



Bank Supervision Department
**Executive summary of the key topics covered in the
*Bank Supervision Department Annual Report 2010***

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.

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 14,7 per cent. The banking sector also remained capitalised at levels well above the minimum regulatory capital requirement throughout the year under review.

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.

2. Chapter 1: Registrar of Bank's review

2.1 Interaction with the International Monetary Fund

During 2010, the International Monetary Fund (IMF) assessed the Department's compliance with the 25 Basel Core Principles for Effective Banking Supervision (Core Principles). The final reports based on the review, namely "South Africa: Detailed Assessment of Compliance with 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. 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 IMF assessors found that the Department was compliant with the majority of the Core Principles, and also 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.

2.2 Developments in banks' compliance with remuneration standards

In order to establish banks' level of compliance with the Principles and Standards for Sound Compensation Practices issued by the Financial Stability Board (FSB) in 2009, in 2010 the Department requested banks to complete a self-assessment questionnaire on the status of implementation of the principles and standards.

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 will be done during 2011 to ensure full compliance.

2.3 Key international regulatory developments, recommendations and focus areas

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. Enhancement of the Basel II framework included, among other things, 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 exposure, changes to the credit conversion factor for short-term liquidity facilities, and the enhancement of Pillar 3, which deals with market discipline or public disclosure, to strengthen disclosure requirements for securitisations, off-balance-sheet exposures and trading activities.

In 2010 the Basel Committee issued a set of requirements to strengthen global capital and liquidity regulations further with a view to promoting a more resilient banking sector. 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.

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

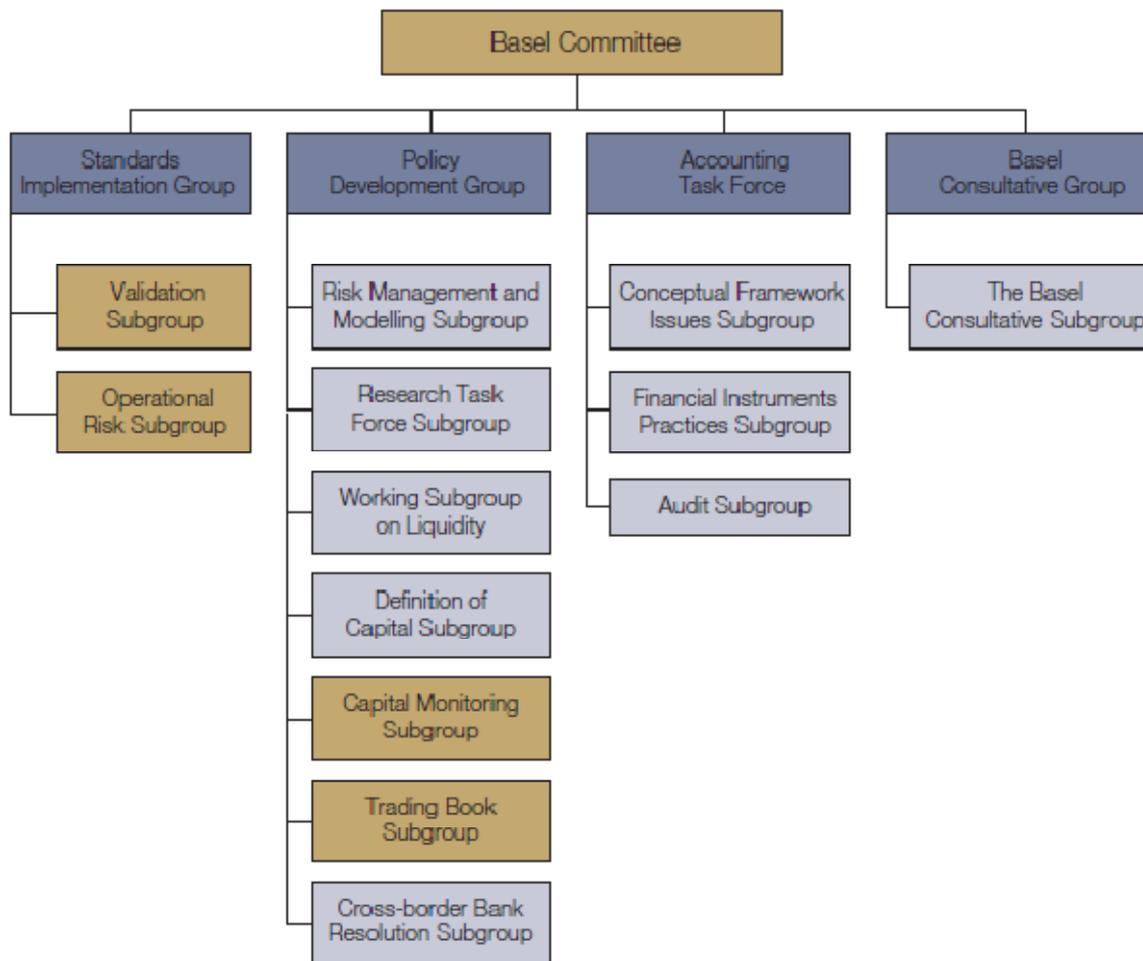
The Financial Stability Institute of the Bank for International Settlements (BIS) and the Department jointly hosted a high-level meeting in Cape Town in January 2010. The meeting focused primarily on the work undertaken by the Basel Committee and the FSB following the crisis, lessons learnt from the crisis, liquidity risk management and cross-border supervision.

2.5 Participation in international regulatory and supervisory forums

In order to keep abreast of international regulatory and supervisory developments, the Department participates in, and contributes to, various international forums,

including 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's work is organised under four main subcommittees, as depicted in Figure 1. The Department's representation is reflected in gold.

Figure 1: Basel Committee on Banking Supervision: Structure of working groups



2.6 Representation in domestic regulatory and supervisory forums

The Department is also represented in various domestic regulatory or supervisory forums, including the Over-the-Counter Derivative Working Group, the Structural Funding and Liquidity Risk Task Team, the Financial Sector Contingency Forum, and the Solvency Assessment and Management Insurance Groups Task Group. In addition, the Department also meets with the Financial Services Board in South Africa on a quarterly basis as part of its consolidated supervision of conglomerate groups in South Africa.

2.7 Regional co-operation

The Department maintained its participation on the Southern African Development Community (SADC) Subcommittee of Banking Supervisors (SSBS) during 2010 and also assisted the Central Bank of Kenya and the Central Bank of Zimbabwe by providing intensive training courses to two senior officials from these central banks.

2.8 Supervisory colleges

In 2010 the Department was invited to participate at two supervisory colleges arranged by international regulatory bodies, namely the Financial Services Authority of the United Kingdom, and the Hong Kong Monetary Authority and the China Banking Regulatory Commission. The Department regards supervisory colleges as a key tool in its supervisory review and assessment processes.

2.9 Compliance by banks with anti-money laundering and the combating of the financing of terrorism standards

The Department strives to maintain an effective compliance framework and operational capacity to oversee banks' compliance with anti-money laundering (AML) and the combating of the financing of terrorism (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 Department meets periodically with the FIC to discuss matters of mutual interest and/or concern with regard to banks' compliance with AML and CFT standards.

2.10 Issues that will 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 and contribution in 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 with developments emanating from the IMF, the Basel Committee, the FSB, the G-20 and the Governors and Heads of

Supervision, 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 the Financial Intelligence Centre Act, 2001 (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 that make 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.

3. Chapter 2: Promoting the soundness of the banking system: Overview of Supervisory activities

3.1 Flavour-of-the-year topics covered during 2010

Each year the Department identifies certain key topics related to the effective functioning of banks that are then reviewed during the annual meetings held with the Board of Directors (the board) and/or board subcommittees of banks. The following topics were chosen for 2010:

- The functioning of the Audit Committees, and the Board Risk and Capital Management Committees of banks
- The management and board oversight of the risks posed and the controls instigated to mitigate the risks posed by diversified banking groups.

The Department found that Audit Committees, and Risk and Capital Management Committees operated adequately which, in turn, contributed to the overall sound corporate governance in South African banks.

With regard to board oversight of the risks posed and the controls instigated to mitigate the risks posed by diversified banking groups, the exercise proved to be

useful in focusing boards' attention on the spread of activities being undertaken across groups. In general, boards appeared to have a grasp on the larger group activities, but were somewhat unsighted on the precipitation of a myriad of smaller group interests or entities and on geographic (global) spread.

3.2 Credit risk

During the year under review, the Department continued to perform both compliance-based and prudential supervision of banks, specifically focusing on banks' credit risk profiles and portfolios that were, and continue to be, impacted by adverse market conditions and strained economic activity. The work carried out covered the following:

- Quantitative analysis of regulatory reporting
- Review of self-assessment templates submitted by banks
- Focused reviews of banks' compliance with requirements for use of the internal rating-based (IRB) approach for the calculation of minimum required regulatory capital relating to credit risk for Pillar 1
- Processing of applications submitted by banks for the implementation of new or revised models and rating systems
- Focused reviews of banks' compliance with requirements for use of the standardised approach for the calculation of minimum required regulatory capital relating to credit risk for Pillar 1
- Reviews of long-form reports by auditors relating to details in models used by banks with approval to use the foundation IRB or advanced IRB approaches
- Assessment of the suitability of rating agencies to provide ratings as a measure of the creditworthiness of banks' assets.

3.3 Market risk

The Regulations relating to Banks include two alternative reporting methods for market risk, namely the models-based internal models approach (IMA) and the standardised approach. Under approved circumstances, banks are also permitted to apply a combination of standardised and models-based reporting. Market risk reviews conducted in 2010 by the Department concentrated on banks with approval to use IMA for regulatory reporting.

The Department received one application for use of the IMA. The application and approval processes were similar to those conducted in the previous years. The Department also continued to conduct annual and quarterly reviews of the trading activities of IMA banks to assess their suitability to continue using the IMA.

These reviews focused on changes in the sources of risk facing banks and their reaction in the form of changes to strategy, products, systems, structure, risk limits and capital.

Levels of market risk in South African banks continued to follow the reduction in volatility that was present in the secondary markets for the most part of 2010 and, consequently, the trading operations of many banks struggled to meet revenue targets.

In 2010 the Department initiated a thematic review that addressed aspects pertaining to the issue of negotiable certificates of deposit, promissory notes or instruments of a similar character. The purpose of the review was to ensure banks' compliance with the requirements of the Regulations relating to Banks as they pertained to the issue of such instruments. The review revealed that banks should pay additional attention to ensuring that policies and processes are developed to enhance monitoring and control and, ultimately, the liquidity risk emanating from the issuance of such instruments. The Department also participated in liquidity risk simulation exercises at banks, which were facilitated by an independent external party.

3.4 Operational risk

The Department continued to promote and enhance the effectiveness of operational risk management at banks and banking groups since it contributes to enhancing the soundness of the banking system. A risk-based approach was applied to the review of banks' operational risk. The work performed during the year included the following:

- Focused operational risk reviews
- Processing of new applications
- Involvement in drafting operational risk consultative papers issued by the Basel Committee.

The most prominent topics addressed during reviews performed in 2010 included the following:

- Review of the management information reports or "dashboards" used for operational risk management on a group consolidated, bank, major subsidiary and material business unit level
- Update and review of outsourcing and business continuity
- Review of the alignment of the group strategy with the operational risk appetite statement
- AMA banks were requested to demonstrate the use of the operational risk management framework and the operational risk measurement system.

- Findings of banks' internal audit in respect of scenarios
- Discussion of internal and external audit reports issued during the banks' 2009/10 financial year related to operational risk management.

3.5 Capital management

During 2010, the Department focussed on the finalisation of internal capital-adequacy assessment process (ICAAP) reviews of smaller banks, and ICAAP reviews of branches of foreign institutions. The general consensus on the former banks' ICAAPs is that, in most of the cases, risk management processes are in place, but their articulation in the ICAAP document is poor. Pertinent risk areas that require more attention include concentration risk, interest rate risk in the banking book and business risk. As regards larger banks, ICAAPs are constantly improved upon and refined. Credit risk remained the most significant risk area for larger banks.

The Department also monitored banks' capital floor reporting during the year under review and, in certain instances, requested the external auditors to review the accuracy of capital floor calculations. Three banks were required to hold more capital during 2010 in order to comply with capital floor requirements.

3.6 Pillar 3 disclosure

Pillar 3 disclosure reviews performed by the Department during 2010 focused on large banks and some of the medium-sized banks in South Africa. A disclosure template was developed and used to facilitate the review process. The key objective of the Pillar 3 reviews was to assist banks in complying with applicable disclosure requirements by identifying gaps and making appropriate recommendations.

The Department noted a marked improvement in the level of public disclosure by banks. All the banks reviewed during 2010 were found to be taking appropriate steps to move towards full compliance with the requirements of regulation 43 of the Regulations relating to Banks as they relate to the disclosure by banks.

3.7 Stress testing

It is necessary for banks and other financial institutions to hold sufficient capital and liquidity buffers to protect themselves against severe unexpected events. Stress testing is an important input to the capital-adequacy assessment process and decisions concerning the adequacy of capital buffers.

During 2010, the Department performed a common scenario stress-testing exercise on the South African banking system. The overall objective of the exercise was to identify and assess the vulnerabilities of the South African banking system under different plausible stressed macroeconomic scenarios.

Overall, the capital adequacy of the banking system remained strong in all scenarios applied, both from an aggregate perspective, and a composition and quality perspective. However, the impact of the implementation of the Basel III changes is not reflected in the stress results and therefore the results might be different once the Basel III reforms have been implemented.

4. Chapter 3: Developments in banking legislation

4.1 Initiatives monitored and developments considered by the Department

The Department has been monitoring, among other things, the developments relating to G-20 discussions, and the press releases, publications and directives issued by the Basel Committee and the FSB, on the one hand, and developments relating to the new Companies Act, the “King Report on Governance for South Africa” and “King Code of Governance Principles” (King III), and court decisions, on the other, in order to identify possible areas that would necessitate amendments to the Banks Act, 1990 (Act No. 94 of 1990) (the Banks Act, 1990) and/or the Regulations relating to Banks.

Where requirements have been finalised and issued by international standard-setting bodies or in instances where sufficient certainty or clarity has been obtained, the Department formulated further proposed amendments to the Banks Act, 1990 and the Regulations relating to Banks.

Other developments monitored by the Department and which will also impact the current legislative framework include the following:

- The findings of the the IMF’s and World Bank’s assessments of the Department
- Further international developments related to the global financial market crisis
- The New Companies Act, 2008.

4.2 Illegal deposit-taking

The Department is afforded certain powers in terms of sections 81 to 84 of the Banks Act, 1990 to control the activities of unregistered persons. These activities are confined to illegal deposit-taking only.

These provisions provide, among other things, that the Registrar may do the following in respect of unregistered persons that are suspected of taking deposits from the general public in contravention of the Banks Act, 1990:

- Apply to court for an order prohibiting anticipated or actual schemes involved in illegal deposit-taking
- Extract information from unregistered persons
- Inspect the affairs of an unregistered person (inspectors are appointed by the Governor or a Deputy Governor of the Bank in terms of the provisions of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989) (SARB Act))
- Direct such a person to repay such money if the Registrar is satisfied that a person has illegally taken deposits from the general public
- Appoint a manager to manage and control the repayment of the money unlawfully obtained.

During the year under review, the Department received a number of complaints, with supporting documentary evidence, pertaining to certain business activities conducted by a number of institutions. In the cases where the Department had reason to suspect that such institutions were accepting deposits from the general public as a regular feature of their business without being registered as a bank, it invoked its powers in terms of the Banks Act, 1990.

4.3 Update on co-operative banks

The establishment of the Co-operative Banks Development Agency (CBDA) in terms of section 54 of the Co-operative Banks Act, 2007 (Act No. 40 of 2007) (Co-operatives Banks Act), brought about the twin regulatory and supervisory units comprising the Bank and the CBDA. The Bank established the Co-operative Banking Supervision Unit and the CBDA a Supervision Unit. During 2010, a total of 16 applications had been received to register co-operative banks, of which 4 are eligible to be regulated by the Bank. As at 31 December 2010 only one of these applications had been formally approved.

Further developments in the co-operative banking environment were the new appointments and reappointments of members of the board of the CBDA following the expiry of the term of office at the end of July 2010 of the board members who were appointed on 15 August 2008.

4.4 Update on Postbank

The South African Postbank Limited Act, 2010 (Act No. 9 of 2010) (Postbank Act) was passed by Parliament and the President assented to it on 1 December 2010 and it was published in Government Gazette no. 33835 of 3 December 2010.

Up until the passing of the Postbank Act, the Postbank owed its existence to sections 51(1), (3) and (4), 52, 53, 55 and 58 of the Postal Services Act, 1998 (Act No. 124 of 1998), and had been operating under an exclusion notice provided for in

terms of section 2(vii) of the Banks Act, 1990. The Postbank Act provides for the incorporation of the Postbank, a division of the South African Post Office, and for the transfer of the enterprise of that division to the Postbank Company. In view of the provisions of the Postbank Act, the Postbank is required to apply to the Department for registration as a bank in terms of the provisions of the Banks Act, 1990. Until such time, the status quo of the Postbank will remain and it will continue to perform the functions it currently performs.

5. Chapter 4: Banking sector overview

5.1 Shareholding structure

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.

5.2 Balance sheet

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 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.

5.3 Off-balance sheet

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.

5.4 Capital adequacy

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.

5.5 Financial leverage multiple

The financial leverage multiple 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.

5.6 Profitability

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.

5.7 Statutory liquid assets

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).

5.8 Credit risk

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.

6. Appendices

Appendices 1 to 5 and 7 to 10 contain useful administrative information pertaining to the banking sector. Appendix 6, in turn, contains 24 tables detailing extensive financial data predicated on risk-based information submitted by banks over a three-year period ending December 2010.
