South African Reserve Bank

Press release by the Registrar of Banks on the 2006 *Annual Report* of the Bank Supervision Department

26 June 2007

The 2006 *Annual Report* of the Bank Supervision Department highlights five key messages, namely:

1. All financial institutions are equally concerned about disruptions to business continuity – a state of continued, uninterrupted operation of a business. Therefore, some views on business disruptions and business continuity planning are highlighted in the introductory section of the report.
2. In 2006 the Basel Committee on Banking Supervision published a revised version of the document titled *Core Principles for Effective Banking Supervision*, commonly referred to as the Core Principles. Banking supervisors as well as the IMF and World Bank use the Core Principles to assess the quality of a banking supervisory system, identify any weakness that may exist and to determine the way in which the major sources of risk to such systems are being managed. The Bank Supervision Department (Department) performed a self-assessment of compliance with the revised Core Principles.
3. The Department continued to monitor corporate-governance practices of banks during 2006, focusing mainly on the induction and development of directors. It was found that banks’ induction and training programmes diverged significantly and, therefore, the Department encouraged banks to make use of a director development programme that was introduced by a local tertiary institution.
4. All parties involved in and impacted by the implementation of the new Capital Accord (Basel II) on 1 January 2008 have intensified their preparation efforts. Legislation required for effecting Basel II implementation is at an advanced stage and will be considered for approval during 2007.
5. The Department is of the opinion that all banks have made good progress in the implementation of anti-money laundering and combating the finance-of-terrorism measures. The Department continued to foster a close working relationship with the Financial Intelligence Centre in the interest of ensuring a high level of value added by the banking industry to the attainment of international best-practice requirements.

Chapter 1 of the report discusses, *inter alia*, the following issues:

- **Overview of trends in the South African banking sector**

  During 2006, the South African banking system remained stable and banks were adequately capitalised, with the banking-sector capital-adequacy ratio remaining in excess of the minimum requirement of 10 per cent. The capital-adequacy ratio decreased from 12,7 per cent in December 2005 to 12,3 per cent in December 2006.

  Total balance-sheet growth remained strong during 2006, but eased towards the end of the year. By the end of December 2006, total banking-sector assets had increased by 23,7 per cent (measured over twelve months) to a level of R2 075,1 billion (December 2005: R1 677,5 billion). The five largest banks constituted 89,7 per cent of the total assets of all banking institutions as at the end of December 2006 (December 2005: 89,6 per cent).

  Non-bank deposits remained the main source of funding for the banking sector and constituted 65,2 per cent of total liabilities (2005: 65,7 per cent). Total non-bank deposits increased by 22,9 per cent (measured over twelve months) amounting to R1 353,2 billion, compared to the 21,1-per-cent growth in December 2005 (R1 101,5 billion). The composition of non-bank deposits remained fairly stable during 2006.

  Profitability ratios improved throughout 2006. By the end of December 2006, a return of 18,3 per cent on net qualifying capital and reserves (12-month smoothed average) was reported, compared to 15,2 per cent in December 2005. Return on assets (12-month smoothed average) amounted to 1,4 per cent at the end of December 2006 (December 2005: 1,2 per cent). The banking sector’s efficiency ratio displayed steady improvement, breaking the 60-per-cent level to end the year under review at 58,9 per cent (December 2005: 66,3 per cent).

  The banking sector maintained an adequate amount of liquid assets during 2006, exceeding the statutory liquid-asset requirement. In December, the average daily amount of liquid assets held by banks represented 111,2 per cent of the statutory liquid-asset requirement, compared to 119,7 per cent in December 2005.

  Non-performing loans continued to decrease during 2006. This decrease should, however, be seen against the backdrop that gross overdues in respect of mortgages deteriorated from R6,1 billion in December 2005 to R6,9 billion in December 2006. This deterioration was offset by an improvement in the gross overdues in respect of other loans and advances. Expressed as a percentage of total loans and advances, gross overdues improved from 1,5 per cent in December 2005 to 1,1 per cent in December 2006. In terms of the minimum regulatory requirements, provisioning by banks remained adequate.

- **Development of bank directors**

During 2006, the Department continued to monitor the corporate-governance practices of banks and focused mainly on the induction and development of individual directors. Notwithstanding the uniqueness of individual banks' operations, the Department is of the view that directors of all banks should be exposed to homogenous development programmes that will equip them to perform their fiduciary duties. However, following an analysis of all banks' induction and training programmes, it was clear that these programmes diverged significantly.

The Department brought the above-mentioned findings to the attention of The Banking Association South Africa which agreed to pursue the matter. A local tertiary institution, as requested by The Banking Association South Africa, developed a director development programme consisting of three courses, namely: Introductory course; Banking Board Leadership Programme; and Bank Board Leadership Forum.

The introductory course aims to familiarise participants with the regulatory environment in which banks operate, and introduce key concepts and principles. The second course will provide participants with a broad understanding of risk management in banks at governance level and will endeavour to equip them with the skills to apply their knowledge in the fulfilment of their statutory and fiduciary duties. The final course is aimed at instilling a deeper understanding of the principles covered in the first two courses by focusing on "real-life" experiences and the development of "best-practice" approaches.

The Department believes that the development programme will meet the needs of both new and experienced directors. The programme is sufficiently comprehensive for new directors to be provided with a solid foundation to comfortably enter the banking arena and for experienced directors to stay abreast of current developments in the banking system. For these reasons, the Department, by way of Banks Act Circular 9/2006, encouraged the chairpersons of banks to utilise the programme to ensure that proposed directors have a basic understanding of banking. Furthermore, it was emphasised that this development programme should be considered supplementary to internal induction and development programmes, and not as an alternative thereto.

- **International supervisory interaction**

As in previous years, the Department continued to interact with other global national supervisors. Meetings were held with host supervisors in Argentina, Mauritius and Namibia, and the Department was invited to attend a seminar hosted by the supervisory authority in Indonesia.

The Department maintained its participation in the working streams, seminars and training events of the Basel Committee, which are viewed as particularly important. Furthermore, representatives of the Department also participated in events organised by the International Monetary Fund (IMF) and World Bank.

- **International Conference of Banking Supervisors**

  In October 2006, the Department attended the International Conference of Banking Supervisors (ICBS) hosted by the National Banking and Securities Commission, Mexico, in the city of Mérida in Mexico. The ICBS is held biennially and is aimed at promoting co-operation among national supervisory authorities and enables these authorities to exchange views on current issues of common concern. A range of topics were discussed at the 2006 ICBS including the following: The main changes to the updated *Core Principles for Effective Banking Supervision*, corporate governance of banks, governance and accountability of financial supervisors, risk-based supervision, and several topics related to the new Basel Capital Accord (Basel II).

- **Proliferation of credit in South Africa**

  Members of the public lately have been exposed to a proliferation of new names linked to banking services. These developments could prove to be confusing to the public as banking names are now being linked to retail outlets, cellular telephone service providers and other such companies. These new names that have entered the banking market might cause uncertainty in the mind of the public as to the origin and soundness of such initiatives. They are portrayed as being stand-alone initiatives, whereas they are undertaken as joint ventures with, or as divisions of, currently registered banking institutions. From a supervisory point of view, the Department ensures that the risk management pertaining to such joint ventures or divisions of banking institutions is of the highest standard and in so doing, endeavours to ensure that these business initiatives and the proliferation of banking services will not dilute the public's trust in the banking system.

- **2006 International Monetary Fund Article IV consultation**

  Following its 2005 Article IV consultation, the IMF commended the South African authorities for their continued implementation of sound macroeconomic and financial policies. In 2006, the Article IV discussions with the IMF were held in Pretoria and Cape Town. The IMF staff report was once again very supportive of the strategies and policies implemented to address social concerns while preserving macroeconomic stability. Furthermore, the view was expressed that the banking sector was sound and well regulated, while noting also the progress made in improving access to banking services for the poor and aligning banking regulations with international standards.

Chapter two focuses on important regulatory and supervisory developments, both locally and abroad. These include the following:

- **Core Principles for Effective Banking Supervision**

  The Basel Committee on Banking Supervision published a revised version of the document titled *Core Principles for Effective Banking Supervision*, commonly referred to as the Core Principles. Banking supervisors as well as the IMF and World Bank use the Core Principles to assess the quality of a banking supervisory system, identify any weakness that may exist and to determine the way in which the major sources of risk to such systems are being managed.

Following the publication of the original Core Principles in 1997, significant developments have taken place in both banking regulation and in the manner in which banks conduct their business. Issues that particularly have come to the fore are risk management, corporate-governance and anti-money laundering concerns. Furthermore, the numerous compliance assessments that have been performed have identified some shortcomings in the Core Principles. In this light, the Basel Committee initiated the process of revising the Core Principles at the end of 2004, culminating in the publication of the revised version in October 2006.

During the first half of 2006 the Department performed a self-assessment of compliance with the revised Core Principles. The Core Principles had, at that stage, not been endorsed for publication and, therefore, the Department monitored all further amendments throughout the assessment process. This exercise was facilitated by the Department having served as a member of the working group responsible for revising the Core Principles. The key objectives of the self-assessment process were to benchmark the South African banking supervisory system against the Core Principles, conduct a comprehensive gap analysis and develop an action plan for eliminating the shortcomings that were identified. A project team continues to meet on a monthly basis to assess the progress made in implementing the action plans. The ultimate objective for the Department is to obtain a favourable rating when it is next assessed by the IMF and World Bank.

- **New Basel Capital Accord**

During 2006 all parties involved in and affected by the activities of the Accord Implementation Forum (AIF) intensified their efforts to prepare for Basel II implementation on 1 January 2008. A second draft of the proposed amendments to the Regulations relating to Banks (proposed Regulations) was made available by the Department to the AIF forums from the end of January 2006. The proposed regulatory returns were subjected to a variety of tests, which highlighted areas for improvement and further refinement. A comprehensive third draft of the proposed Regulations was made available in October 2006, whereafter further updated modules were released until the end of November 2006. It is anticipated that the Minister of Finance will consider for approval the proposed Regulations during the latter part of 2007, which will enable the implementation of Basel II on 1 January 2008.

During the year, the Department requested locally incorporated banks targeting the advanced approaches for credit and/or operational risk and other specially selected smaller banks to take part in Quantitative Impact Study 5 (QIS 5). The purpose of QIS 5 was, *inter alia,* to obtain relevant information pertaining to the impact of implementing Basel II, assess the state of preparedness for Basel II implementation, and develop guidance on relevant issues pertaining to Basel II. Banks that did not participate in QIS 5 conducted formal field tests of the proposed statutory returns for credit risk and financial information. The purpose of the field tests was to assist the Department in assessing the level of preparedness for the implementation of the new regulatory framework and to ensure that the objectives set for the proposed Regulations could be met and that they would facilitate the implementation of Basel II.

Apart from the quality of resources, supervisors worldwide continue to face many challenges in ensuring that the implementation of Basel II can be effected in a manner that is appropriate in their respective countries, while at the same time ensuring that the objectives of the Basel II framework are achieved.

- **Review of compliance with the Financial Intelligence Centre Act, 2001**

During 2006 the Department performed a review, similar to that conducted at the five largest banks during 2005, of the remaining banks and selected branches of foreign banks to verify compliance with the requirements of the Financial Intelligence Centre Act, 2001 (FICA). The Department is of the view that banking institutions have made good progress in the implementation of anti-money laundering and combating the finance-of-terrorism measures. As part of its ongoing monitoring and supervision in this regard, the Department proposed that the role of the internal audit function of banks be extended to include FICA requirements.

- **Combating of illegal deposit-taking**

The Department is primarily responsible for the regulation and supervision of registered banks in the Republic of South Africa. It neither registers nor supervises investment schemes. The Banks Act, however, provides that no person may conduct the "business of a bank" unless such a person is a public company and is registered as a bank. Sections 81 to 84 of the Banks Act, 1990 afford the Department certain powers to control the activities of unregistered persons. During the year under review, the Department investigated approximately forty such unregistered businesses or investment schemes.

- **Market-risk management by South African banks**

During 2006, the Department conducted in-depth reviews on banks following the internal model approach (IMA) to calculate the capital requirement for market risk. These reviews were part of the process of annual IMA approval and re-assessment of the value-at-risk (VaR) multiplication factor. Accompanying the task of annual and new approvals for this approach is a strategy for increased frequency of on-site reviews that the Department has begun to deploy.

- **Liquidity risk management**

Due to the growth in long-dated assets, i.e. mortgage loans, which were mainly being funded by short-term funding, the Department continued to focus on liquidity risk management during the year under review. This asset growth had resulted in a general increase in liquidity risk especially in the short-term maturity mismatch of banks. At the annual meetings held with the respective boards of directors of the banks, the Department engaged on this issue.

- **Supervision of financial conglomerates: Joint Forum**

  The Joint Forum – established under the auspices of the Basel Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors – is the standard-setting body in respect of financial conglomerates. South Africa, together with two other non-Joint Forum member countries, was invited to participate in a new Joint Forum working stream on Conglomerate Principles in 2006. The exercise comprises stock taking of the implementation by supervisors globally of the principles contained in the Joint Forum's *Supervision of Financial Conglomerates*.

- **Independent Regulatory Board of Auditors**

  Following recommendations made by the Review Panel on the Accountancy Profession, on which the Department served, the Auditing Profession Act, 2005 (the Act) was promulgated and assented to by the President of the Republic of South Africa in January 2006. The Act created the Independent Regulatory Board of Auditors (IRBA) and places a duty on registered auditors to report to IRBA instances where reportable irregularities have taken or are taking place in an entity in respect of which they are the registered auditors. In terms of the Act, the IRBA is required to report such continuing irregularities pertaining to banking institutions to the Department.

Chapter 3 highlights developments in the South African banking regulatory framework, as follows:

- **Developments relating to banking legislation**

  In May 2006, the Standing Committee for the Revision of the Banks Act, 1990 approved draft six of the proposed Banks Amendment Bill (the Bill), after which it was submitted to the Minister of Finance for his consideration and approval to publish for public comment. Draft seven of the Bill, which incorporated public comments and subsequent comments from the November Standing Committee meeting, was submitted to the Minister of Finance in order to initiate the Parliamentary process during 2007. The Bill is intended to be effective from 1 January 2008.

- **Regulations relating to Banks**

  In August 2006 draft three of the proposed amendments to the Regulations relating to Banks (proposed Regulations) was submitted to the Minister of Finance for initial review and evaluation. Draft three of the proposed Regulations was also circulated to the AIF in October 2006 for further testing and to facilitate discussion of high-priority issues. The comments received were incorporated into the proposed Regulations and it is envisaged that draft four of the proposed Regulations will be available during the first quarter of 2007. The proposed Regulations will be tabled at the Standing Committee during 2007 for approval, after which it will be finalised and submitted to the Minister of Finance for his consideration and approval.

In **Chapter 4 and Appendix 6** trends in the South African banking sector, based on risk-based information submitted by banks during 2006, are outlined according to the following headings:

- **Balance-sheet structure**

  The aggregated balance-sheet size of the banking sector in South Africa amounted to R2 075,1 billion as at 31 December 2006, in comparison to R1 677,5 billion as at 31 December 2005 and R1 498,4 billion as at 31 December 2004. During 2006 the aggregated balance sheet of the banking sector continued to grow strongly, albeit at a slower rate, during the fourth quarter of 2006. During 2006 the growth rate accelerated until September 2006 (27,4 per cent) and ended the year at 23,7 per cent (December 2005: 12 per cent). The main source of funding, in the amount of R1 353,2 billion, remained domestic deposits from the public constituting 65,2 per cent of total liabilities in December 2006 (December 2005: 65,7 per cent). Short-term deposits remained the largest component of total non-bank funding and accounted for 67,3 per cent of total non-bank funding as at the end of December 2006, compared to 66,2 per cent as at the end of December 2005. Total loans and advances equalled R1 735,8 billion by the end of December 2006, as opposed to R1 353,6 billion as at the end of December 2005, representing a growth rate of 28,2 per cent. The strong growth during 2006 was mainly due to growth in mortgage loans, followed by growth in overdrafts and loans, instalment debtors and foreign-currency loans.

- **Capital adequacy**

  Total net qualifying capital increased by 20,3 per cent, from R127,4 billion in December 2005 to R153,3 billion in December 2006. However, the total capital requirement increased by 24,5 per cent, from R100,3 to R124,9 billion during the corresponding period, resulting in the capital-adequacy ratio decreasing from 12,7 per cent in December 2005 to 12,3 per cent in December 2006. Although the capital-adequacy ratio was lower, it remained in excess of the minimum 10-per-cent requirement throughout 2006.

- **Profitability**

  Favourable economic conditions, among other things, contributed to the improvement in banks' profitability ratios during 2006. At the end of December 2006, an after-tax return of 1,4 per cent on total assets (2005: 1,2 per cent) was reported, whereas an after-tax return of 18,3 per cent on net qualifying capital and reserves (2005: 15,2 per cent) was reported. The banking sector's efficiency ratio (smoothed over a 12-month period) improved from 66,3 per cent in December 2005 to 58,9 per cent in December 2006.

- **Liquidity risk**

  Throughout 2006 the average daily amount of liquid assets held by banks exceeded the statutory liquid-asset requirement. The average daily amount of liquid assets held in December 2006 represented 111,2 per cent of the statutory liquid-asset requirement, compared to 119,7 per cent in December 2005.

- **Derivative contracts**

  During 2006 forward contracts remained the main contributors to total derivative turnover. Turnover in forward contracts amounted to R1 879 billion in December 2006 (December 2005: R1 346 billion), while the remainder of the turnover in derivative contracts amounted to R739,2 billion in December 2006 (December 2005: R728,9 billion).

- **Credit risk**

  Gross overdues continued along a downward trend, tapering off from R20,1 billion in December 2005 to R18,8 billion in December 2006. Expressed as a percentage of total loans and advances, gross amounts overdue improved from 1,5 per cent in December 2005 to 1,1 per cent in December 2006 as a result of strong asset growth and a decline in gross overdues caused by favourable economic conditions. Although total gross overdues decreased, it should be noted that gross overdues in respect of mortgages increased from R6,1 billion in December 2005 to R6,9 billion in December 2006.

- **Currency risk**

  During 2006 the aggregated effective net open foreign-currency position fluctuated at higher levels than in 2005, but remained well within the limit of 10 per cent of net qualifying capital and reserves. In December 2006 the net open foreign-currency position amounted to 1,1 per cent, compared to 1,5 per cent in December 2005.

Appendices 1 to 5 and **7 to 9** of the report contain useful administrative information.

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