisory co-ordination in Basel II implementation. He further addressed the need to co-ordinate requirements, implementation and approval processes between supervisors, and the need to understand a group's internal strategy, plans and processes for Basel II. He also stressed the importance, as highlighted in the Core Principles, of sharing information between supervisors and that the need to ensure the protection of confidentiality of information should not impede effective co-operation and information sharing between supervisors.

Basel II implementation in West and Central Africa

Mr Barthelemy Kouezo (on behalf of Mr Mahamat Mustapha, Chairperson of the Committee of Bank Supervisors in West and Central Africa), covered developments and remaining challenges related to Basel II implementation in West and Central Africa. Messrs Gert Kruger, Head of Group Credit and Economic Capital, FirstRand Banking Group, and Paul Smith, Chief Risk Officer, Standard Bank Group Limited (the SBG), described Basel II implementation from their banking groups' perspectives, covering the various aspects that had to be considered and addressed the challenges that needed to be overcome. They also explained the co-operative approach adopted in South Africa between the Department, the banking sector, and the accounting and audit profession, which underpinned the Basel II implementation process.

revision of the Core Principles

As regards the revised Core Principles, Ms Zahra El-Mekkawy, Vice President of the Federal Reserve Bank of New York, described the process followed and considerations taken into account during the revision of the Core Principles. She also described the rationale for the review and the deadlines from September 1997 when the original Core

Principles were published to October 2006 when the revised Core Principles were approved and endorsed by bank supervisors from 120 countries at the International Conference of Banking Supervisors. She touched on policy considerations relating to risk treatment of Basel I and Basel II, risk management enhancements, home-host relationships, risk-based supervision, corporate governance and internal controls that had to be taken into consideration during the review process. The Department provided a detailed explanation of the manner in which it had benchmarked its supervisory process against the revised Core Principles, also setting out examples of action plans implemented towards achieving full compliance.

current issues and developments in AML/CFT

The second day was devoted to AML/CFT. Mr Phillip Marr, Director of Banking at the Guernsey Financial Services Commission – who also served as a member of the Basel Committee Working Group on Cross-border Banking – dealt with the evolution of current issues and developments in AML/CFT. He traced the history of AML/CFT, starting with the development of FATF's 40 Recommendations in 1990, which were initially targeted at 'non-co-operative' jurisdictions, the development of the KYC best practice paper drafted by the Working Group on Cross-border Banking, the addition of CFT standards, and the impetus given to the finalisation of these standards as a result of the events of 11 September 2001 leading to the publication, in October 2001, of the Basel Committee's "Customer Due Diligence" paper. He also dealt with the FATF's further revision of its 40 Recommendations, and the fact that CFT standards had to be applied on a risk-sensitive basis, and explained the provisions of Recommendation 5, which set out the key CFT measures to be taken by financial institutions, and Recommendation 6, requiring enhanced due diligence in respect of politically exposed persons. He highlighted the fact that Core Principles 7, 18 and 24 included provisions dealing with AML/CFT.

AML/CFT in South Africa

Mr Murray Michell, Director of South Africa's FIC, dealt with the implementation of AML/CFT in South Africa. He gave the history of events aimed at AML/CFT in South Africa, starting from 1996 when legislation was passed, up to the creation of the FIC in 2003. He highlighted the need, identified, *inter alia*, by the FATF mutual evaluation report, for amendments to South African-enabling legislation. He advised that proposed legislation aimed at clarifying the functions of supervisors in relation to overseeing compliance with AML/CFT measures was under discussion. (See also the section on Financial Intelligence Centre Amendment Bill, 2007 on page 6 of this report.)

AML/CFT in Belgium

Mr Rudi Bonte described the implementation activities relating to AML/CFT and enforcement actions in Belgium, which was followed by a report on implementation activities relating to AML/CFT and enforcement actions in the western African region by Mr Kouezo. Mr Mike Triggs, Group Head Financial Crime Risk at Standard Chartered Bank in the United Kingdom (UK), and Ms Isabelle Monestes from Citigroup in Russia each outlined challenges in implementing AML/CFT regulatory requirements from their individual banking group's perspectives.

## Companies Bill, 2008

aims to modernise company law

The second and final draft of the Companies Bill, 2008 was released by the Department of Trade and Industry in November 2007. The proposed Bill, an extensive document of 480 pages, will replace the Companies Act, 1973 (Act No. 61 of 1973). The Bill represents a significant departure from the Companies Act, as it aims to modernise company law, aligning it with other South African statutes, notably the Auditing Profession Act and the Securities Services Act, and international best practice.

The Department welcomes the promulgation of the Companies Bill as a law of general application, and will set out to prepare action plans to adapt and amend the Banks Act, 1990 accordingly to enable the Department to discharge its roles and responsibilities properly in respect of banks, controlling companies and banking groups.

Section 11 of the Banks Act, 1990 provides that no person shall conduct the business of a bank unless such person is a public company and is registered as a bank. Thus the litmus test before an entity can qualify to be a bank is, first and foremost, to meet the requirements of the Companies Act, 1973, namely to operate as a public company and adhere to the provisions of this Act. A public company can graduate to bank status only by fulfilling additional requirements, such as start-up capital and tighter systems, including higher thresholds of governance, risk awareness and prudential requirements than in non-banks, which are all underscored by a higher standard of fitness and propriety.

meet requirements of Companies Act and Banks Act

In view of the essential function fulfilled by banks in an economy and their special nature, the Department believes that the Banks Act, 1990 should prevail in the case of an inconsistency between the Banks Act and the proposed Companies Bill, thus ensuring the Department's continued ability to regulate and supervise the banking system effectively and efficiently, thereby maintaining confidence in the overall banking system. Confidence is one of the most critical cornerstones of a banking system, and any loss of confidence can lead to the immediate withdrawal of deposits and capital, in turn, inducing a banking-system crisis.

Banks Act should prevail

## Human resources issues in the Bank Supervision Department

During 2007 one of the Department's key initiatives was to fill its vacancies. Good progress was made in that 17 new staff members were appointed, while 8 resigned, which resulted in the workforce increasing from 84 to 93. Furthermore, 20 promotions and 34 salary adjustments were effected during this period.

fill vacancies

With the proposed targets of 50 per cent blacks and females at all levels of the Bank's staff compliment by 2011, the filling of the vacancies resulted in the Department achieving its employment equity objectives as a whole. At the end of 2007, 51 per cent of the Department's workforce was black. In terms of gender, 49 per cent of the staff members were males and 51 per cent were females.

employment equity objectives

An analysis of the race progress by level, however, indicates that the Department met its target in three out of five broad band levels, namely General Management, Junior Professional and Supervisory, and Trainee Professional and Clerical. In the Professional and Vocational Management broad band 46 per cent of the workforce was black, while in the Senior Professional and Management broad band only 7 per cent was black. An analysis of the gender progress by level indicates that the Department reached its proposed target on the non-management level, that is, Junior Professional and Supervisory, and Trainee Professional and Clerical, where 32 per cent of the staff members were male and 68 per cent were female.

On the management level, that is, General Management, Senior Professional and Management, and Professional and Vocational Management the Department has not achieved its gender targets, where 64 per cent of the staff members were male and 36 per cent were female. The Department is proactively trying to find solutions and interventions to meet the proposed 2011 employment equity targets.

## Staff training

skills base constantly improving

To ensure that the skills base of the Department is constantly improved, considerable resources are allocated for training purposes. During the year under review 95 employees of the Department received training at a total cost of R1,4 million. The training enables staff to

- implement sound global supervisory standards and practices;
- share supervisory practices and experiences; and
- promote cross-border supervisory contacts and co-operation.

A foundation-level course was introduced for new graduate staff joining the Department. The aim of the week-long course was to provide a broad and solid foundation for the new staff in the Department. The course covered the following:

- Overview of the banking system
- Regulatory framework
- Risk-based supervisory approach.

This was supplemented with training on specialised software programs used in the Department. Four of these courses were held during the year.

latest developments in the banking industry

To enable staff to stay abreast of the latest developments in the banking industry, the following presentations were held in-house:

- Change management
- Liquidity risk management
- Developments in the economy
- Strategic issues in the banking industry
- Amendments to the Companies Act
- International Financial Reporting Standards (IFRS)
- Global economic crime survey.

## International courses attended

During the year under review, staff members attended the following courses:

- International Monetary Fund (IMF) Seminar Integrating Off-site and On-site Supervision, in Tunisia
- Banking Sector Education and Training Authority (BANKSETA) International Executive
- Development Programme, in Canada
- Swedish International Development Co-operation Agency (SIDA) Seminar on Risk Management, in Sweden
- Meeting on Risk Minds, in Switzerland.

## Basel II training

The implementation of Basel II is a significant challenge to supervisory authorities and the Department has recognised these challenges and commenced training on a number of fronts as outlined below:

- The proposed amended Regulations relating to Banks (proposed amended Regulations)
- Quantitative impact study (QIS) 5.5
- Working sessions after the second formal field test
- Basel II industry sessions
- Credit risk modeling and model reviews
- Operational risk – sound practices and different approaches.

## Issues to receive particular attention in 2008

In addition to fulfilling its normal supervisory and regulatory tasks, the Department will place particular focus on the following issues during 2008:

focus areas for 2008

- The effective implementation of the amended regulatory framework, which encapsulates Basel II and the revised Core Principles.
- Continued refinement of the Department's supervisory processes to support the implementation of the amended regulatory framework.
- Ongoing assessment and monitoring of the South African banking industry's exposure to the global financial market turmoil. This includes the ongoing monitoring of the banking industry's initiatives to deal with the impact of the financial market turmoil, while also enhancing the Department's contingency arrangements.
- Assessment of the involvement of board remuneration subcommittees in banks' incentive schemes.
- Evaluation of board members' involvement in the implementation of banks or banking groups' internal capital-adequacy assessment processes.
- Review of the involvement of boards of directors in the oversight of banks' operational risk frameworks.
- Continued monitoring of bank's compliance with AML/CFT legislation.
- Ongoing assessment of banks' corporate governance and risk management policies and processes.
- Ongoing participation in the initiatives and activities of international and regional bank supervisory bodies, such as the Basel Committee and the Subcommittee of Bank Supervisors of the Southern African Development Community.
- Continued combating and investigation of illegal deposit-taking by unregistered institutions and persons, and participation in consumer education initiatives.
- Ongoing training of staff, focusing on the latest regulatory and supervisory standards as well as local and international financial market developments.

## Expression of gratitude

I wish to extend my appreciation to the Minister and Deputy Minister of Finance for their valued input on requests not only in terms of statutory requirements, but also in terms of general counsel. Sincere thanks also go to the Governor and deputy governors of the Bank for their continuous co-operation, guidance and support.

Several individuals and organisations, locally and abroad, continued their co-operation with the Department. These include, to name but a few, the Chief Executive of the Financial Services Board (FSB) and his staff; the senior executives of banking institutions and their external auditors; The Banking Association South Africa; the Standing Committee for the Revision of the Banks Act, 1990 (the Standing Committee); the individuals in the auditing profession; staff of other departments of the Bank; the Basel Committee; and the central bankers and bank supervisors, both in southern Africa and elsewhere in the world, with whom the Department interacted on an ongoing basis.

My sincere appreciation also goes to the staff members in the Department for their continued professionalism and enthusiasm. The implementation of Basel II, in particular, required extreme dedication and perseverance.

Errol M Kruger
Registrar of Banks and Executive General Manager: Bank Supervision Department