Chapter 1: Registrar of Banks' review

1.1 Introduction

In many respects, global financial and banking systems stabilised during 2010 and most jurisdictions seem to be on the road to recovery, albeit not at levels similar to those prior to the global financial crisis, but rather at levels depicted by many as the "new normal". Although the South African banking sector was not impacted by global events of the past few years to the same extent as many of its international counterparts, the spillover effects of the crisis, coupled with the cyclical downturn in the domestic economy, did impact the operating environment of the sector negatively. This was evidenced by a very moderate recovery in growth in total banking-sector assets, and in loans and advances in particular during 2010 against a backdrop of subdued economic activity and a weak property market in South Africa. Also, the banking sector's cost-to-income ratio continued to deteriorate during 2010 and the level of impaired advances remained stubbornly high, improving only slightly to 5,8 per cent of gross loans and advances at the end of December 2010 (December 2009: 5,9 per cent). Notwithstanding this difficult operating environment, banks still managed to remain profitable during 2010 with an average return on equity ratio of 15 per cent. The banking sector also remained capitalised at levels well above the minimum regulatory capital requirement throughout the year under review.

moderate recovery in growth in total banking-sector assets

From a regulatory framework perspective, global regulatory and supervisory standard-setting bodies such as the Group of Twenty Finance Ministers and Central Bank Governors (G-20), the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (the Basel Committee) continued to develop and put in place the reform agenda, which was crystallised at the G-20 summit held in Pittsburgh, United States (US), in 2009. The Basel Committee's bank-specific reforms, commonly referred to as "Basel III", focus on making banks and financial systems more resilient to future periods of stress, and include the further strengthening of existing requirements in terms of the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* issued in June 2006 (Basel II) and the introduction of new global standards in respect of, among other things, minimum regulatory capital requirements, a leverage ratio, and liquidity risk management and monitoring. The Bank Supervision Department (the Department) of the South African Reserve Bank (the Bank) commenced a formal process to amend the regulatory framework in accordance with the latest internationally agreed regulatory and supervisory best practices and standards, and the Department, as a member of the Basel Committee, will continue to be actively involved in future developments and reforms, thereby promoting the safety and soundness of the domestic banking system and supporting long-term economic growth.

Basel Committee's bank-specific reforms

Specific topics covered in this chapter include the Department's interaction with the International Monetary Fund (IMF) during 2010; developments with regard to banks' compliance with remuneration standards issued by the FSB and the Basel Committee, and key international regulatory developments, recommendations and focus areas; and the Department's response thereto. Furthermore, an overview is provided of the Bank for International Settlements' (BIS) Financial Stability Institute's (FSI) high-level meeting for African banking supervisors held in 2010; the Department's participation in international and domestic regulatory and supervisory forums; supervisory colleges attended; and regional co-operation during 2010. Finally, a high-level overview is provided of skills development-related issues; and the Department's oversight role in respect of compliance by banks with anti-money laundering (AML) and the combating of the financing of terrorism (CFT) standards is discussed.

1.2 High-level overview of the banking sector

1.2.1 Key banking-sector trends

As at the end of December 2010, 30 banking institutions reported data to the Department (excluding 2 mutual banks, but including 1 institution conducting banking business in terms of

30 banking institutions reported data to the Department

an exemption from the provisions of the Banks Act, 1990 (Act No. 94 of 1990) (the Banks Act, 1990), namely Ithala Limited) and 41 international banks with authorised representative offices in South Africa.

Of the nominal value of the total South African banking sector's shares in issue at the end of December 2010, foreign shareholders held 42,6 per cent, domestic shareholders 29,9 per cent and minority shareholders 27,5 per cent.

banking-sector assets amounted to R3 126 billion

Total banking-sector assets amounted to R3 126 billion at the end of December 2010 (December 2009: R2 967 billion), representing a moderate year-on-year increase of 5,3 per cent. The four largest banks in South Africa contributed 84,6 per cent to the balance-sheet size of the total banking sector, a level similar to that recorded in 2009. Gross loans and advances, which represented, on average, 74 per cent of banking-sector assets during 2010, increased marginally by 2,5 per cent to R2 314 billion at the end of December 2010, mainly due to modest growth in homeloans and higher overnight and interbank call loan balances.

Homeloans and term loans, accounting for 35,3 per cent and 15,3 per cent respectively of gross loans and advances, remained the single largest components of gross loans and advances at the end of December 2010. Other loans, leasing and instalment debtors, and commercial mortgages represented 11 per cent, 10,5 per cent and 9,8 per cent respectively of gross loans and advances.

The composition of banking-sector liabilities, which comprised predominantly deposits (on average representing 85,8 per cent of liabilities during 2010), remained largely unchanged when compared with 2009. Banking-sector deposits on average comprised primarily fixed and notice deposits (28,4 per cent), current accounts (17,6 per cent), negotiable certificates of deposit (17,4 per cent) and call deposits (16,9 per cent) during 2010.

corporate and retail customers were the main source of banking-sector deposits

Corporate and retail customers were the main source of banking-sector deposits throughout 2010, and accounted for an average of 43,3 per cent and 21,3 per cent respectively of total deposits. Deposits from banks represented, on average, 13,1 per cent of banking-sector deposits in 2010. Other sources of deposits included deposits from securities firms (averaging 7,4 per cent), the public sector and local authorities (averaging 7,0 per cent), and sovereigns (averaging 3,7 per cent) during 2010.

Off-balance-sheet items expressed as a percentage of total assets increased to 27,4 per cent in December 2010, up from 13,8 per cent in January 2010, mainly due to a change in regulatory reporting of off-balance-sheet items to include the banking sector's revocable facilities.

the banking sector remained adequately capitalised

The banking sector remained adequately capitalised at 14,9 per cent at the end of December 2010, improving from 14,1 per cent a year earlier, mainly because of an increase in primary qualifying capital and reserve funds. The sector's Tier 1 capital-adequacy ratio was 11,8 per cent as at the end of December 2010, compared with 11,1 per cent in December 2009.

The financial leverage multiple[1] of the banking sector continued to decline during 2010, amounting to 14,7 times at the end of December 2010 compared with 15,7 times in December 2009. This improvement was attributable to a higher rate of growth in equity relative to the rate of growth in total assets.

banks remained profitable during 2010

Banks remained profitable during 2010. The sector's operating profit increased year-on-year by 6,4 per cent as at December 2010. Total banking-sector return on equity was 14,7 per cent, and the return on assets approximately 1 per cent as at December 2010, utilising a 12-month moving average as a basis for calculation. Staff expenses remained the single largest cost component and accounted for 53,8 per cent of the banking sector's total operating expenses during 2010. The 12-month moving average cost-to-income ratio of the sector deteriorated during 2010 and was 56,4 per cent at the end of December 2010 compared to 51,1 per cent as at December 2009.

statutory liquid assets held by banks exceeded those required throughout 2010

Statutory liquid assets held by banks during 2010 on average exceeded those required throughout 2010. The average liquid assets held by the banking sector expressed as a percentage of liquid assets required to be held increased to 174,8 per cent at the end of December 2010 (December 2009: 144,8 per cent).

1 The financial leverage multiple is calculated by dividing total assets by total equity attributable to equity holders.

The difficult economic conditions experienced during 2009 prevailed in 2010 and contributed to very modest loan growth being experienced by the banking sector. Banks continued to focus on proactive credit risk management processes, including in-depth reviews of industries and clients, stricter lending criteria and management of highly indebted consumers. Impaired advances expressed as a percentage of gross loans and advances decreased to 5,8 per cent at the end of December 2010 from 5,9 per cent in December 2009. The sector increased specific impairments covering impaired advances to 32,6 per cent in December 2010, compared with 29,6 per cent as at December 2009.

modest loan growth experienced by the banking sector

increased specific impairments

1.2.2 Concentration in the South African banking system

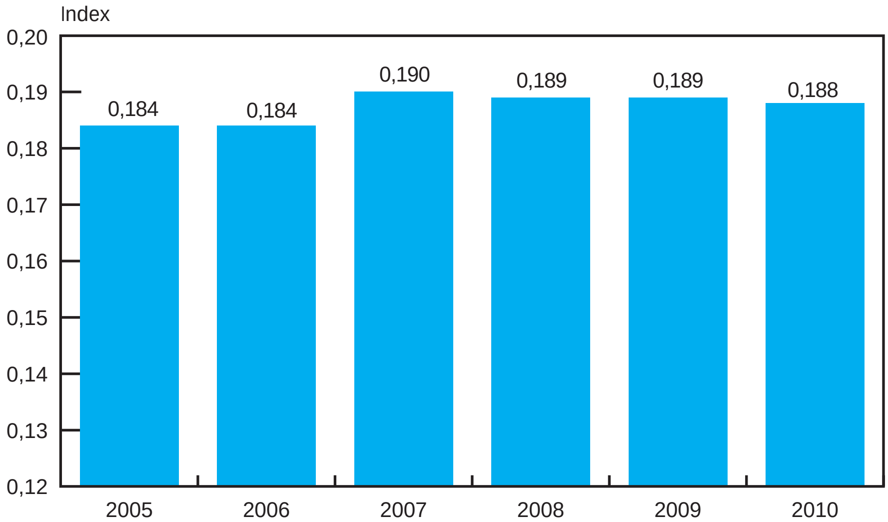
The Herfindahl–Hirschman Index (H-index) is a commonly accepted measure of market concentration in a banking system. The index is calculated by squaring the market share, in terms of total assets, of each bank in the system and subsequently summing the squares.

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 indicates a high level of concentration.

Figure 1.1 indicates the level of concentration in the South African banking sector, measured using the H-index. The index amounted to 0,188 at the end of December 2010 compared with 0,189 at the end of December 2009. The high index is attributable to the concentration of banking-sector assets among the four largest banks, which accounted for 84,6 per cent of total assets at the end of December 2010.

four largest banks accounted for 84,6 per cent of total assets

Figure 1.1 Herfindahl–Hirschman Index for the South African banking system (2005–2010)



1.3 Interaction with the International Monetary Fund during 2010

1.3.1 Introduction

The IMF conducted a detailed assessment of the Department's compliance with the 25 Basel Core Principles for Effective Banking Supervision (Core Principles) in March 2010.[2] The related reports based on the review, namely "South Africa: Detailed assessment of compliance with

2 Refer to the Basel Committee on Banking Supervision paper titled "Core principles methodology" issued in October 2006 (http://www.bis.org/publ/bcbs130.htm).

Basel Core Principles for Effective Banking Supervision (IMF Country Report no. 10/353)" (Country Report) and "South Africa: Report on the observance of standards and codes on banking supervision, insurance supervision and securities' regulation (IMF Country Report No. 10/352)" (ROSC) were issued on 8 December 2010.

"Staff Report" for the 2010 Article IV Consultation completed in September 2010

In addition to the detailed assessment reports referred to above, the IMF also held annual bilateral discussions, in terms of Article IV of the IMF Articles of Agreement, with appropriate South African officials during May 2010. The "Staff Report for the 2010 Article IV Consultation" (Staff Report) was completed on 21 September 2010. A Public Information Notice (PIN) (No. 10/132) that summarises the views of the IMF's Executive Board as expressed during its discussion of the Staff Report concluded the 2010 Article IV Consultation. All these reports are available on the IMF's website.[3]

1.3.2 Assessment of compliance with the Basel Core Principles for Effective Banking Supervision

effective banking supervision reduced the impact of the global financial crisis

The assessors concluded that banking supervision in South Africa had been effective and had contributed towards reducing the impact of the global financial crisis on the domestic financial sector. They commended the Department on its early adoption and full implementation on 1 January 2008 of Basel II in an emerging-market environment. The assessors believed the overall implementation of the Basel II advanced approaches to be rigorous and comprehensive. They noted that the systemic risk add-on and the implementation of idiosyncratic capital buffers contributed to the strength and stability of the banking system.

The gradings attributed to the assessment are the following:

1. Fully compliant
2. Largely compliant
3. Materially non-compliant
4. Non-compliant.

fully compliant with 20 of the component parts of the Core Principles

The detailed assessment found that of the 30 component parts of the Core Principles the Department was fully compliant with 20, largely compliant (LC) with 7 and materially non-compliant (MNC) with 3. There were no non-compliant ratings. The three areas of the regulatory and supervisory framework rated as materially non-compliant by the assessment and that required improvement were the following:

i Comprehensive related-party information: The Department does not obtain comprehensive information on a regular basis on banks' aggregate exposures to related parties nor on individual related-party exposures.

ii. Country and transfer risk: A specific regulation dealing with country and transfer risk should be drafted. Although the exposures are considered relatively small, the Department does not have a consolidated view of banks' individual country and transfer risks. Prudential returns should be expanded to include information on country and transfer risk exposures, and on related-party lending.

iii. Strengthening of the Registrar's remedial powers: The Registrar of Banks' (the Registrar) remedial powers to address problems in banks should be strengthened. At present, the Registrar cannot appoint a curator at a bank in his sole capacity, and there are limitations on his authority to cancel or suspend a bank's licence. These constraints limit the Registrar's ability to act decisively in the case of emerging problems at a bank.

A detailed discussion of the findings relating to the LC and MNC principles is presented in Table 1.1.

3 http://www.imf.org .

Table 1.1: Summary of compliance with Core Principles graded as largely compliant and materially non-compliant

No.	Principle*	Grading**	IMF comments on finding	Department's comments on finding
1.	CP 1(3): Legal framework EC 2: The law empowers the supervisor to set prudential rules (without changing laws). The supervisor consults publicly and in a timely way on proposed changes, as appropriate.	LC	It is not the Registrar but the Minister of Finance who is responsible for setting prudential regulations. Prescribed prudential returns and instructions for their completion are included in the regulations issued by the Minister. The Registrar's formal role in this respect is limited to issuing circulars with guidelines regarding the application and interpretation of the provisions of the Banks Act, 1990 (BA section 6(4)). In practice, however, it is the Registrar who takes the initiative for changes to regulations and who prepares the drafts that are issued for consultation.	The Department's role is to administer laws and regulations, not to issue laws and regulations. The issuance of laws and regulations is the duty of an elected official (such as the Minister who is a member of Parliament). In practice, however, it is the Registrar who takes the initiative for changes to regulations and who prepares the drafts that are issued for consultation.
2.	CP 1.4: Legal powers EC 3: When, in a supervisor's judgement, a bank is not complying with laws or regulations, or it is or is likely to be engaged in unsafe or unsound practices, the supervisor has the power to • take (and/or require a bank to take) prompt remedial action; and • impose a range of sanctions (including the revocation of the banking licence).	LC	In order to ensure that the Registrar's ability to act decisively when banks encounter serious difficulties will not be hampered, the Minister's role in supervisory remedial actions and the required consent of the bank's chief executive officer (CEO) or chairperson for the appointment of a curator needs to be reconsidered.	The Department undertakes to study the IMF comments to consider possible implications.
3.	CP 5: Major acquisitions EC 1: Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need prior supervisory approval. EC 2: Laws or regulations provide criteria by which to judge individual proposals.	LC	The Banks Act and the Regulations relating to Banks • do not define the amounts (absolute or in relation to a bank's capital) of investments by a bank in a subsidiary that need prior supervisory approval; • do not specify the criteria that the Registrar uses for approving or disapproving proposed investments in subsidiaries and joint ventures, although to some extent they are implicit in the information that has to be submitted with an application for permission for acquisitions or investments (regulation 56); and • departmental circulars do not clearly indicate in which instances notification after the investment or acquisition is sufficient. Apparently, all acquisitions and investments, no matter how small, require the Registrar's prior approval. The efficiency of the Department's use of resources might be increased, and the burden that supervision puts on the banks might be reduced by exempting investments and acquisitions under a certain threshold from prior approval.	The Department undertakes to study the IMF comments regarding notification for investments or acquisitions to consider possible implications.

Table 1.1: Summary of compliance with Core Principles graded as largely compliant and materially non-compliant (continued)

No.	Principle*	Grading**	IMF comments on finding	Department's comments on finding
4.	CP 6: Capital adequacy EC 7: Where the supervisor permits banks to use internal assessments of risk as inputs to the calculation of regulatory capital, such assessments must adhere to rigorous qualifying standards and be subject to the approval of the supervisor. If banks do not continue to meet these qualifying standards on an ongoing basis, the supervisor may revoke its approval of the internal assessments.	LC	There is no explicit power for the Registrar to revoke the use of the advanced approaches for credit or market risk. Although the accreditation conditions point out that banks need the Registrar's prior written approval and banks are continually required to meet the advanced model user conditions, an explicit revocation power should be added to the regulation, similar to regulation 33(6) on operational risk.	The Department undertakes to address this matter in the revisions to the Regulations relating to Banks.
5.	CP 9: Problem assets, provisions and reserves Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.	LC	The Department relies, as part of its supervisory approach, on the International Financial Reporting Standards (IFRSs) provisions as audited by the external auditors and the outcomes of the external auditors' report under regulation 46(4). It is recommended that more specific qualitative guidance on the Department's requirements be provided to the external auditors and/or the banks to ensure that all the essential criteria of this Core Principle are addressed. This applies in particular to areas such as the periodical assessment of the value of risk mitigants, the periodic review of problem assets, the adequacy of organisational resources for identification, the oversight and collection of problem assets, and timely and appropriate information to the Board of Directors (the Board) on the condition of the asset portfolio. The Department should also clarify its expectations with regard to forward-looking provisioning for prudential purposes with banks and/or external auditors. More explicitly, a general allowance for credit impairment is not a clearly defined concept under IFRSs and part of it may be included in Tier 2 capital.	The Department undertakes to study the IMF comments to consider practical implementation.
6.	CP 11: Exposures to related parties In order to prevent abuses arising from exposures (both on- and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.	MNC	The Department does not obtain comprehensive information on banks' aggregate exposures to related parties on a regular basis. It is currently considering the inclusion of related party exposures as a separate reportable item on form BA 600 (consolidated return that already includes reporting of group large exposures). The Department also does not obtain regular information on individual related party exposures, which makes it doubtful whether it would be able to use its authority to instruct a bank to deduct such exposures from its capital effectively.	The Department undertakes to address this matter in the revisions to the Regulations relating to Banks.

Table 1.1: Summary of compliance with Core Principles graded as largely compliant and materially non-compliant (continued)

No.	Principle*	Grading**	IMF comments on finding	Department's comments on finding
6.	CP 11: Exposures to related parties (continued)		The Department does not as yet require that transactions with related parties and the write-off of related party exposures exceeding specified amounts or otherwise that pose special risk be subject to prior approval by the bank's Board. However, it is currently in the process of proposing amendments to regulation 36(15) to include these requirements, as well as a requirement that persons benefiting from a particular exposure shall not be responsible for managing that exposure. In addition, there is no specific requirement for banks to have policies and processes to identify individual exposures to related parties. Prior Board approval is not yet required for a bank's transactions with related parties in excess of specified amounts. An amendment to regulation 36 incorporating such a requirement is under preparation.	The Department undertakes to address this matter in the revisions to the Regulations relating to Banks.
7.	CP 12: Country and transfer risks Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.	MNC	A regulation specifically dealing with country and transfer risk should be promulgated since these are material risks to some of the banks. The granularity of regional exposures on form BA 210 should be increased so that the Department is in a position to monitor country and transfer risk on an ongoing basis.	The Department undertakes to study the IMF comments to consider practical implementation. The Department undertakes to address this matter in the revisions to the Regulations relating to Banks.
8.	CP 15: Operational risk Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.	LC	It is recommended that the Department prioritise information technology (IT) capacity building within its specialist risk areas in order to enable it to assess fully and adequately all aspects of banks' operational risk management and thus to reduce reliance on the work carried out by external auditors on IT systems as part of their certification of the annual accounts. Board awareness for business continuity was raised in 2006, but the Department should clarify its requirements into a regulation so that supervisory expectations are clear.	The Department undertakes to study the IMF comments to consider practical implementation. The Department is awaiting the finalisation of the Basel Committee's paper titled "Sound Practices for the Management and Supervision of Operational Risk". Adoption of this paper into the operational risk framework should address this finding.

Table 1.1: Summary of compliance with Core Principles graded as largely compliant and materially non-compliant (continued)

No.	Principle*	Grading**	IMF comments on finding	Department's comments on finding
9.	CP 21: Supervisory reporting EC 1: The supervisor has the power to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance and risks at regular intervals. These reports provide information on such matters as on- and off-balance-sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, asset concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk and market risk.	LC	Although the range of periodic prudential returns is fairly wide, some essential information is not reported to the Department on a regular basis. This includes related party lending (refer to Principle 11) and country and transfer risk (refer to Principle 12).	Refer to the Department's comments in items 6 and 7.
10.	CP 23: Supervisors' corrective and remedial powers EC 3: The supervisor has an appropriate range of supervisory tools available for use when, in the supervisor's judgement, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened. These tools include the ability to require a bank to take prompt remedial action and to impose penalties. In practice the range of tools is applied in accordance with the gravity of a situation. EC 4: The supervisor has available a broad range of possible measures to address such scenarios as described in EC 3 above and provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, Board directors or controlling owners, facilitating a takeover by, or merger with, a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking licence.	MNC	The severe limitations on the Registrar's authority to cancel or suspend a bank's licence or to restrict a bank's activities (sections 23–26 of the Banks Act, 1990), in particular the delay of at least 30 days between the announcement of such measures to a bank and their actual application, call his ability to use these supervisory powers decisively, expediently and effectively seriously into question. The same comment applies to the Registrar's inability to appoint a curator without the consent of the CEO or the chairperson of the Board of the bank concerned.	The Department undertakes to study the IMF comments to consider practical implementation.

* To assess compliance with a core principle (CP), the Basel Committee methodology proposes a set of essential and additional assessment criteria for each core principle. The essential criteria (EC) are the only elements on which to gauge full compliance with a core principle. The additional criteria (AC) are suggested best practices for which countries that have advanced banks should aim (refer to the Basel Committee document titled Core principles methodology issued in October 2006 for further information).

** Grading scales: LC = largely compliant; MNC = materially non-compliant

1.3.3 Staff Report for the 2010 Article IV Consultation

1.3.3.1 General observations

The PIN states that the banking system had withstood the global economic crisis without major problems and had benefited from a strong supervisory framework. There was no need for public support and capital-adequacy ratios had remained above their regulatory minima throughout the crisis period. It was also observed that private-sector credit growth had turned negative following growth of around 20 per cent during the period 2005–08. It noted that there had been pronounced increases in impaired loans and advances in the banking sector with a resultant decrease in banks' profitability.

1.3.3.2 Overview of key findings

Details of the key banking-sector risks identified in the Staff Report, in addition to the above-mentioned general observations, are provided below.

banking sector's activity affected by the recession

i. The IMF stated that the banking sector had remained essentially sound, although its activity had been affected by the recession. Banks remained profitable despite the increase in impaired loans to 6 per cent of gross loans and advances in January 2010 from 2 per cent two years earlier. The IMF noted that no public support was extended during the recession and capital-adequacy ratios had remained above their regulatory minima throughout the crisis period. This, in part, reflected the banking sector's moderate exposure to foreign risk and the proactive approach pursued by regulators (e.g., the Department spearheaded the early adoption of Basel II, concluded in 2008, with capitalisation requirements above those recommended by the Basel Committee). The report stated that the rise in idle capacity and the sizeable job losses resulted in a contraction in credit extended to the private sector in 2010.

ii. It was noted that South Africa had a strong bank supervisory framework. The follow-up of the 2009 Financial Sector Assessment Program (FSAP) update recommendations identified ongoing actions by the bank and non-bank regulators to exchange information on a regular basis. These actions included regular supervisory meetings between the Financial Services Board and the Department to discuss matters relevant to the three largest banking and insurance groups. The IMF noted that there were plans to host a College of Supervisors from those African countries in which South African banks had a presence. In this regard, the Department is reviewing a paper published by the Basel Committee in October 2010, titled "Good Practice Principles on Supervisory Colleges",[4] with a view to hosting the College of Supervisors from selected African countries in the course of 2011. The Staff Report also explained that the Department had been developing a framework for the analysis of macroprudential risks, as well as reviews of liquidity risk and liquidity simulation exercises involving the country's major banks.

development of a framework for the analysis of macro-prudential risks

1.4 Developments with regard to banks' compliance with remuneration standards issued by the Financial Stability Board and the Basel Committee on Banking Supervision

Compensation practices at large financial institutions are regarded as one of the factors that contributed to the financial crisis that began in 2007. In April 2008 the Financial Stability Forum, later renamed the 'Financial Stability Board', recommended that regulators and supervisors work with market participants to mitigate the risks arising from remuneration policies. In late 2008 the FSB formed a Compensation Workstream Group with a mandate to draft sound practice principles for large financial institutions.

Principles for Sound Compensation Practices

In April 2009 the FSB issued Principles for Sound Compensation Practices as part of a call by the G-20 at the Pittsburgh Summit to set global standards as part of pay structure reforms.

4 http://www.bis.org/publ/bcbs177.htm.

In July 2009 the Basel Committee issued various enhancements to the Basel II framework (as discussed in more detail in section 1.5 of this report). Among other things, the enhancements contained supplementary Pillar 2 guidance pertaining to the supervisory review process. The Basel Committee refers to the Principles for Sound Compensation Practices in the supplementary Pillar 2 guidance (paragraphs 84 to 94).

As part of the Department's mission to promote the soundness of the banking system and to minimise systemic risk through the effective and efficient application of international regulatory and supervisory standards, it included in its flavour-of-the-year topics for meetings with banks' boards during 2008 a discussion on the involvement of the board remuneration subcommittee in the banks' incentive schemes.

self-assessment questionnaire on the status of implementation of principles and standards issued by the FSB

As a follow-up to the above-mentioned discussions held with banks' boards, and in order to establish the level of compliance by banks with the principles and standards issued by the FSB in 2009, the Department requested banks to complete a self-assessment questionnaire in 2010 on the status of implementation of the principles and standards issued by the FSB. The self-assessment questionnaire required banks to indicate the current status of compliance with the principles and standards, and to disclose the actions that were planned to ensure full compliance within a reasonable period.

The results of the self-assessment indicated that banks in South Africa were duly cognisant of the importance of implementing the above-mentioned principles and standards, and had made progress towards their implementation. However, from a supervisory perspective, more work needs to be done to ensure full compliance, and it is the intention of the Department to focus on this aspect as part of the 2011 supervisory review and evaluation process (SREP).

1.5 Key international regulatory developments, recommendations and focus areas, and the Bank Supervision Department's response thereto

1.5.1 Introduction

Since the commencement of the sub-prime and financial market crisis in 2007 and the subsequent worldwide economic crisis, various international standard-setting bodies such as the G-20 Forum, the FSB and the Basel Committee have announced comprehensive initiatives and strategies, and have issued various new or amended requirements or standards in respect of a wide range of key focus areas to comprehensively address the fundamental weaknesses revealed by the international financial market and economic crisis.

the Basel Committee issued three documents that materially impacted regulation and supervision

In its Annual Reports of 2007, 2008 and 2009, the Department reported fully on matters such as the background to, and causes of, the crisis, and the identified weaknesses that required specific attention or correction. For example, as reported extensively in the Department's 2009 Annual Report, in July 2009 the Basel Committee issued three documents that materially impacted on the regulation and supervision of banks and banking groups, namely

i. "Enhancements to the Basel II Framework";
ii. "Revisions to the Basel II Market Risk Framework"; and
iii. "Guidelines for Computing Capital for Incremental Risk in the Trading Book".

Originally, these amended internationally agreed requirements were scheduled for implementation on 1 January 2011. However, on 18 June 2010 the Basel Committee agreed and announced certain adjustments to the requirements originally issued during July 2009, including a revised co-ordinated implementation date of not later than 31 December 2011 for all elements of the July 2009 package.

1.5.2 Enhancements to the Basel II framework

As previously reported, the documents that deal with the enhancements to the Basel II framework include the following:

enhancements to the Basel II framework

- Requirements to strengthen the treatment of certain securitisations in Pillar 1 of the Basel II framework, which deals with minimum capital requirements.
- Higher risk weights for resecuritisation exposures, often being referred to as 'collateralised debt obligations' (CDOs) of asset-backed securities (ABS), to reflect the risk inherent in these products better.
- Changes to the credit conversion factor for short-term liquidity facilities granted to certain off-balance-sheet conduits.
- Requirements for banks to conduct more rigorous credit analyses of externally rated securitisation exposures.
- Supplemental guidance under Pillar 2 of the Basel II framework, which deals with the supervisory review process. This guidance addresses the flaws in risk management practices revealed by the crisis and raises the standards for
  - bank-wide governance and risk management;
  - capturing the risk of off-balance-sheet exposures and securitisation activities;
  - managing risk concentrations; and
  - providing incentives for banks to manage risk and returns better over the long term.

  The supplemental guidance under Pillar 2 of the Basel II framework also incorporates the Principles for Sound Compensation Practices, originally issued by the FSB in April 2009.
- Enhancements to Pillar 3 of the Basel II framework, which deals with market discipline or public disclosure, to strengthen disclosure requirements for securitisations, off-balance-sheet exposures and trading activities.

  The additional disclosure requirements will help to reduce market uncertainties regarding, among other things, the strength of banks' balance sheets related to capital market activities.

additional disclosure requirements

1.5.2.1 Enhancement of the capital framework for market risk

Since the financial market crisis began in mid-2007, many of the losses that had occurred were related to positions held in the banks' trading books. A main contributing factor was that the current capital framework for market risk, based on the 1996 Amendment to the Capital Accord to incorporate market risk, does not capture all the key risks.

In response, the Basel Committee supplemented the current value-at-risk- (VaR) based trading book framework with an incremental risk capital (IRC) requirement, which includes default risk and migration risk, for unsecuritised credit products.

For securitised products, the capital requirements of the banking book will apply with the limited exception for certain so-called correlation trading activities, where banks may be allowed, subject to the prior written approval of the Registrar and strict qualitative minimum requirements that include stress-testing requirements, to calculate a comprehensive risk capital requirement. These measures are intended to reduce the incentive for regulatory arbitrage by banks between the banking book and the trading book.

measures will reduce the incentive for regulatory arbitrage

(a) Stressed value-at-risk requirement

An additional response to the crisis was the introduction of a stressed VaR (sVaR) requirement. Losses in most banks' trading books during the financial crisis have been significantly higher than the minimum capital requirements under the Pillar 1 market risk rules. Therefore, the amended framework now requires banks to calculate an sVaR requirement, taking into account a one-year observation period relating to significant losses, which has to be calculated in addition to the VaR requirement based on the most recent one-year observation period. The additional sVaR requirement will also help to reduce the procyclicality of the minimum capital requirements for market risk.

(b) Incremental risk capital requirement

changes address a number of perceived shortcomings in the current VaR framework

The IRC requirement is intended to complement additional standards being applied to the VaR model framework. The changes address a number of perceived shortcomings in the current VaR framework and are incremental to the risks captured by the VaR-based calculations. Foremost is that the current VaR framework fails to adequately address credit risk underlying certain traded instruments. VaR calculations are typically based on a 99 per cent confidence interval. By contrast, the IRC represents an estimate of the default and migration risks of unsecuritised credit products over a one-year capital horizon at a 99,9 per cent confidence level, taking into account the liquidity horizons of individual positions or sets of positions. No specific approach for capturing the incremental risks is prescribed by the Basel Committee and consequently banks are expected to develop their own models to calculate the IRC for the relevant positions. Such models may be applied for regulatory capital determination with prior approval of the Registrar. Banks that do not capture the incremental default risks through an internally developed approach must use the specific risk capital charges under the standardised measurement method.

The document issued by the Basel Committee in July 2009 provides guidelines to specify the positions and risks to be covered by the incremental risk capital charge. It also contains guidance for the Department on how to evaluate banks' IRC models.

1.5.3 Strengthening global capital and liquidity standards to promote a more resilient banking sector

In its 2009 *Annual Report* the Department reported that, at its 8–9 December 2009 meeting, the Basel Committee approved for consultation a package of proposals to strengthen global capital and liquidity regulations further with a view to promoting a more resilient banking sector.

Along with the measures taken by the Basel Committee in July 2009 to strengthen the Basel II framework, additional proposals announced on 17 December 2009 contributed to the Basel Committee's comprehensive response to addressing the lessons of the crisis in what has subsequently been termed the Basel III framework.

measures intended to raise the resilience of the banking sector

The Basel Committee, and international regulatory and supervisory authorities, including the Department, are mindful of the need to introduce the aforementioned measures, intended to raise the resilience of the banking sector over the longer term, while avoiding negative effects on banks' lending activities that could impair the economic recovery. In this regard, the Basel Committee initiated a comprehensive impact assessment of the capital and liquidity standards proposed in the December 2009 consultative documents.

At its 10 January 2010 meeting, the Group of Central Bank Governors and Heads of Supervision (GHOS) – the oversight body of the Basel Committee – welcomed the substantial progress made by the Basel Committee in translating the GHOS's September 2009 agreements into a concrete package of measures, as elaborated in the Basel Committee's 17 December 2009 *Consultative Proposals for Strengthening the Resilience of the Banking Sector and the International Framework for Liquidity Risk Measurement, Standards and Monitoring*, and requested the Basel Committee to deliver a fully calibrated and finalised package of reforms by the end of 2010.

principles for enhancing sound corporate governance practices

On 16 March 2010 the Basel Committee issued for consultation a set of principles for enhancing sound corporate governance practices in banks and banking groups. These principles address fundamental deficiencies in bank corporate governance that became apparent during the financial crisis, and include matters related to the following:

- The role of the board, which includes approving and overseeing the implementation of the bank's risk strategy, based on the bank's long-term financial interests and safety
- The board's qualifications, such as that it should have adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue, to enable effective governance and oversight of the bank

- The importance of an independent risk management function, including a chief risk officer or equivalent with sufficient authority, stature, independence, resources and access to the board
- The need to identify, monitor and manage risks on an ongoing basis, based on the bank or banking group's risk management systems, and internal control infrastructure, appropriate for its external risk landscape and risk profile
- The board's active oversight of the compensation system's design and operation, including careful alignment of employee compensation with prudent risk-taking, consistent with the FSB's principles. These aforementioned principles also stress the importance of the board and senior management having a clear knowledge and understanding of the bank or banking group's operational structure and risks, which include risks arising from special-purpose entities or related structures.

principles stress the importance of boards having a clear understanding of banking groups' operational structures

The need for sound corporate governance improvements has also been observed in other financial sectors.

Subsequently, the Basel Committee concluded its work in this regard and on 4 October 2010 issued a set of principles for enhancing sound corporate governance practices at banking organisations.

On 18 March 2010 the Basel Committee issued its final *Report and Recommendations of the Cross-border Bank Resolution Group*. Based on the lessons learnt from the crisis, the report sets out ten recommendations that fall into the following three main categories:

i. Strengthening national resolution powers and their cross-border implementation

National authorities need to have powers to intervene sufficiently early, and to ensure the continuity of critical functions in banks and banking groups. The report recommends that national authorities seek convergence of national resolution tools and measures to promote the co-ordinated resolution of banks active in multiple jurisdictions.

convergence of national resolution tools and measures

The Basel Committee also recommends that supervisors work closely with their foreign counterparts and resolution authorities concerned to understand the way in which complex group structures and operations could be resolved in a crisis. One of the main lessons learnt from the crisis was that the enormous complexity of some corporate structures makes resolutions difficult, costly and unpredictable. If an institution's group structure is too complex to permit an orderly and cost-effective resolution, national authorities should consider imposing regulatory incentives, through capital or other prudential requirements, to encourage simplification of the structure.

ii. Bank-specific contingency planning

Banks, as well as key home and host authorities, should develop practical and credible plans to promote resiliency in periods of severe financial distress and to facilitate a rapid resolution should that be necessary. The plans should ensure access to relevant information in a crisis and assist the authorities' evaluation of resolution options.

The report recommends that systemically important cross-border banks and banking groups provide a plan to preserve the institution or group as a going concern, promote the resilience of key functions, or facilitate a rapid resolution or wind-down should that prove necessary.

plan to preserve the institution or group as a going concern

iii. Reducing contagion

Risk mitigation through mechanisms such as netting arrangements, collateralisation practices and the use of regulated central counterparties should be strengthened to limit the market impact of a bank failure. Recognising the wide diversity of national legal and resolution frameworks, the Basel Committee's report represents an internationally agreed set of recommendations for improving resolution.

recognising the wide diversity of national legal and resolution frameworks

On 26 July 2010 the GHOS reached broad agreement on the overall design of the Basel Committee's capital and liquidity reform package (Basel III framework). In particular, this includes the definition of capital, the treatment of counterparty credit risk, the leverage ratio and the global liquidity standard.

In reaching its broad agreement, the GHOS considered the comments received during public consultation on the Basel Committee's proposed reforms published in December 2009. The GHOS also took account of the results of the Quantitative Impact Study (QIS), the assessment of the economic impact over the period of transition, and the long-run economic benefits and costs.

reports prepared as input into the calibration of the new bank capital and liquidity standards

On 18 August 2010 the FSB and Basel Committee published reports prepared as input into the calibration of the new bank capital and liquidity standards, and to inform the transition arrangements for implementation of the new standards.

The Basel Committee's assessment of the long-term economic impact finds that there are clear net long-term economic benefits to increasing the minimum capital and liquidity requirements from their current levels in order to raise the safety and soundness of the global banking system. The benefits of higher capital and liquidity requirements accrue from reducing the probability of financial crises and the output losses associated with such crises. The benefits substantially exceed the potential output costs for a range of higher capital and liquidity requirements.

Subsequently, the FSB and Basel Committee concluded their assessment of the macroeconomic impact of the transition to the new bank capital and liquidity standards, and published their final report on 17 December 2010.

On 12 September 2010, following its meeting in Basel, the GHOS announced a substantial strengthening of existing capital requirements and the introduction of global liquidity standards. Among other things, the strengthening of the existing capital requirements entails the following:

buffer of capital that can be used to absorb losses during periods of financial stress

- An increase in the minimum common equity requirement, from 2 per cent to 4,5 per cent.
- A capital conservation buffer of 2,5 per cent to withstand future periods of stress, bringing the total common equity requirements to 7 per cent. The capital conservation buffer of 2,5 per cent, which is above the specified regulatory minimum requirement, should be met with common equity after the application of specified deductions. The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks will be allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the specified minimum requirement, the greater the constraints on discretionary distributions such as dividend payments, share buybacks and bonuses will be.

  The aforementioned two requirements reinforce the stronger definition of capital agreed on by the GHOS in July 2010, and the higher capital requirements for trading, derivative, securitisation and resecuritisation activities to be implemented on 1 January 2012.
- An increase in the Tier 1 or primary capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, from 4 per cent to 6 per cent.

countercyclical buffer introduced as an extension of the conservation buffer

- A countercyclical buffer within a range of 0 per cent to 2,5 per cent of common equity or other fully loss-absorbing capital. This capital requirement will be implemented according to national circumstances. The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth. For any given country, this buffer will only be in effect when there is excess credit growth that would result in a system-wide build-up of risk. The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.

Based on the aforesaid, and for ease of reference, a comparison between the Basel II capital framework and the newly released Basel III capital framework is set out in Table 1.2.

Table 1.2: Baseline capital structure*

Description	Basel II (per cent)	Basel III (per cent)
1. Statutory minimum required capital and reserve funds		
Core Tier 1 or common equity	2 (50% of total Tier 1) Before deductions	4,5 After deductions
Other elements or instruments qualifying as Tier 1 capital (non-core Tier 1)	2 Residual	1,5 Residual
Total Tier 1 or primary capital	4 (50% of total Pillar 1 minimum)	6
Tier 2 or secondary capital	4 (50% of total Pillar 1 minimum)	2 Residual
Total Pillar 1 required capital and reserve funds	8	8
Plus: Pillar 2(a) for systemic risk	Not specified	Not specified
Plus: Pillar 2(b) for idiosyncratic risk	Not specified	Not specified
Statutory minimum required capital and reserve funds	8	8
2. *Plus*: additional conservation buffer		
– for periods of stress (to be met with core Tier 1 capital that may be drawn during periods of stress)	–	2,5
3. *Plus:* further add-on: countercyclical buffer		
– for credit growth (national discretion: to be determined from time to time during credit cycles)	–	0 to 2,5
4. Aggregate impact: specified elements of “1” plus “2”		
Core Tier 1 or common equity after deductions	–	7 (4,5% plus 2,5%)
Total Tier 1 or primary capital after deductions	–	8,5% (6% plus 2,5%)
Total Pillar 1 after deductions	–	10,5% (8% plus 2,5%)

* Unless specifically stated otherwise, all percentages indicated in the table relate to the required amount of qualifying capital and reserve funds expressed as a percentage of the reporting entity’s prescribed or specified risk-weighted exposure

The aforementioned capital requirements will be supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures. For the past few years, as part of its supervisory framework, the Department had already calculated and monitored banks’ leverage multiples and ratios to monitor the potential build-up of risk.

capital requirements supplemented by a non-risk-based leverage ratio

The GHOS also agreed on transitional arrangements for the implementation of the new Basel III standards. The transitional arrangements will help to ensure that the global banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy. In this regard, internationally, the implementation of specific requirements related to the strengthening of existing capital requirements and the global liquidity standards will be phased in during predefined periods that will commence on 1 January 2013.

On 22 September 2010, as part of his opening remarks at the 16th International Conference of Banking Supervisors (ICBS) held in Singapore, Mr Nout Wellink, Chairperson of the Basel Committee and President of De Nederlandsche Bank, provided an overview of the international background to, and height of, the international financial crisis that required specific international reforms to be undertaken. He confirmed that the required reforms included the following:

- A comprehensive review of various international regulatory and supervisory standards
- Bank-specific reforms related to matters such as a stronger and more robust definition of capital and improved risk coverage of capital requirements, higher levels of required capital and reserve funds, the introduction of specific capital buffers and a supplemental leverage ratio, and the introduction of internationally agreed minimum liquidity standards, as part of the new Basel III framework
- Guidance for supervisors on important bank-specific initiatives, such as stress testing, valuation, corporate governance, compensation, supervisory colleges, and high-level principles for financial instruments accounting
- Broader macroprudential measures to strengthen the resilience of the entire banking system, and to address matters such as procyclicality, specified capital buffers, the role of "going concern" and "gone concern" capital instruments, interconnectedness and the perception that some banks are too big to fail.

ongoing work to strengthen the resilience of banks and the global banking system

On 19 October 2010 the Basel Committee issued a report to the G-20 that elaborated on the measures taken by the committee and its governing body, the GHOS, to respond comprehensively to the lessons learnt from the global financial and economic crisis, and to strengthen the resilience of banks and the global banking system. Among other things, the Basel Committee Report to the G-20 detailed the key elements of the committee's reform programme and the ongoing work to strengthen the resilience of banks and the global banking system, including matters related to the following:

- *Microprudential measures*: The cornerstone of the Basel Committee's reforms is stronger capital and liquidity regulation. But, at the same time, it is critical that the reforms regarding stronger capital and liquidity be accompanied by improvements in supervision, risk management and governance, and greater transparency and disclosure. Specific matters addressed as part of the micro-prudential measures include
  - capital and, in particular, the quality and level of the capital base, the increased risk coverage of the amended capital framework, the decision to raise the level of required capital and reserve funds and matters related to leverage;
  - liquidity and, in particular, the introduction of global minimum liquidity standards and a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity trends;
  - matters related to corporate governance, risk management and supervision; and
  - matters related to public disclosure.
- *Macroprudential measures:* While stronger individual banks will lead to a stronger banking system, a bank-specific approach only will not be adequate to promote financial stability sufficiently. Broader measures to address, among other things, procyclicality and the strengthening of the resilience of the entire banking system are equally important. Specific matters addressed as part of the macroprudential measures include
  - procyclicality and, in particular, requirements related to capital buffers, and matters related to provisioning and fair value measurement; and
  - systemic risk and interconnectedness, including matters related to contingent capital and cross-border bank resolution.

specific matters addressed as part of the implementation and reform measures

- *The implementation of the reform measures*: An integral component of the Basel Committee's standard-setting activities is to consider the potential impact of its proposed standards carefully. In this regard, the Basel Committee's report to the G-20 also covers the work undertaken by the committee to assess the impact of the reforms, and details the transitional arrangements. Specific matters addressed as part of the implementation and reform measures include
  - an impact assessment and, in particular, matters related to the earlier comprehensive QIS undertaken to assess the impact of the reform package and the earlier macroeconomic impact assessment; and
  - the transitional arrangements for the implementation of the new standards and requirements.
- *Future work*: The Basel Committee continues to work on a range of initiatives that are important to the resilience of banks and banking groups, including timely and full

implementation and rigorous supervisory follow-up. Specific areas addressed as part of future work to be undertaken include matters related to a fundamental review of the trading book, ratings and securitisations, systemically important banks, contingent capital, large exposures, cross-border bank resolution and a review of the Core Principles.

On 16 December 2010 the Basel Committee issued the Basel III rules text, which presents the details of global regulatory standards on bank capital adequacy and liquidity agreed to by the GHOS, and endorsed by the G-20 leaders at their November 2010 Seoul summit.

The Basel Committee has put in place processes to ensure the rigorous and consistent global implementation of the updated Basel III framework. The standards will be phased in gradually so that the global banking sector can move to the higher capital and liquidity standards while supporting lending to the economy. Both the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) will be subject to an observation period and will include a review clause to address any unintended consequences.

processes to ensure the rigorous and consistent global implementation of the Basel III framework

As a member of the Basel Committee, the Department has been, and will continue to be, actively involved in developing reforms that not only promote the safety and soundness of the banking system, but also continue to support long-term economic growth.

In order to ensure that the regulatory framework for banks and banking groups remains relevant and current, the Department commenced a formal process to amend the regulatory framework in accordance with the latest internationally agreed regulatory and supervisory best practices and standards, as described in further detail in Chapter 3.

1.6 Financial Stability Institute: High-level meeting for African banking supervisors

The FSI of the BIS and the Department jointly hosted a high-level meeting in Cape Town, South Africa, on 28 and 29 January 2010. The meeting focused primarily on the work undertaken by the Basel Committee and the FSB following the crisis, lessons learnt from the crisis, liquidity risk management and cross-border supervision. The attendees included Mr Nout Wellink and Ms Gill Marcus, Governor of the Bank. Mr Josef Tošovský, Chairperson of the FSI, chaired the proceedings.

the meeting focused primarily on work undertaken by the Basel Committee and the FSB

Mr Tošovský's introductory remarks covered matters such as strengthening the capital framework, and proposed liquidity and leverage ratios. Mr Errol Kruger, Head of the Department and the South African Registrar of Banks, advised that the crisis offered regulators the opportunity to reassess the adequacy of regulatory and supervisory frameworks. Mr Kruger stated that it was essential for regulators globally to take appropriate steps to strengthen their respective regulatory frameworks. However, regulators should guard against overreaction, which could result in unintended negative consequences in their respective jurisdictions.

Mr Wellink provided a high-level overview of the impact of the crisis. He stated that the social contract between banks and society in general had been impaired as a result of the crisis. Banks had to be structured such that they were better able to absorb losses, he added. It was also stated that the quality of banks' Tier 1 capital had to be improved and that more attention had to be paid to leverage ratios, liquidity risk management and the compensation schemes of banks.

Ms Marcus discussed Africa in the context of global adjustments. She commented that the additional regulatory requirements could not guarantee that no banks would fail in future. Therefore, in developing and implementing additional regulatory requirements, the focus should be on creating a more robust financial system and avoiding an implosion of the system as a result of implementing over-restrictive requirements. She added that the Basel Committee should be aware of the impact of its current and future standards on African countries. She concluded by saying that regulators and other stakeholders should focus on restoring confidence in and strengthening the financial system, rather than castigating banks.

Mr Rudi Bonte, member of the Management Committee: Bank Supervision, Banking, Finance and Insurance Commission, Belgium, discussed the reduction of procyclicality of capital regulation. The measures for such reduction included more stringent risk coverage of the capital framework; raising the quality, consistency and transparency of Tier 1 capital; the introduction of a leverage ratio; and the introduction of countercyclical capital buffers.

Mr Daniel Zuberbühler, Vice Chairperson of the Swiss Financial Market Supervisory Authority, addressed the Swiss approach to the design of a leverage measure and a risk-based approach for banks. His talk focused on additional regulatory requirements introduced following the advent of the crisis, and concentrated on capital-adequacy and leverage ratio requirements for Swiss banks.

an overview of the FSB's seven current priorities

Mr Nigel Jenkinson, Adviser to the FSB, discussed the FSB's work on the assessment of vulnerabilities affecting financial systems. He also provided an overview of the seven current priorities of the FSB, which were as follows: (i) banks' capital and liquidity; (ii) compensation practices of financial institutions; (iii) over-the-counter (OTC) derivative markets; (iv) accounting standards; (v) crisis management; (vi) systemically important financial institutions; and (vii) overall implementation of issued standards.

Messrs Kruger, Geoffrey Mortlock (Senior Manager: Policy, Australian Prudential Regulation Authority) and Bradley Fried (then Chief Executive Officer: Investec Bank plc, United Kingdom (UK)) discussed liquidity risk with the emphasis on supervisory expectations versus daily management. Discussions covered the importance of liquidity risk management, the introduction of a global liquidity standard and the management of liquidity in times of crises.

Messrs Bonte, Mortlock and Paul Smith (then Group Chief Risk Officer, Standard Bank Group Limited) covered cross-border regulatory co-operation. Discussions included the management of global systemic risk, requirements for effective cross-border supervision, and enhancement of cross-border supervision and supervisory colleges.

the role of fair value measurement during and post the global financial crisis

Ms Sylvie Mathérat (Director of Financial Stability, Bank of France), Mr Gregg Tanzer (Secretary General of the International Organization of Securities Commissions) and Dr Hennie van Greuning (Independent Director of FirstRand Bank Limited) shared their views on the subject of "Valuation of Financial Instruments: International Financial Reporting Standards Versus Prudential Regulation". Discussions covered the role of fair value measurement during and post the global financial crisis, the scope of fair value measurement, and a comparison between fair value measurement and prudential regulatory requirements.

Mr Zuberbühler addressed the supervision of systemically important financial institutions. He covered the contentious subject of "Too-big-to-fail Institutions, Compensation Policies, Challenges in Cross-Border Wealth Management and the Key Role of Political Support". The topic of Mr Tanzer's paper was "Incentive Structures for Bankers: The Issue of Bonus Payments", while Ms Mathérat and Mr Yandraduth Googoolye, First Deputy Governor, Bank of Mauritius, spoke on "The Macroprudential Approach to Regulation and Supervision".

The final session included African banking supervisors who provided an overview of the current activities of supervisors in the region. Mr David Scott, Advisor: Financial Sector Operations and Policy, World Bank, discussed "Stress Testing and Simulation Exercises" and Mr Andres Portilla, Deputy Director: Regulatory Affairs, Institute of International Finance (IIF), addressed an IIF report on "Reforms in the Financial Services Industry: Strengthening Practices for a More Stable System".

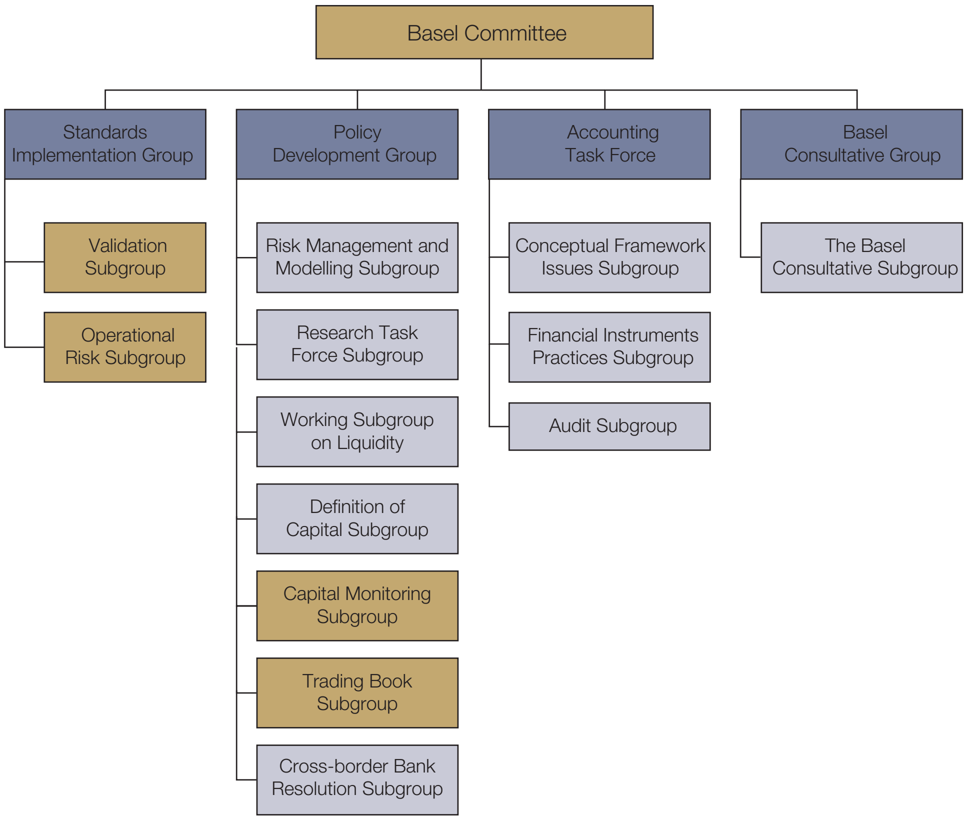
1.7 Participation in international regulatory or supervisory forums

1.7.1 Introduction

In order to keep abreast of international regulatory and supervisory developments, the Department participates in, and contributes to, various international forums. These include the G-20, the FSB and the Basel Committee and its subgroups. The Basel Committee, in particular, provides a forum for regular co-operation between member countries on banking supervisory matters, thereby enhancing their understanding of key supervisory issues and improving the quality of banking supervision across the globe. The Basel Committee is arguably best known for its international standards on capital adequacy (including Basel II and, more recently, Basel III) and the Core Principles. South Africa became a member of the Basel Committee in June 2009 and has since then continued to participate in various technical subgroups of the Basel Committee. The Basel Committee's work is organised under four main subcommittees,[5] as depicted in Figure 1.2 below. The Department's representation is reflected in gold.

the Basel Committee's work is organised under four main subcommittees

Figure 1.2 Basel Committee on Banking Supervision: Structure of working groups



1.7.2 Standards Implementation Group: Validation Subgroup

The Standards Implementation Group Validation Subgroup (SIGV) explores issues related to the validation of systems used to generate the ratings and parameters that serve as inputs into the internal ratings-based (IRB) approaches to credit risk.

5 http://www.bis.org/bcbs/.

The Department is represented on the SIGV and during 2010 the SIGV held four meetings. Among other things, the discussions at these meetings focused on the following key items:

- The validation practices of IRB estimates among banks
- Banks' stress-testing programmes and the way in which they should be assessed during on-site visits. Different supervisors shared their experiences on ways to approach stress testing on-site visits and the common findings from such on-site reviews
- Issues encountered by supervisors when assessing loss-given-default (LGD) and exposure-at-default (EAD) estimates
- The main regulatory challenges when assessing banks' economic capital models. The common findings from such visits were also shared among supervisors.

bank practices relating to the application of the maturity input to the risk-weighted assets formula

In 2010 the SIGV initiated a project among its members to research acceptable supervisory and bank practices relating to the application of the maturity input to the risk-weighted assets (RWAs) formula for corporate, bank and sovereign exposures for banks that adopted the advanced IRB (AIRB) approach to calculate their minimum required capital and reserve funds relating to credit risk. A subgroup of the SIGV, consisting of representatives of South Africa, Australia and the UK, examined the maturity input.

The research on maturity was specifically initiated as a result of the supervisory work and guidance documents previously issued by regulators that had focused mainly on other IRB parameters such as probability of default (PD), LGD and EAD. Banks had also concentrated much of their Basel II implementation efforts on the other IRB parameters. The research addressed two issues, that is, which maturity date should be used and a review of the maturity dates allowed by various supervisory bodies as input into the RWAs formula for exposure under the AIRB, that is, the maturity date of the drawings or the maturity date when the facility expires. A questionnaire was circulated in July 2010 to 22 countries represented at SIGV meetings, to solicit their interpretation of the maturity directives contained in paragraphs 318 to 324 of the Basel II text. Views from those countries that had not yet reached an interpretation on the subject, or had not yet implemented Basel II, were also requested. Furthermore, countries were required to provide the working group with current bank practices on the maturity input.

The initial results of the research were presented at the SIGV meeting held in Rio de Janeiro in October 2010. A report on the findings was also tabled at the first SIGV meeting of 2011 for agreement by members on the content, after which the results would be escalated to the Standards Implementation Group (SIG) for notification and recommendation of further work if required.

The SIG has also requested the SIGV to commence a research project with a view to understanding the effects of the recent economic crisis on LGD estimates and it is anticipated that this proposed LGD project would be discussed in detail at upcoming SIGV meetings.

1.7.3 Standards Implementation Group: Operational Risk Subgroup

SIGOR focuses on operational risk implementation issues

The Standards Implementation Group: Operational Risk Subgroup (SIGOR) is a permanent working group of the SIG that focuses on operational risk implementation issues, particularly the implementation of advanced measurement approaches (AMA) for operational risk. The Department is an active member of SIGOR which met three times during 2010.

The principal focus of SIGOR is the practical challenges associated with the successful development, implementation and maintenance of an operational risk framework that addresses the requirements and expectations of the Basel Committee's AMA with regard to the calculation of capital requirements in respect of operational risk. Subgroup members share identified operational risk implementation issues within their respective jurisdictions and actively participate in developing resolution plans.

Another important element of SIGOR's mandate is to facilitate the resolution of issues associated with the cross-border supervision of international banking groups, especially in relation to operational risk.

1.7.3.1 Key focus areas of the Standards Implementation Group: Operational Risk Subgroup

The following were two key focus areas of SIGOR during 2010:

i. Recognition of insurance mitigation in advanced measurement approaches

SIGOR concluded work with supervisors, banks, insurance brokers and insurance providers to clarify its expectations with regard to the recognition of insurance mitigation in the AMA. The Basel Committee issued a final document in October 2010, titled "The Risk-Mitigating Impact of Insurance in Operational Risk Modelling". The paper discusses the potential benefits and shortcomings of banks' use of insurance to mitigate operational risk. The regulatory capital framework permits banks, subject to certain criteria and limitations, to use insurance to mitigate the operational risk capital charge under the AMA. The implementation of this provision has raised some challenges and technical questions. In response, the report clarifies supervisory expectations on the range of industry AMA practices, while promoting increased convergence in operational risk management.

potential benefits and shortcomings of banks' use of insurance to mitigate operational risk

The paper raises a number of key considerations and complexities in the recognition of insurance mitigation in AMAs, including concerns surrounding the quantification of a capital reduction for insurance. Particular emphasis is placed on the extent to which operational risk can be identified and transferred outside a bank through the use of insurance and the extent to which other risks (e.g., strategic, reputational and counterparty) are created as a result.

The intention of the paper is not to dispute or discourage enhancements in the use of insurance within an operational risk management framework. However, the use of insurance raises concerns that it might be relied upon as a replacement for risk management and potentially as a replacement for capital. The Department invited selected South African banks, already on AMA or targeting AMA, to participate in the informal consultative process.

ii. Performance of the current practices for calculating operational risk capital charge

SIGOR originated a work stream to review the calibration of the operational risk capital charge. Enhanced operational risk data availability enables SIGOR to study the manner in which the current practices employed for calculating the operational risk capital charge have performed since the operational risk framework's introduction in 2004. This work includes reviews of the manner in which operational risk losses and operational risk capital charges have evolved over the years. These reviews are expected to shed light on the ability of the current regulatory frameworks, that is, the basic indicator approach (BIA), the standardised approach (TSA) and the AMA, to capture the level and trend of operational risk at both the levels of individual banks and the industry as a whole. SIGOR also intends to review the relative performance of the simpler approaches of the BIA and TSA with respect to the AMA, including whether incentives exist to encourage banks to move along the spectrum of available approaches as they develop more sophisticated operational risk systems and practices.

reviews of the manner in which operational risk losses and operational risk capital charges have evolved over the years

1.7.4 Policy Development Group: Capital Monitoring Subgroup

The Basel Committee established the Capital Monitoring Subgroup (CMG) to monitor the level and cyclicality of minimum required capital (MRC) produced under the Basel II framework effectively. The CMG collects and analyses data from banks that have adopted one of the IRB approaches to credit risk and reports the results of its analysis to the Basel Committee every six months. The analysis covers areas such as MRC, capital ratios and buffers, RWAs, portfolio-level exposures,

CMG collects and analyses data

risk parameters and transitional floors. The CMG also shares experiences in monitoring capital requirements and the levels of capital on a national basis.

At present data from 95 banks across 14 countries are collected and analysed for inclusion in the CMG report submitted to the Basel Committee. These data are submitted by national supervisors via standard reporting templates based on information received from the respective banks in their jurisdictions.

The Department has participated in the CMG since its inception in 2008, and collates the required data from the relevant BA returns for the large IRB banks in South Africa before submitting them to the CMG on a confidential basis. The CMG met twice during 2010.

1.7.5 Policy Development Group: Trading Book Group

a fundamental review of the trading-book capital framework

The primary objective of the Basel Committee's Policy Development Group (PDG) is to identify and review emerging supervisory issues and, where appropriate, to propose and develop policies to promote a sound banking system and high supervisory standards. The Trading Book Group (TBG), a technical subgroup of the PDG, focuses primarily on performing a fundamental review of the trading-book capital framework. South Africa was among the selected nations invited to participate in the activities of the group which held six meetings during 2010.

Two publications, namely *Revisions to the Basel II Market Risk Framework and Guidelines for Computing Capital for Incremental Risk in the Trading Book* emanated from the group's work in 2009. In the course of 2010 the group debated and introduced refinements to these documents to address issues related to stress testing of the correlation trading portfolio and a substantial list of interpretive matters. The group also contributed to the debates of other task teams in the Basel Committee, including the definition of capital, credit valuation adjustments for counterparty credit risk, the Accounting Task Force's research on valuation uncertainty, and the Working Group on Liquidity's assessment of market liquidity.

Work on the TBG's fundamental review of trading activities progressed with the development of a framework for assessing proposals to alter the market risk framework. Factors that would have to be addressed by a fundamental review were agreed on and documented comprehensively. TBG members made a number of rudimentary submissions on alternative approaches to reformulating rules for market risk and debate proceeded on the basic tenets of each suggestion. A substantial review of literature was undertaken by the Research Task Force on behalf of the TBG that provided guidance on the sophistication of banks' risk measurement practices.

1.7.6 Quantitative Impact Study Working Group

The Basel Committee established the QIS Working Group to assess the impact of amendments to the Basel II framework such as "Revisions to the Basel II Market Risk Framework", "Guidelines for Computing Capital for Incremental Risk in the Trading Book", "Enhancements to the Basel II Framework", "Strengthening the Resilience of the Banking Sector" and the "International Framework for Liquidity Risk Measurement, Standards and Monitoring".

data collection exercises to assess the impact across all participating countries

The QIS Working Group co-ordinates the data collection exercises to assess the impact assessment across all participating countries, and provides reporting templates and instruction guidelines.

The Department again participated in this group during 2010 when a comprehensive QIS was conducted to assess the possible impact of the new Basel III framework originally proposed in December 2009. A total of 263 banks from 23 countries participated in the QIS and the Basel Committee published the detailed results in December 2010.

In South Africa a total of 7 banks participated in the exercise and data were compiled by the banks themselves and then submitted by the Department to the QIS Working Group on a confidential basis.

The Department will continue to participate in these studies during 2011 where further studies will be conducted to monitor the impact of the new Basel III framework released in December 2010.

1.8 Participation in domestic regulatory or supervisory forums

1.8.1 Over-the-Counter Derivative Working Group

Following the G-20's Pittsburgh Summit in September 2009, the leaders called for the implementation of a number of reforms for financial markets globally. Among these were specific initiatives that the OTC derivatives industry and its regulators were required to undertake in order to improve transparency in the derivatives markets, mitigate systemic risk and protect against market abuse.

In response to this requirement, the Financial Services Board of South Africa commissioned a report on the status of the South African OTC derivatives market and on considerations that required cognisance when implementing the G-20 programme. A working group was established to draft the report with representatives of both commercial and regulatory bodies within the South African financial markets community. A senior representative of the Department was co-opted onto the working group to provide perspective on the OTC derivative activities of banks and the controls imposed on them through the Banks Act regulations. OTC contracts dominate banks' activities in which derivatives are involved.

report on the status of the South African OTC derivatives market

The principal notions proposed by the G-20 were that

- all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate;
- all standardised OTC derivatives contracts should be cleared through central counterparties by the end of 2012 at the latest;
- non-centrally cleared contracts should be subject to higher capital requirements; and
- OTC derivative contracts should be recorded on trade repositories.

The working group concluded its work by issuing a report which is in the domain of the Financial Services Board. The report proposes several specific and alternative recommendations to strengthen the current regulatory framework of the South African OTC derivatives markets, with an emphasis on the G-20 measures.

1.8.2 Structural Funding and Liquidity Risk Task Team

Under the direction of the South African Minister of Finance, a financial cross-sectoral task team was established in 2010 and commissioned to consider issues relating to the lack of retail savings, the disintermediation of banks due to the increase in money-market funds and the disparate regulatory treatment of banks and money-market funds. Liquidity risk limitations on banks introduced through the LCR and NSFR detailed in the liquidity framework imposed by the Basel Committee were also to be examined.

The Department is represented on both the task team's Steering Committee and its Technical Committee. Other interest groups represented on these committees include the National Treasury (NT), the Financial Services Board, the Banking Association of South Africa (BASA), the Association for Savings and Investment SA (ASISA), and invited domestic banks and asset management firms.

the Department is represented on both the task team's Steering Committee and its Technical Committee

Work of the Technical Committee has been assigned to several work streams whose ambit of investigation includes the structural funding profile of the South African financial sector, the distribution of savings between different products, regulatory asymmetries, the business models of financial institutions as they pertain to structural funding and liquidity risk management, and the management of liquidity risk in banks as affected by the LCR specified in the Basel Committee document *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*, dated December 2010.

In 2011 the Department will continue to participate in these forums and contribute towards the ongoing efforts of the various work streams.

1.8.3 Financial Sector Contingency Forum

The Financial Sector Contingency Forum (FSCF) was established after the events of 11 September 2001 to facilitate cross-sectoral co-operation in identifying risk to the stability of the financial sector and to mitigate such risk. In November 2009 the FSCF was restructured, and its various subcommittees and working groups were consolidated into two subcommittees, namely the Operational Risk Subcommittee (ORS) and the Financial Risk Subcommittee (FRS). The membership of the ORS includes representation from the banking industry. The ORS is continuing with its efforts to monitor and mitigate systemic operational risk. The membership of the FRS includes the Bank and the NT.

identification and mitigation of financial risks and financial crisis planning

The FRS focuses on the identification and mitigation of financial risks and planning for a pure financial crisis. Since a crisis triggered by an operational disruption can easily mutate into a financial crisis and vice versa, cross-representation between the subcommittees ensures that efforts remain synchronised without unnecessary duplication. The FRS also engaged the services of an international consultant and reviewed the existing crisis management plan. Recommendations from the review included the expansion of the existing plan beyond the banking sector to the broader financial markets. A key element of the crisis management plan is to facilitate a quick but informed assessment of the likely impact of a shock. A working group was established to develop a framework for such an assessment, which included the NT, the Bank, the Financial Services Board and Strate (the licensed Central Securities Depository (CSD) for the electronic settlement of financial instruments in South Africa).

1.8.4 Solvency assessment and management: Insurance Groups Task Group

The Financial Services Board is in the process of developing a revised prudential regulatory regime for South African short- and long-term insurers, which will be based on the Solvency II regime being implemented by European insurers and reinsurers. It will be called the 'solvency assessment and management' (SAM) regime and its objective is to ensure that insurance regulation in South Africa complies with international best practice. The planned implementation date of the SAM regime is January 2014.

improve the protection of policyholders and beneficiaries

The primary purpose of the new regulatory framework is to improve the protection of policyholders and beneficiaries. Other objectives of the new framework are to

- align the capital requirements of insurers with their underlying risks;
- develop a proportionate, risk-based approach to the supervision of insurers with appropriate treatment both for small insurance companies and large, cross-border insurance groups;
- provide incentives to insurers to adopt more sophisticated risk monitoring and risk management tools; and
- help to maintain overall financial stability.

The Financial Services Board is developing the SAM regime in consultation with industry participants and other key stakeholders. Various task groups were formed to help with its development.

The Department was invited, together with industry participants and other key stakeholders, to join the SAM Insurance Groups Task Group. This provided participants with the opportunity to be part of the process from its inception and enabled all stakeholders to keep abreast of developments pertaining to the requirements of Solvency II and insurance group supervision. The Department's recent experience with the implementation of Basel II enabled it to share the lessons learnt and provide input on group supervision.

1.8.5 Consolidated supervision quarterly supervisory meetings with the Financial Services Board

Sharing of information between regulators is of paramount importance and improves effective supervision of financial groups. Accordingly, in the latter part of 2009 the Department and the Financial Services Board started a process of holding quarterly supervisory meetings between the supervisory teams responsible for the South African financial conglomerate groups with significant investments in banking, insurance and securities. The meetings facilitate the sharing of relevant, appropriate and timely information. The objectives of such meetings are to

- enhance supervisory information sharing between the supervisory bodies in an effort to eliminate any gaps that might exist in the supervision of conglomerate groups;
- discuss issues that may pose a risk to the financial stability of each banking group;
- identify any regulatory arbitrage that might exist; and
- foster close working relations between the supervisory teams responsible for each conglomerate group.

meetings facilitate the sharing of relevant, appropriate and timely information

The financial groups that were identified were those where the Department or the Financial Services Board was responsible for consolidated supervision in the capacity as lead supervisor. Each financial group is discussed in detail during the separate meetings.

The Department and the Financial Services Board developed and agreed on a standard agenda that covers various quantitative and qualitative issues such as corporate governance, management structures, risk management, compliance, control environment and regulatory concerns, group structures, and systemic and contagion risk.

The meetings have led to the Department and Financial Services Board gaining a better understanding of the respective institutions' supervisory frameworks and the risks that banking, insurance and securities groups are facing, and have also created a platform to

- discuss material issues of mutual interest and concern;
- communicate emerging issues and developments of a material and potentially adverse nature;
- establish and maintain contact between the two offices; and
- establish a climate of co-operation and trust.

The process outlined above has significantly contributed to a heightened awareness and more effective application of consolidated supervision of conglomerate groups in South Africa.

more effective application of consolidated supervision

1.9 Regional co-operation

1.9.1 Southern African Development Community Sub-committee of Banking Supervisors

The Department maintained its participation on the Southern African Development Community (SADC) Sub-committee of Banking Supervisors (SSBS) during the year under review. The Seychelles joined the SADC group, which brings the membership of the group to 14 countries. The following key focus areas for the SADC region continued to be addressed:

key focus areas for the SADC region

- The effective implementation of the Core Principles
- Training of supervisors and the effective implementation and ongoing enhancement of risk-based supervision
- The effective implementation and ongoing review of AML and CFT measures
- Implementation of International Accounting Standards (IASs)
- Harmonisation of banking supervision and legal and regulatory reforms.

The following training initiatives identified by the SADC during 2009 were successfully completed during 2010:

- The IMF assisted with the training of two financial soundness indicator courses held in Mauritius and Tunisia respectively
- The FSI assisted with a risk-based supervision course in Mauritius.

A working group of the SSBS was established in 2010 to draft central banking model law, which was completed at the end of December 2010. Member countries will debate the document further in 2011.

Some member countries have made limited progress with regard to compliance with the Core Principles. The Department distributed a self-assessment template to all member countries but only a few countries have completed the exercise; the main constraint identified being the lack of dedicated resources.

SADC was relatively unscathed by the international financial crisis but the second-round effects of the crisis affected the economies of these countries. Major international regulatory reforms initiated by the Basel Committee, and the issuance of a global regulatory framework for more resilient banks and banking systems (Basel III) issued in December 2010, will have an impact on SADC countries. A training intervention on regulatory reforms, assisted by the FSI, will be held in 2011.

1.9.2 Macroeconomic and Financial Management Institute of Eastern and Southern Africa: Regional Workshop on Consolidated Supervision

the workshop covered most of the important aspects of consolidated supervision

A representative of the Department was requested to make a presentation at a five-day workshop hosted by the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) in Windhoek, Namibia, during September 2010. The workshop was attended by 31 participants from all the MEFMI member countries and covered most of the important aspects of consolidated supervision.

Member states of the MEFMI include Angola, Botswana, Kenya, Malawi, Mozambique, Swaziland, Lesotho, Zimbabwe, Namibia, Tanzania, Rwanda, Zambia and Uganda.

The objective of the workshop was to provide participants with a comprehensive view of the consolidated supervision framework, including accounting consolidation and the supervision of large domestic and cross-border financial groups.

The topics covered by the Department's representative included the following:

- Capital adequacy on a conglomerate-wide basis
- Practical exercise: Assessing capital adequacy in financial conglomerates
- Regulatory framework for financial conglomerates
- Cross-sector and cross-border co-operation and information sharing.

Active participation in all the discussions led to the success of the workshop. Workshops of this nature will contribute to the implementation of consolidated supervision by MEFMI member countries in the region. MEFMI expressed its sincere appreciation to the Department for its involvement in, and support of, the above-mentioned programme.

1.9.3 Professional attachment of an official from the Central Bank of Zimbabwe

practical experience in analysing banking groups on a consolidated basis

In the latter part of 2010 the Department received a request from MEFMI for a representative of the Central Bank of Zimbabwe to be attached to the Department to gain practical experience in analysing banking groups on a consolidated basis. An intensive two-week programme was prepared covering all the aspects related to consolidated supervision.

The representative concerned, who is also a MEFMI graduate fellow, was experienced in consolidated supervision. Before being assigned to the Department he had prepared a technical paper, in partial fulfilment of the MEFMI Fellowship Programme, called: "Recommendations on the Practical Implementation of Consolidated Supervision in MEFMI Countries". The paper discusses some of the practical challenges involved in the supervision of a conglomerate, mixed-activity group or banking group. It also contains recommendations on ways in which MEFMI country supervisors could oversee such banks on a consolidated basis in accordance with international best practice.

The Department viewed its involvement in accommodating the representative as an opportunity to assist in promoting consolidated supervision in the region and, in turn, he experienced the training provided by the Department as invaluable.

1.9.4 Professional attachment of an official from the Central Bank of Kenya

Through its support for the development of appropriate regulatory practices, the IMF requested assistance from the Department with the implementation of regulations for market risk in Kenya. In 2009 the IMF arranged a mission to the Central Bank of Kenya (CBK) structured around a workshop for members of staff of the Bank Supervision Department of the CBK, which was attended by a member of the Department in the capacity of presenter or subject expert. In order to sustain the momentum and relationship, a follow-up mission took place in South Africa.

the Department provided assistance with the implementation of regulations for market risk in Kenya

During January 2010 a senior manager in the on-site supervision team from the CBK was seconded to the Department for a two-week period. The objectives of the secondment included both interactive refinement of the proposed regulations for market risk and training in market risk supervision, of which the CBK had previously had no experience.

Training took the form of regular analysis of banks' market risk returns, theoretical instruction in market risk and its origins, and participation in two quarterly on-site market risk meetings with banks. The visit also included an overview of the Department's mission, operations, structure and principles, which provided a perspective on the supervision of market risk as conducted by the Department. While the secondment proved fruitful for the CBK, the Department regards the strengthening of an ongoing relationship with regulators on the continent as a vital outcome.

1.10 Supervisory colleges

1.10.1 Introduction

The G-20 raised the importance of supervisory colleges in supporting the effective supervisory oversight of international banking groups in the aftermath of the global financial market crisis and, in this regard, the Basel Committee issued a paper titled "Good Practice Principles on Supervisory Colleges" in October 2010[6] which expands on principles previously published by the committee. The paper outlines good practices in colleges and provides some enhanced principles that could be used as a basis for further improving the operation of supervisory colleges. The Department regards supervisory colleges as an important component of the effective supervision of large, systemically important banks in South Africa and internationally active banking groups, and is of the opinion that they assist both home and host supervisors in the performance of their supervisory duties in respect of such groups. The Department uses supervisory colleges at a domestic and international level as a key tool in its supervisory review and assessment processes. In this regard, and similar to previous years, the Department held regular meetings with the Financial Services Board to discuss the cross-sectoral operations of the large systemically important banks in South Africa and it is planning a supervisory college, at international level, in respect of one of the largest internationally active South African banks. Furthermore, in 2010 the Department was invited to participate at two supervisory colleges arranged by international regulatory bodies, as detailed in the sections that follow.

supervisory colleges regarded as an important component of effective supervision of systemically important banks

6 http://www.bis.org/publ/bcbs177.htm.

1.10.2 Hongkong Shanghai Banking Corporation Limited and HSBC Group Asia Regional College of Supervisors (Hong Kong)

The UK's Financial Services Authority (FSA) and the Hong Kong Monetary Authority (HKMA), in their roles as consolidated supervisors for the Hongkong Shanghai Banking Corporation Limited (HSBC) Group and HSBC respectively, invited departmental representatives to attend the HSBC Asia Regional College of Supervisors at the offices of HKMA in Hong Kong from 5 to 6 July 2010.

One of the principal aims of this college was to facilitate discussion between participants so as to build a deeper common understanding of the risk assessments undertaken by various supervisory authorities.

The HKMA and the FSA presented their supervisory assessment of HSBC, the HSBC regional strategy and key supervisory issues. They provided information on group and regional strategy. Thereafter, representatives of Australia, China, Indonesia, Malaysia and Singapore, where the HSBC group has material operations, also presented their assessment of HSBC's activities for which they are responsible.

college contributed to a better understanding of the extent of supervision

This very successful college contributed to a better understanding between supervisors of the extent of supervision in their respective jurisdictions, the risks the HSBC group is facing and the type of business that is conducted in the different jurisdictions. Host supervisors have specific knowledge of the banking conditions in their jurisdictions that is invaluable to a home supervisor's overall supervisory assessment of a banking group.

1.10.3 College of Supervisors Bank of China (Beijing, China)

The Department participated in a Bank of China (BOC) supervisory college that had been arranged and hosted by the China Banking Regulatory Commission (CBRC) in Beijing from 9 to 10 September 2010. Representatives of 22 countries in which the BOC has operations attended the college.

Delegates were welcomed to the college by Mr Liu Mingkang, Chairperson of CBRC, and the college then commenced with a presentation by the CBRC Vice Chairperson, Mr Jiang Dingzhi. He sketched the People's Republic of China's macroeconomic situation and developments in the banking industry, and in China's banking supervision and regulatory system.

As regards the macroeconomy, he highlighted the rapid, but stable, economic growth with the gross domestic product (GDP) growth rate being 11,1 per cent for the first six months of 2010, while the consumer price index and producer price index were at levels of 2,9 per cent and 6,4 per cent respectively. As regards developments in the banking industry, he highlighted the following improvements in banking-sector statistics that had occurred following banking reforms that had been introduced in 2003:

- The sector average capital-adequacy ratios had improved from 2,1 per cent in 2003 to 11,3 per cent in 2009, while non-performing loans expressed as a percentage of outstanding loans had reduced from 16,8 per cent in 2003 to 1,8 per cent in 2009.
- The sector had produced an average return on assets of 1,1 per cent in 2009.
- Total banking-sector assets as at June 2010 stood at 87,2 trillion yuan, equating to R98,5 trillion at the then prevailing exchange rate.

As regards bank regulation, he advised that the CBRC, which had been established in 2003, followed global best practice in supervision. It had introduced regulatory requirements, focused on sound corporate governance and was enhancing co-operation domestically and internationally with other regulators. It was also implementing macroprudential supervision. Mr Yang Jiacai, the CBRC's Director-General of Banking Supervision Department 1, gave a presentation covering the following topics:

- The supervisory framework of BOC
- Institutional overview of BOC
- BOC's risk assessment
- Regulatory practice in respect of BOC.

He started by explaining the supervisory framework applied to BOC at head office, local and group levels. He proceeded to explain that BOC was the fourth largest bank in China, and that of all the Chinese banks it had the broadest network of overseas operations and the most diversified business operations. Domestically, BOC had 10 024 branches serving 1,45 million corporate clients and 125 million individual customers.

With respect to BOC's risk assessment, he commented on its capital, provisions, asset quality and liquidity ratios. He gave a detailed explanation of the CBRC supervisory indicators, namely dealing with capital adequacy, risk concentration, provisioning coverage, asset quality, affiliated institutions, liquidity and swindle prevention and control (called 'CARPALS'). He also explained the objectives of CBRC's supervisory philosophy applied to BOC that included protecting depositors and consumers, maintaining market confidence, increasing public knowledge about modern financial products, reducing bank-related crimes and improving skills in the conduct of risk-based supervision.

detailed explanation of the CBRC supervisory indicators

Mr Xiao Gang, the BOC Chairperson, gave a brief overview of BOC, which had 10 996 branches and a staff complement of 261 470 globally, setting out details of its business units, history since its founding in 1912, corporate governance, risk management framework and its historical financial performance.

Brief presentations were then made by the attending host regulators on the branch and subsidiary operations operating in their jurisdictions, encompassing a brief overview of activities covered by each operation, its size and financial performance, risk assessment, and supervisory interactions that had taken place.

The college concluded with a discussion of the mechanisms and suggestions for future CBRC supervisory colleges.

1.11 Skills development

1.11.1 Introduction

The Department spent R1 086 515,00 on the training of approximately 103 staff members during 2010. The training interventions covered technical and behavioural competencies, and consisted of seminars, workshops and courses. Similar to the previous year, the main purpose of the training interventions during 2010 was to ensure that staff members

- could implement sound supervisory standards and practices;
- were equipped with sector-specific knowledge and skills;
- were kept updated on the latest information on market products, practices and techniques;
- could perform their supervisory tasks efficiently and effectively; and
- continually enhance their personal and "softer" skills.

the Department spent R1 086 515,00 on training

1.11.2 Key training interventions

Tables 1.3 and 1.4 list the training interventions staff members attended during the review period. A brief description of the important training interventions is also furnished.

Table 1.3 Key local training interventions

Training intervention	Date
Induction programmes (for new staff)	13–14 January 2010 23 February 2010 21 April 2010 8 June 2010
Foundation courses (for new staff)	15–19 January 2010 24–26 February 2010 22–26 April 2010 9–10 June 2010
South African Institute of Chartered Accountant update seminars	4 February 2010 11 February 2010 17 March 2010 30 April 2010 10 May 2010 2 August 2010 27 August 2010 11–12 October 2010 18 November 2010 22 November 2010
Futures, options and structured products updates seminar	20–21 January 2010
Basel Core Principles workshops	17, 18, 19, 22 February 2010 11–12 March 2010 16–18 March 2010
Analysis workshops	1 March 2010 21 May 2010 7 September 2010 5 November 2010
Operational risk presentation	5 March 2010
Notarial practice course	19–20 April 2010
Event architecture course	9–10 June 2010
Counterparty and credit risk seminar	2–3 August 2010
Basel III presentation	6 August 2010
Corporate governance seminar	13 August 2010
Internal audit conference	16–18 August 2010
Gartner symposium	30 August – 1 September 2010
Time series econometrics course	14 September 2010
Introduction to derivatives course	21–22 October 2010
Financial stability seminar	8–12 November 2011
Monitoring economic indicators course	15–19 November 2010
Asset and liability management simulation seminar	24–26 November 2010
Compliance Institute monitoring course	8–9 December 2010
Visual Basic course	13–14 April 2010
Stepping into leadership course	4–6 August 2010
Information security awareness presentation	11 August 2010
Senior manager development programme	6–10 September 2010
Seven habits of highly effective office professionals seminar	12–14 September 2010
Development of leadership and team skills	14–17 September 2010
Presentation skills course	22 September 2010
Situational leadership course	5 October 2010

Table 1.4 Key international training interventions

Training intervention	Date
Financial Stability Institute international accounting and auditing for banks seminar (Basel, Switzerland)	16–18 February 2010
Financial soundness indicators course (Tunis, Tunisia)	15–26 March 2010
New York Federal Reserve Bank supervision course (New York, US)	10–14 May 2010
World Bank overview of financial-sector issues and analysis seminar (Washington, US)	17–21 May 2010
Workshop on systemic risk and financial regulations (Basel, Switzerland)	18–26 May 2010
Monetary Authority of Singapore (MAS) banking supervision training programme (Singapore)	29 May – 4 June 2010
World Bank/US Federal Reserve/International Monetary Fund 10th annual seminar (Washington, US)	2–4 June 2010
FSI 27th international banking supervision seminar (Beatenberg, Switzerland)	8–13 August 2010
DFID Course on financial soundness indicators (Port Louis, Mauritius)	23–25 August 2010
Seminar on corporate governance reforms (Basel, Switzerland)	11–13 October 2010
Liquidity risk management course (London, UK)	8–12 November 2010

1.11.3 Local training interventions

1.11.3.1 Foundation courses

The Department continued to present a foundation course to all graduate staff members who joined the Department and four courses were presented in 2010. During the year, the foundation course was reviewed. Based on the findings, an enhanced orientation and training programme was developed which consists of four core modules:

i. Basic induction course
ii. Foundation course
iii. Intermediate course
iv. Advanced course.

The orientation and training programme, developed in conjunction with the South African Reserve Bank College (SARB College), will commence in 2011.

The Department also makes use of FSI Connect, an online information and learning resource for global banking supervisors.

an online information and learning resource for global banking supervisors

1.11.3.2 Basel Core Principles for Effective Banking Supervision workshops

Four three-day workshops were held to familiarise staff members with the Core Principles and their application by the Department. The following areas were covered:

- The background to the Core Principles
- The objectives and content of the Core Principles
- Cross-referencing the Core Principles to the Banks Act, 1990 and the Regulations relating to Banks
- Cross-referencing the Core Principles to the Department's SREP Manual
- The Department's compliance with the Core Principles.

1.11.3.3 Analysis workshops

During the year under review, four one-day workshops on the analyses of the trend graphs produced from the data submitted by banks in terms of the Regulations relating to Banks were held. The key aspects covered during the workshop included the following:

- The purpose and interpretation of the trend graphs
- The actual or potential impact of the economy on the operations of banks and their risk management practices
- Matters of concern highlighted by the trend graphs.

1.11.3.4 Programme for the Development of Leadership and Team Skills

During September 2010, the Programme for the Development of Leadership and Team Skills (POLS) was presented at Stellenbosch University Business School Executive Development Limited. Candidates from the Department attended the four-day contact session held in Bellville, Western Cape. The course took the form of presentations by facilitators, various syndicate and class discussions, self-study and post-programme application of learning, and was aimed at providing attendants with the opportunity to develop knowledge of, and insight into, individuals' behaviour and the functioning of effective task-orientated working groups and intergroup activities in the workplace, which would ultimately add to the core business process of an organisation.

effective task-orientated working groups

1.11.3.5 Seminar on financial stability

In November 2010 various representatives of the Department attended a seminar on financial stability that was hosted by the SARB College and presented by Dr Dale Gray from the IMF.

A wide range of topics that impacted on the Department's work was covered during the seminar, including lessons from the financial and economic crisis, and various matters related to the following:

- The interrelationships between financial stability, monetary policy and fiscal and debt policy
- Macroprudential policy, instruments and frameworks
- Systemic risk models
- Financial, corporate and sovereign risk analysis
- Stress testing
- Volatility
- Transmission of risk during distress
- Financial instruments, including credit derivative instruments
- Interest rates, yield curves and credit spreads
- Options and option pricing
- Equity values
- Default risk
- Leverage
- Risk-adjusted balance sheets and contingent claims analysis
- Extracting market prices and information
- Ratio analysis.

1.11.4 International training interventions

1.11.4.1 Monetary Authority of Singapore Banking Supervisors Training Programme

Two representatives of the Department were afforded the opportunity to attend the Monetary Authority of Singapore (MAS) Banking Supervisors Training Programme, held in Singapore from 31 May to 4 June 2010. The programme was developed in response to requests from various central banks and regulatory agencies, and consisted of supervisory training modules that MAS had developed for the training of its staff.

supervisory training modules developed by MAS

The training programme participants included supervisors from China, Malaysia, Bahrain, Brunei Darussalam, Cambodia, India, Indonesia, Kazakhstan, Kuwait, Laos, Mauritius, Nepal, Philippines, Qatar, Saudi Arabia, Singapore, Sri Lanka and Thailand.

The following key topics were covered during the training:

- Introduction to MAS and the Singapore financial services sector
- Objectives and principles in financial supervision
- MAS financial and macro-surveillance
- Mapping of the Core Principles
- Overview of the banking regulatory framework
- Capital-adequacy framework for Singapore-incorporated banks
- Singapore Banking Act and notices
- AML and CFT
- Corporate governance
- Integrated supervision
- MAS framework for the impact and risk assessment of financial institutions
- Risk-focused supervision
- Credit derivatives
- Securitisation and CDOs
- Causes and impact of the sub-prime crisis and lessons for regulators
- Case studies on Barings Bank, Allied Irish Bank, National Australia Bank and Daiwa Bank.

The programme afforded the Department's representatives the opportunity not only to receive training, but also to network with, and learn from, supervisors of the various countries represented. Furthermore, it offered them the opportunity to gain a better understanding of the functioning of the MAS, which differs in many instances from the South African model.

The most significant differences were embedded in economic policy and mandate. The interest rate mechanism is not used to manage inflation in Singapore. Most goods and services in Singapore are imported and, as a result, inflation was seen as an external factor. Consequently, Singapore focused on maintaining a strong exchange rate to offset the effects of any external inflation.

difference in
the mandate of
supervisory authority

The other major difference was found in the mandate of the supervisory authority. South Africa has a supervisory authority with the sole mandate over banks, whereas insurance entities and other related financial services companies are supervised by other financial services supervisory authorities. Singapore, conversely, has adopted an integrated supervisory approach. As regards banking supervisory methodologies, it was apparent that South Africa was on a par with the MAS.

1.11.4.2 Specialised course in bank supervision (New York, United States)

In May 2010 a representative of the Department attended a specialised course in bank supervision, which was hosted by the Federal Reserve Bank of New York. The topics covered broadly encompassed banking supervision as a whole, including the following:

- Lessons learnt from the financial crisis
- Risk-based supervision
- Guidance for an effective AML programme
- Internal controls
- External and internal audit
- Stress testing and scenario analysis
- Supervision of large complex banking groups
- Corporate governance.

The presenters were examiners and specialists from the Federal Reserve Bank of New York. The course was attended by participants from more than 40 different countries. Such intervention provides invaluable input into the benchmarking of the bank supervision practices applied by the Department.

1.11.4.3 Financial Stability Institute seminar on international accounting and auditing for banks (Basel, Switzerland)

The FSI hosted a seminar on international accounting and auditing for banks and the recent financial crisis in Basel from 16 to 18 February 2010. The seminar was attended by

50 participants from 45 countries. Presenters included representatives of the International Accounting Standards Board (IASB), the International Auditing and Assurance Standards Board (IAASB), global banking organisations, the FSB and other supervisory bodies. A selection of the topics discussed during the seminar included the following:

- The role of accounting and auditing in the global financial crisis, and recommendations for reform
- The replacement of IAS 39: Financial instruments – Recognition and measurement
- An overview of IFRS 9: Financial instruments – Classification and measurement of financial assets
- The IASB exposure drafts relating to amortised cost, impairment and fair value measurement
- A banker's perspective on expected loss accounting in practice
- A summary of the financial statement presentation project.

1.11.4.4 Overview of financial-sector issues and analysis conference (Washington, United States)

The World Bank invited the Department to nominate a representative to attend a conference: "Overview of Financial-Sector Issues and Analysis: The Financial Sector after the 2007–08 Crisis" held from 17 to 21 May 2010. The presenters were from international financial institutions, the Basel Committee, regulatory authorities and the private sector. The key topics covered included the following:

- Origins and reach of the financial crisis
- Policy lessons from the crisis
- Risk management in banks after the crisis
- The future of financial regulation
- Crisis management
- Stress testing in banks
- Bank-resolution frameworks
- Capital market developments after the crisis
- Access to finance and microfinance.

1.11.4.5 Financial soundness indicators course (Tunisia and Mauritius)

In March and August 2010 the IMF organised courses on financial soundness indicators in Tunisia and Mauritius respectively. These courses, presented by the IMF's Statistics Department, were intended for central bank officials and supervisory agencies for the financial sector who are involved in the collection, compilation and analysis of financial soundness indicators.

analytical tools to support macroprudential analysis

The financial soundness indicators are analytical tools that were developed by the IMF, together with the international community, with a view to supporting macroprudential analysis, and assessing the strengths and vulnerabilities of financial systems. It is incumbent on IMF member countries to compile, monitor and submit the indicators to the IMF regularly.

The courses covered concepts and definitions, data sources, and fundamental aspects of the methodology such as coverage, aggregation, consolidation and valuation for the compilation of financial soundness indicators, as contained in the *FSI Compilation Guide*. Participants were introduced to a new financial soundness indicator template for use in the regular reporting of financial soundness indicator data and metadata to the IMF, and were afforded an opportunity to take part in the practical compilation of the financial soundness indicators using the *FSI Compilation Guide* as a reference tool. Apart from this, participants also received an opportunity to interact and share their country's experiences on the compilation and dissemination of financial soundness indicators.

The following outcomes were observed at the end of the courses:

- *Financial soundness indicator concepts and definitions*: Increased level of comprehension of the financial soundness indicators and their importance for financial-sector surveillance.
- *Compilation of financial soundness indicators*: More insight was gained into data requirements, aggregation and consolidation basis for successful financial soundness indicator compilation.

- *Financial soundness indicator template*: Practical exercises enhanced the level of understanding of the format and structure of the template in which the compiled data are submitted to the IMF.
- *Financial soundness indicator Compilation Guide*: increased level of understanding and usefulness of the guide in the compilation process.

1.11.4.6 Seminar on Corporate Governance Reforms (Basel, Switzerland)

The FSI invited a representative of the Department to participate in its seminar on "Corporate Governance Reforms" held in Basel from 11 to 13 October 2010.

Presenters at the seminar included senior executives, advisers or representatives of the following organisations:

- FSI of the BIS
- Organisation for Economic Co-operation and Development (OECD)
- FSB
- Basel Committee
- Leading regulatory and supervisory authorities
- Large international banks
- Institutional investors
- Auditors of banks.

Various matters related to corporate governance were presented and discussed during the seminar, including the following:

various matters related to corporate governance were presented and discussed

- The global financial crisis: Supervisory lessons on corporate governance and the future of financial regulation
- Emerging sound corporate governance practices in response to the crisis
- The Basel Committee's Revised Principles for Strengthening Corporate Governance
- Enhancing the role of the board: The South African Reserve Bank experience
- The approved persons regime: Significant influence function review in the UK
- A roundtable discussion: Sharing experiences on enhancing the role of boards and senior management in banks
- Standard setters work on compensation principles and standards
- Strengthening governance and remuneration practices: Example from Switzerland
- A roundtable discussion: Sharing experiences on improving compensation practices, effectively aligning incentives and promoting sounder banking practices
- The investors' perspective on corporate governance
- The role of internal audit in promoting sound corporate governance: Barclays Bank perspective
- The compliance function in banks: Deutsche Bank experience
- The governance of risk management: Banco Santander work
- External audit work and banking supervisory expectations
- A roundtable discussion: Sharing experiences on promoting sounder practices on auditing, compliance and the governance of risk management at banks.

1.11.4.7 Liquidity risk management course (London)

In November 2010 a representative of the Department attended a liquidity risk management course that was presented by Euromoney Financial Training in the UK. The intensive course was structured to provide participants with practical skills and knowledge with regard to the measurement and management of liquidity risk. The training course was specifically aimed at professionals involved in areas such as risk management, auditing and supervision. The course content was highly relevant in view of the increased focus by international regulatory and standard-setting bodies such as the Basel Committee and the G-20 on setting liquidity risk standards at a global level. The training course covered the following key topics:

practical skills and knowledge with regard to the measurement and management of liquidity risk

- An introduction to the different types and sources of liquidity risk
- A high-level overview of the financial crisis during the period 2007 to 2009 and the key lessons learnt
- The building blocks of pricing liquidity risk measurement, such as cash-flow analysis, behavioural adjustments, market risk adjustments and credit risk adjustments

- Liquidity risk metrics, with a focus on various product cases such as securitisation products, derivatives and deposits
- The measurement of liquid assets, also linking central bank collateral eligibility
- Liquidity risk stress testing (based on relevant case studies), covering issues such as firm-specific and systemic stress tests and the challenges related to stress testing
- Liquidity pricing, with a specific focus on the fundamentals of a funds-transfer-pricing system and how to align business incentives with the liquidity risk tolerance of a firm
- Liquidity contingency planning
- The impact of liquidity risk on banks' ratings
- Liquidity risk standards issued by international regulatory and standard-setting bodies.

1.12 Compliance with anti-money laundering and the combating of the financing of terrorism standards

1.12.1 Introduction

compliance framework and operational capacity to oversee compliance with AML and CFT standards

The Department strives to maintain an effective compliance framework and operational capacity to oversee compliance by banks with AML and CFT standards. In order to achieve this objective, the Department co-operates with the Financial Intelligence Centre (FIC) by communicating all FIC guidance notes, circulars and other pronouncements to all banks. In addition, the two regulatory bodies also meet periodically to discuss matters of mutual interest and/or concern with regard to banks' compliance with AML and CFT standards.

1.12.2 Issuance of Public Compliance Communications

1.12.2.1 Public Compliance Communications No. 1 (PCC 01): Establishment of the Public Compliance Series

The FIC launched a new communication platform – a Public Compliance Communication (PCC) series – on 22 February 2010. The purpose of the PCC is to facilitate a better understanding of the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001) (FICA) by all businesses, including accountable institutions; and to address some of the complex questions arising from the administration of FICA and its subordinate legislation. The main purpose of the PCC series is to provide guidance under section 4(c) of FICA on the FIC's interpretation of the relevant legislation. This form of guidance will have the same legal status as the guidance notes that have been, and will continue to be, issued by the FIC.

PCC series serve as additional platform to address contentious issues around the interpretation of FICA

The PCC series does not replace any of the existing communication platforms such as guidance notes, circulars, frequently asked questions and/or regular meetings with stakeholders. Rather, it will serve as an additional platform to address contentious issues that arise around the interpretation of FICA.

1.12.2.2 Public Compliance Communications No. 2 (PCC 02): Period of Record Keeping of Matters Reported to the Financial Intelligence Centre

The objective of PCC 02 is to provide the FIC's view on a reasonable period that records of matters reported to the FIC under section 29 of FICA must be kept. Given that the investigation and prosecution of a FICA-related crime could take in excess of five years, the FIC recommends that records relating to matters reported to the FIC should be kept for at least five years from the date of filing the suspicious transaction report, where possible.

1.12.2.3 Public Compliance Communications No. 3 (PCC 03): Identification and Verification Matters Relating to Account Opening Procedures for Asylum Seekers and Refugees

The objective of PCC 03 is to clarify the identification and verification requirements relating to asylum seekers and refugees in terms of account opening procedures; and to provide guidance to accountable institutions in meeting their identification and verification obligations in terms of section 21 of FICA and the Money Laundering and Terror Financing Control Regulations to FICA (FICA Regulations).

The FIC indicated that the refugee identity document, which contains a 13-digit barcoded identity number, meets the requirements of an identifying document for the purposes of regulation 3 of the FICA Regulations (information concerning South African citizens and residents). The FIC also regarded the United Nations Certified Travel Document passport as an acceptable form of identification.

Since refugees are given the status of residents and are in possession of a refugee identity document that can be dealt with in the same way as a South African identity document is dealt with, the identity of such individuals should be established and verified in terms of regulations 3 and 4 of the FICA Regulations (verification of information concerning South-African citizens and residents).

ensure appropriate internal controls

Accountable institutions were reminded that the refugee identity document was temporary in nature, that is, it was only valid for two years, whereafter it was subject to renewal. Accountable institutions were encouraged to ensure that appropriate internal controls were in place to monitor such accounts to ensure that upon expiry of the two-year period, the accounts were suspended or frozen to prevent any further transactions from taking place on the accounts pending the renewal of such identity documents.

1.12.2.4 Public Compliance Communications No. 3A (PCC 03A): Supplementary Information Applicable to PCC 03 – Identification and Verification of Refugees and Asylum Seekers

business relationships and transactions with asylum seekers and refugees

PCC 03A is an addendum to, and forms part of, PCC 03, and should be read in conjunction with PCC 03. PCC 03A provides an interim measure intended to assist accountable institutions in instances where an official identification document is not available and the circumstances under which reliance on the sections 22 and 24 permits issued to asylum seekers and refugees, in terms of the Refugees Act, 1998 (Act No. 130 of 1998), would be permissible as alternative forms of identification. It guides accountable institutions on how to review the processes used to establish or conclude business relationships and transactions with asylum seekers and refugees.

1.12.2.5 Public Compliance Communications No. 4 (PCC 04): Obligations Arising from the Financial Intelligence Centre Act Pertaining to the Voluntary Disclosure Programme

The Minister announced a Voluntary Disclosure Programme (VDP) in February 2010. The VDP was implemented through the promulgation of the VDP and Taxation Laws Second Amendment Act, 2010, and of regulation 24 of the Exchange Control Regulations, 1961. The objective of the VDP is to provide a window of opportunity, from November 2010 to October 2011, to disclose and pay undeclared tax liabilities at a reduced interest charge and without penalties, and to disclose exchange control violations without fear of liability arising from past non-compliance.

In an effort to pre-empt uncertainty regarding the relationship between the VDP and the role of professional advisers in promoting the objectives of the VDP, on the one hand, and the obligations flowing from FICA, on the other, the FIC deemed it necessary to issue PCC 04 formally to express its views on the application of FICA in relation to the VDP, and to make known its expectations of persons who assist clients with benefiting from the VDP.

1.12.2.6 Public Compliance Communications No. 5 (PCC 05): Registration of Accountable and Reporting Institutions with the Financial Intelligence Centre

The objective of PCC 05 is to provide guidance to accountable and reporting institutions on how to register correctly with the FIC as required by section 43B of FICA, as amended.

1.12.2.6.1 Registration requirements in terms of the Financial Intelligence Centre Act

Section 43B of FICA, which became effective on 1 December 2010, requires all accountable and reporting institutions as listed in Schedules 1 and 3 respectively to register with the FIC within the prescribed period and in the prescribed manner.

1.12.2.6.2 Registration of branches

Where the accountable or reporting institution is required to register its branches, it is important to note that reporting to the FIC could still be centralised, but all reports should be filed using the login credentials of the branch of the firm involved. All the branches of a banking group should be in a position to provide advice and administrative services to their clients. Each individual branch is therefore not required to register on its own. Banks that house other accountable institutions in the same legal entity have to ensure that all these different accountable institutions have registered separately.

1.12.3 Key guidance notes issued by the Financial Intelligence Centre during 2010

1.12.3.1 Guidance Note 4: Implementation of Revised and New Reporting Streams and Registration System of the Financial Intelligence Centre

general guidance on the implementation of revised and new reporting streams

The FIC informed all accountable institutions, reporting institutions and any other persons as described in section 29 of FICA of measures it planned to take to improve its systems to combat money laundering and the financing of terrorism in the Republic of South Africa. The FIC provided general guidance on the implementation of revised and new reporting streams, and the registration system of the FIC.

The FIC intended to introduce revised and improved Suspicious Transaction Report (STR) and Terrorist Property Report (TPR) forms in terms of FICA. According to the FIC, both these forms would enhance the way in which it captured and analysed the information generated by the various financial institutions and other businesses.

1.12.3.2 Guidance Note 5: Cash Threshold Reporting

The FIC also prepared Guidance Note 5 to assist accountable institutions and reporting institutions in meeting their reporting obligations in terms of FICA. The guidance note provides general guidance on the obligations of accountable institutions in terms of section 28 of FICA. More specifically, the guidance note explains reporting timelines, how reports have to be sent to the FIC, what information has to be included in these reports and how to use the electronic reporting mechanism.

mechanism to monitor and report proactively on cash transactions linked to money-laundering activities

Cash threshold reporting (CTR) will provide the FIC with a mechanism to monitor and report proactively on cash transactions that may be linked to money-laundering activities so that potential proceeds of crime are identified and investigated in a timely manner. The FIC has implemented CTR as part of its mandate to identify the proceeds of crime and to combat criminal money being laundered into the South African economy. CTR requires accountable and reporting institutions to report any transactions amounting to R25 000 or more to the FIC.

CTR obligations will apply to, among others, dealers in Krugerrands; financial and other institutions such as banks, insurers and dealers in foreign exchange; financial advisers; and estate agents. To facilitate the CTR reporting process, the FIC introduced a range of electronic reporting mechanisms, including an Internet-based reporting system using login credentials.

1.12.4 Amendments to the Financial Intelligence Centre Act

The amendments to FICA made during 2010 not only broaden the functions of the FIC, but also materially broaden the functions of various other supervisory bodies, including the Department, to ensure greater AML and CFT compliance in South Africa. Furthermore, they strengthen the ability of the FIC to detect and prevent illicit monies from being laundered through the country's financial system.

The amendments to FICA afford the FIC and other supervisory bodies a number of administrative measures to ensure compliance with the requirements of FICA, and to deal proactively and reactively with failure to comply with FICA. These measures include the

administrative measures to ensure compliance with the requirements of FICA

- ability to conduct inspections by supervisory bodies or the FIC;
- authority to impose administrative sanctions, such as monetary penalties; and
- establishment of an appeal board for those who wish to challenge decisions made by the FIC or other supervisory bodies concerned.

The amended FICA (which came into effect on 1 December 2010) also requires all accountable and reporting institutions to register with the FIC from 1 December 2010 to 1 March 2011. The main objective of this requirement is to ensure that the FIC is aware of the number of institutions that fall within the ambit of FICA. It also provides the FIC with additional information regarding these institutions, such as their type of business activities and physical address.

Amendments to FICA that are directly relevant to the Department include the following:

amendments to FICA directly relevant to the Department

- Increased supervision and enforcement responsibility
- Provision for the issuance of directives to accountable institutions
- Appointment of inspectors to assist with supervision and enforcement
- Imposition of administrative sanctions for non-compliance
- Provision for an appeals process and the establishment of an appeal board
- Provision for applications to court.

1.12.5 Meeting of the Counter Money Laundering Advisory Council

The Counter Money Laundering Advisory Council (CMLAC) held a meeting of all institutions nominated as supervisory bodies in Schedule II of FICA on 22 September 2010. The CMLAC is a body that was established in terms of section 18 of FICA to

- at the Minister's request or at its own initiative, advise the Minister on
  – policies and best practices to identify the proceeds of unlawful activities and to combat money-laundering activities; and
  – the exercise by the Minister of the powers entrusted to the Minister in terms of FICA;
- advise the FIC on its performance of its functions; and
- act as a forum in which the FIC, associations representing categories of accountable institutions, organs of state and supervisory bodies can consult one another.

The FIC informed the meeting that it intended to enter into bilateral memorandums of understanding (MoUs) with each supervisory body concerned as provided for in the amendments to FICA.

1.12.6 Amnesty granted to Zimbabweans and the implications thereof for banks

The special dispensation granted Zimbabweans who crossed into South Africa the right to live, work, attend educational facilities and to access basic health care in the country for a period of six months ended on 31 December 2010. The Minister of the South African Department of Home Affairs (DHA) invited all Zimbabwean immigrants to apply for identification documents and register their status in the country before the dispensation expired. The process was aimed at ensuring that Zimbabweans complied with South African immigration laws. Two hundred and forty (240) DHA officials, deployed in 46 regional offices across the country, facilitated the process. In terms of the amnesty extended to Zimbabweans, all fraudulent South African identity documents had to be handed back at the various DHA regional offices.

concerns regarding the amnesty extended by the DHA

At a meeting held in October 2010 between the FIC and the Department, certain concerns regarding the amnesty extended by the DHA were highlighted, including the fact that whereas the purpose of the amnesty was to help Zimbabweans, the closing date of 31 December 2010 seemed unrealistic for the DHA to complete the planned conversion process. In addition, a significant constituency of Zimbabweans with false documents had built up their entire existence around their false identities. Consequently, bank accounts, property and motor vehicles financed by banks, pensions and insurance policies with insurance companies, and so forth could all have been based on false identification information.

The Department was invited to consider these issues since banks and the FIC were expected to react to bank clients coming forward and declaring their true identities as part of FICA customer due diligence (CDD) processes. This continues to be a focus area for the Department.

1.12.7 Money laundering and terrorist financing: High-risk jurisdictions

jurisdictions divided into four categories

In February 2010 the Financial Action Task Force (FATF) issued a public statement on a list of jurisdictions with high levels of AML/CFT risks or threats and a lack of effective AML/CFT frameworks. In terms of the FATF's list, jurisdictions are divided into four categories based on certain criteria. The four categories are as follows:

i. Category 1 includes all jurisdictions subject to the FATF and who call on its members and other jurisdictions to apply countermeasures to protect the international financial system from the ongoing and substantial AML/CFT risks emanating from the jurisdiction.
ii. Category 2 includes all jurisdictions with strategic AML/CFT deficiencies that have not committed to an action plan developed with the FATF to address key deficiencies as of February 2010. The FATF calls on its members to consider the risks arising from the deficiencies associated with such jurisdictions.
iii. Category 3 includes all jurisdictions previously publicly identified by the FATF as having strategic AML/CFT deficiencies, which remain to be addressed as of February 2010.
iv. Category 4 includes all jurisdictions that have strategic AML/CFT deficiencies for which they have developed an action plan with the FATF and that have provided a written high-level political commitment to addressing the identified deficiencies.

application of countermeasures to listed jurisdictions

The FATF's issuing of this public statement is regarded as an important step towards reducing the vulnerability of the international financial system to money laundering and terrorist financing. While, under international law, the FATF's public statement carries with it no formal sanction, in reality, a jurisdiction placed on the FATF list often finds itself under intense international pressure to improve its system. The FATF also has at its disposal the ability to call on its members and members of regional bodies to apply countermeasures to listed jurisdictions.

The FATF reaffirmed its call on members and urged all jurisdictions to advise their financial institutions to give special attention to business relationships and transactions with Iran, including Iranian companies and financial institutions. In addition to enhanced scrutiny, the FATF reaffirmed its 25 February 2009 call on its members and urged all jurisdictions to apply effective countermeasures to protect their financial sectors from AML/CFT risks emanating from Iran. The FATF urged jurisdictions to protect their banks against correspondent relationships being used to bypass or evade countermeasures and risk mitigation practices, and to take into account AML/CFT risks when considering requests by Iranian financial institutions to open branches and subsidiaries in their jurisdiction.

1.13 Issues to receive particular attention during 2011

In addition to fulfilling its normal supervisory and regulatory tasks, the Department will focus specifically on the following issues during 2011:

- Continued participation in, and contribution at, the various international forums responsible for ongoing supervisory and regulatory developments to strengthen the resilience of the banking sector further
- Ongoing review and amendment of the regulatory framework in accordance with the latest internationally agreed regulatory, supervisory and market best practices and standards
- Further enhancement and refinement of the Department's supervisory review and evaluation processes to align them with developments emanating from the IMF, the Basel Committee, the FSB, the G-20 and the GHOS, with particular focus on the macroprudential supervisory framework and processes
- Development of appropriate frameworks and processes to discharge expanded supervisory responsibilities flowing from legislative developments such as amendments to FICA and the Companies Act, 2008
- Participation in the Basel Committee's additional comprehensive quantitative impact assessment of the new global funding liquidity risk measurement, standards and monitoring, and ongoing assessment of the progress made by banks to align liquidity risk measurement, standards and monitoring with the new Basel III standard
- Performance of thematic reviews focusing on equity risk in the banking book and risk and remuneration disclosure
- Ongoing focused reviews of banks making use of advanced approaches to calculate credit risk, market risk and operational risk capital requirements
- Continued monitoring of banks' compliance with AML and CFT legislative requirements
- Continued investigation of illegal deposit-taking by unregistered institutions and persons, and participation in consumer education initiatives
- Ongoing training of staff to meet the challenges of the changing regulatory and supervisory landscape.

1.14 Expression of gratitude

I wish to express my appreciation to the Minister of Finance, Mr Pravin Gordhan, for his input on requests in terms of statutory requirements. To the Governor of the Bank, Ms Gill Marcus, and Senior Deputy Governor Dr Xolile Guma: thank you for your ongoing co-operation, guidance and support during 2010. A word of thanks also goes to my colleagues with whom I serve on the Governors' Executive Committee of the Bank.

During 2010 the Department worked in close co-operation with various individuals and organisations, locally and abroad. These include, to name but a few, the senior executives of banking institutions; the BASA; the Standing Committee for the Revision of the Banks Act, 1990; the Chief Executive of the Financial Services Board and his staff; the Basel Committee; the FSI; central bankers and bank supervisors, both in southern Africa and elsewhere in the world; and staff of other departments of the Bank.

My sincere appreciation goes to the staff members of the Department, for their continued efforts and willingness to often go beyond the call of duty to meet the challenges and demands of an ever-changing supervisory and regulatory landscape.

Finally, after eight years as Registrar of Banks and Head of the Bank Supervision Department of the South African Reserve Bank (the Bank) I will be handing over the baton and will be retiring as from 31 July 2011. I wish to record that my term as Registrar has been one of the most intellectually stimulating and enjoyable periods of my 34-year career at the Bank, to whom I shall always be indebted for providing me with such an exciting and rewarding opportunity.

The period was notably characterised by the exceptionally high quality of people with whom I had the privilege of interacting. The absolute highlight of my career is two-fold. On the one hand, to know that together with the team of superb banking supervisors in my department, we all contributed to making a difference to the lives of South Africans insofar as they, unlike so many people in other countries, did not have to contend with the fear of potentially losing their savings during the worst global financial crisis since the Great Depression that the world has recently experienced. South Africa's banking system remained safe, stable and sound throughout this period. On the other hand, during my term of office neither the central bank nor National Treasury was called upon, either to provide any bank with financial assistance or to assist with the winding up of any bank. I leave both the Department and the bank supervision function in good shape, and am confident that my successor, ably supported by the team of smart, dedicated and well-trained existing banking supervisors, will be in a position to take the function to new levels of excellence and professionalism in the face of whatever new and unknown challenges may arise.

Errol M Kruger
Registrar of Banks