South African Reserve Bank

Press release by the Registrar of Banks on the *Annual Report* 2007 of the Bank Supervision Department

29 July 2008

The 2007 *Annual Report* of the Bank Supervision Department (the Department) highlights five key messages:

1. Financial-sector regulators and market commentators are again, as in previous years, questioning the appropriateness of banking institutions' incentive schemes. Consequently, some thoughts on incentive schemes are highlighted in the introductory section of the report.

2. The turmoil caused by the sub-prime mortgage market was a major development in financial markets during 2007. The Department requested a selection of South African banks to provide detailed reports on their exposure to the prevailing risks. The findings were that South African banks were not impacted directly, but indirect effects were observable.

3. The Department, in close co-operation with the Financial Intelligence Centre, continued to monitor banking institutions' compliance with anti-money laundering and the combating of the financing of terrorism (AML/CFT) legislation. Furthermore, the Department prepared for the Financial Action Task Force on Money Laundering's (FATF) planned mutual evaluation of South Africa in 2008.

4. The process followed in implementing Basel II was a major exercise undertaken over several years. Prior to taking the decision to implement Basel II, the Department considered a range of preconditions that would facilitate the process. This process was characterised by its broad consultative approach; several quantitative impact studies and field tests; amendments to the regulatory and supervisory frameworks; and regular interaction with all South African banking institutions, since Basel II was to be implemented by all banks on 1 January 2008.

5. In 2007 regulatory approval was granted for the acquisition of a material shareholding in one of South Africa's largest banking groups namely, Standard Bank Group Limited (the SBG), a bank controlling company, by Industrial and Commercial Bank of China (ICBC). The transaction, a US$5,5 billion equity investment in the SBG, resulted in ICBC acquiring approximately 20 per cent of the banking group's shareholding. This was the second major investment in one of South Africa's largest banks, the other being the acquisition of a majority shareholding by Barclays Bank plc (UK) in Absa Group Limited in 2005.

Contents of the *Annual Report 2007*

Chapter 1

In this chapter the following issues, *inter alia*, are discussed:

Overview of trends in the South African banking sector

The South African banking system remained stable and banks were adequately capitalised during 2007. Banks maintained capital-adequacy ratios above the minimum requirement of 10 per cent. The capital-adequacy ratio increased from 12,3 per cent in December 2006 to 12,8 per cent in December 2007.

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

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

Profitability ratios remained strong during 2007. The return on regulatory capital amounted to 18,1 per cent at the end of December 2007, compared with 18,3 per cent at the end of December 2006, while the return on assets equalled 1,4 per cent at both the end of December 2006 and December 2007. The efficiency ratio improved from 58,8 per cent at the end of December 2006 to 56,9 per cent at the end of December 2007.

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

During 2007 credit risk ratios deteriorated with non-performing loans increasing from R18,8 billion at the end of December 2006 to R29,4 billion at the end of December 2007, representing an annual growth rate of 56,4 per cent. Expressed as a percentage of total loans and advances, non-performing loans deteriorated from 1,1 per cent at the end of December 2006 to 1,4 per cent at the end of December 2007. The increase in interest rates, together with other adverse developments in the South African and international economic environments, contributed to the deterioration of the credit risk ratios.

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

The turmoil caused by the sub-prime mortgage market was undoubtedly the major development in financial markets during 2007. What began as credit concerns in the United States (US) sub-prime mortgage market developed into concerns in global credit markets as the extent of exposures and potential losses from the sub-prime market were not known. The resultant uncertainty made financial market participants exceedingly risk-averse.

The ongoing boom in the US housing market attracted clients who would not normally have qualified for loans. Loans granted to these clients are commonly known as 'sub-prime mortgage loans'. In some instances the sub-prime loans were offered at initial low 'teaser' rates, which reset to higher rates after a few years. As these loans began to reset and the housing market began to cool off during 2006 (i.e., growth in house prices decreased), these clients found themselves unable to meet the higher payment obligations and were not able to refinance their loans. It was during this period that non-performing sub-prime mortgage loans increased rapidly.

Concurrent with the granting of sub-prime mortgage loans, certain institutions securitised their mortgage loans. Numerous methods and instruments were developed to facilitate this process, and the instruments became increasingly complex. Instruments such as mortgage-backed securities and collaterised debt obligations offered tranches of risk, ranging from high-risk equity tranches to low-risk senior tranches. As a result, a wide range of banks and investors faced significant exposure, directly and indirectly, to the US sub-prime mortgage market.

Following an assessment of certain South African banks, it was found that local banks had no direct exposure to the sub-prime mortgage market, while the banks' international franchises had very limited exposure. The securitisation schemes of local banks in South Africa are traditionally cash-backed securitisation schemes, and are used mainly as part of banks' liquidity and capital management strategies. In those instances where banks had acted as liquidity providers for external parties, such contingent liabilities were included in the banks' asset and liability committee (ALCO) processes. Furthermore, banks had not been exposed to any change in the behaviour of providers of foreign funding towards roll-overs, since at that stage most of them did not have facilities maturing within the following six months.

The wider impact of the global crisis on the local banking sector is still uncertain, but it is expected that as credit spreads widen and pricing for risky assets increases, the borrowing costs of banks will increase.

Compliance with anti-money laundering legislation

The Financial Intelligence Centre Amendment Bill, 2007 was released for comment in November 2006. The Bill primarily aims to adhere to international standards for regulation and supervision with regard to compliance with AML/CFT measures as contained in the recommendations of the FATF. While the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001) (FICA) provides for the enforcement of its provisions only through criminal sanctions, the proposed amendments seek to introduce an administrative enforcement framework to FICA.

In 2007, in keeping with current global expectations to optimise banks' compliance with AML/CFT, the Department took pre-emptive steps in supervising compliance with FICA. The flavour-of-the-year topic for trilateral discussions between the Department, banks' audit committees and banks' external auditors during the 2007 calendar year focused on the activities of the internal audit function vis-à-vis AML/CFT. As part of the ongoing co-operation between the Department and the FIC, the Director of the FIC attended a number of the above-mentioned trilateral discussions.

As a member of FATF, South Africa will undergo a mutual evaluation in 2008 to assess whether the necessary laws, regulations or other measures required under the new standards are in force and effective; that there has been full and proper implementation of all necessary measures; and that the systems in place are effective.

Securitisation

During 2007 extensive work was undertaken to review the existing securitisation regulatory framework. This culminated in the finalisation of the proposed amended Exemption Notice relating to Securitisation Schemes (the proposed amended Exemption Notice), which was due to be implemented on 1 January 2008.

Securitisation curtails balance-sheet growth and eases the regulatory capital charge by moving assets off the books of the originating bank or by reducing the cost of capital as a proportion of asset exposure. The benefits derived from such activities are, however, not without risk. These risks include interest-rate risk, default risk, funding risk, servicer risk, reduction in asset quality, and reputational risk.

The total value of assets securitised by securitisation schemes – involving banks directly (as originator) and indirectly (in performing a secondary role) – that have been approved by the Department since 2001 is approximately R223 billion.

High-level meeting for African banking supervisors

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

Companies Bill, 2008

The second and final draft of the Companies Bill, 2008 was released by the Department of Trade and Industry in November 2007. The proposed Bill will replace the Companies Act, 1973 (Act No. 61 of 1973). The Bill represents a significant departure from the Companies Act as it aims to modernise company law, aligning it with other South African statutes. The Department welcomes the promulgation of the Companies Bill, and will set out to prepare action plans to adapt and amend the Banks Act, 1990 accordingly to enable the Department to discharge its roles and responsibilities properly in respect of banks, controlling companies and banking groups.

Chapter 2

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

Implementing Basel II in South Africa

The Department's effort to implement Basel II on 1 January 2008 was a major exercise undertaken over several years. Before proceeding with the implementation of Basel II, the Department considered a range of preconditions that would facilitate the successful implementation of Basel II and was satisfied that South Africa met these preconditions.

The implementation process constituted a participative and consultative process, which involved the immediate stakeholders, namely the banks, the National Treasury, the South African Reserve Bank, external auditors of banks, The Banking Association South Africa and the Department. During 2003 the Department established the Accord Implementation Forum (AIF) – a joint public and private sector forum – to assist in driving the Basel II implementation process. The AIF's mandate was to promote, co-ordinate and drive initiatives for the implementation of Basel II in South Africa. The AIF, through its Steering Committee, was chaired by the Registrar of Banks and the Secretariat was provided by The Banking Association South Africa.

As regards the goal of each bank implementing Basel II, banks were requested to perform a high-level gap analysis and readiness assessment to facilitate planning, identification of key deliverables, deadlines and the responsible person(s). Furthermore, banks participated in quantitative impact studies, field tests in respect of selected proposed statutory returns and a parallel-run process during the fourth quarter of 2007, by submitting, in accordance with prescribed schedules, both the existing (Basel I-based) statutory returns and the proposed (Basel II-based) statutory returns.

Internally, the Department focused on modifying its supervisory process; upgrading its information technology database; approving banks' approaches to credit and operational risk; and up-skilling and right-skilling its staff.

The technical Basel II prescriptions were effected to the Regulations relating to Banks. However, amendments to the Banks Act, 1990 were required to enable amendments to these regulations. On 13 December 2007, the Minister of Finance granted his approval for the publication and the subsequent implementation on 1 January 2008 of the amended Regulations.

Application in terms of section 37 of the Banks Act, 1990 for the acquisition of shares in Standard Bank Group Limited, a bank controlling company

On 24 October 2007, South African regulatory approval was granted to ICBC for the acquisition of up to 20,5 per cent equity in the SBG, a bank controlling company. The acquisition of the minority interest by ICBC resulted in R36,7 billion (approximately US$5,5 billion) equity investment into the SBG. The transaction is the second material international investment in one of the largest banks in South Africa, and resulted in the largest inflow of foreign direct investment capital since the second quarter of 2001.

Prior to this transaction, the shareholder base of the SBG had been relatively widely dispersed. The transaction provided the SBG with a shareholder of reference. The foreign ownership in the SBG has increased from approximately 25 per cent to 40 per cent and the SBG will therefore still be majority-owned by South Africans. ICBC has committed itself to the broad-based economic empowerment targets set for the SBG in terms of the Financial Sector Charter.

The approval of this transaction and the conditions imposed on the SBG–ICBC transaction are specific to this transaction. Any future application by an international bank to acquire a majority shareholding in a major domestic bank would be considered on its own merits, taking into account the circumstances prevailing at that time.

Illegal deposit-taking

The acceptance of deposits from members of the public as a regular feature of business is tantamount to conducting "the business of the bank", as defined in section 1 of the Banks Act, 1990. In terms of this Act, it is an offence for any person to conduct the business of a bank unless such person is a public company and is registered as a bank in terms of the Act.

During the year under review, 18 new inspections, together with 24 inspections carried over from previous years, were undertaken. The inspection of these 42 schemes was delegated to 16 forensic auditing firms. The Department finalised five investigations during 2007. Two were reported to the South African Police Service (SAPS) Commercial Branch; two others were already under SAPS investigation; while the fifth scheme was found not to be conducting the business of a bank.

Maintenance of a board directorship continuity programme

Maintenance of a board of directors continuity programme was selected as a topic for discussion with banks at meetings with their board of directors in 2007.

The exercise proved invaluable to both the banks' board of directors and the Department. In a few instances, it became clear that an assessment of whether individual members of the board had sufficient time to prepare for meetings in order to enable them to contribute meaningfully to the deliberations at such meetings had never been made. There have also been instances where, following the discussions that took place at the meeting with the board of directors, some directors had reconsidered their ability to discharge meaningfully their duties as directors of a bank or banking group and decided on either relinquishing some of their other board commitments or resigning from the board of the bank or banking group.

In the light of the onerous responsibilities resting on bank directors, as trustees who need to ensure that public deposits and savings are properly safeguarded, it is imperative that boards of directors of banks comprise persons with a broad mix of skills, competence, experience and available time to discharge the duty of trust imposed on them properly.

Consumer education

In 2001, the Financial Services Board (FSB) − the non-bank financial services regulator – appointed the Consumer Education Review Committee (the Review Committee), to review and monitor the progress made by the FSB in promoting appropriate programmes and initiatives by the financial services industry to inform and educate users and potential users of financial services and products. The Department is represented on the Review Committee, and believes that consumer education has been instrumental in preventing some illegal schemes. Despite these measures, several people still became victims during the year under review.

Bank on-site visits

The function of the Review Team of the Department is to support the teams responsible for the supervision of assigned banks (the analysis teams) in the execution of their duties by performing on-site reviews. Assignments for the Review Team are identified by the analysis teams and focus on aspects of a bank’s operations about which the analysis team requires a better understanding or which may be of concern. With the implementation of Basel II, the team’s activities will be broadened to include assisting the Department’s operational risk-related reviews.

Update on the implementation of the revised Core Principles for Effective Banking Supervision

The Department embarked on a project to reach an acceptable level of compliance with the revised Core Principles during 2006. The project team established for this purpose continued to monitor the Department’s compliance status throughout 2007, closely following the progress made on a monthly basis and approving updates to the progress reports. During the year under review, compliance with the Core Principles improved as the amendments to the Banks Act, 1990 and the Regulations relating to Banks progressed, and changes were made to the supervisory process to incorporate the new supervisory actions as stipulated in the Core Principles Methodology.

Banking Code for Responsible Credit Extension

An issue of concern to the Department was the seemingly unscrupulous unsolicited offers of retail lending activities that were emerging from banks who utilised both mail and electronic means of communication. The Department engaged with the industry in order to resolve what was clearly unacceptable conduct, not to mention inherent poor risk management practices that would evolve from such activities. The result was that in March 2007 The Banking Association South Africa unveiled a code of conduct, agreed to by all major consumer lending banks, setting out a standard in respect of lending practices to which banks undertook to adhere.

Market risk

In 2007, 11 banks in South Africa reported market risk under the prevailing regulations. Three alternative reporting methods were available to banks, that is, the internal models approach (IMA), and two standardised approaches (STA), namely the building block approach and the simplified approach. During the year under review, the Department conducted renewal reviews in three banks employing the IMA. In addition, three banks applied for initial IMA approval. Apart from assessing the modelling attributes of applicant banks, the economic, organisational, technological and procedural-related elements also came under scrutiny.

Independent Regulatory Board for Auditors

In terms of the Auditing Profession Act, 2005, the Independent Regulatory Board for Auditors is required to establish committees to assist in the performance of its function. The Department is represented on two of the six permanent committees, namely the Committee for Auditor Ethics and the Committee for Auditing Standards.

The National Credit Regulator

The National Credit Regulator (NCR) was established as the regulator under the National Credit Act, 2005 (the NCA), and was tasked with the promotion of a fair and non-discriminatory market place for access to consumer credit, and the regulation of the conduct of lenders in general. Furthermore, it is tasked with educating, researching, developing policy, registering industry participants, investigating complaints and ensuring enforcement of the NCA.

Chapter 3

This chapter highlights developments in the South African banking regulatory framework:

Developments relating to the Banks Act, 1990

The proposed amended Banks Act, 1990 as assented to by the President of the Republic of South Africa was published as Notice No. 1080 in *Government Gazette* No. 30474 on 15 November 2007. The proposed amendments may be divided into two main themes, namely (1) those amendments that are deemed necessary to comply with the prescriptions of Basel II, and (2) those amendments that have been necessitated by changing supervisory policies, market developments and practical considerations.

Regulations relating to the conditions for the conducting of the business of a bank by a foreign institution by means of a branch

The provisions of the Banks Act, 1990 as well as the Regulations relating to Banks apply equally to foreign branches, if and where relevant. The unique features of a branch, however, have necessitated the inclusion of certain unique prescriptions in a separate regulation, titled *Conditions for the Conducting of the Business of a Bank by a Foreign Institution by Means of a Branch* (the Branch Regulations). The effective date of the Branch Regulations is 1 January 2008, to coincide with the amended Banks Act, 1990 and the amended Regulations relating to Banks.

Designation of an activity not falling within the meaning of "the business of a bank" (securitisation schemes)

In terms of the Banks Act, 1990, the Registrar of Banks has, with the approval of the Minister of Finance, designated securitisation schemes as an activity that does not fall within the meaning of "the business of a bank", provided such schemes adhere to the conditions prescribed in the Schedule. The designation will be gazetted on 1 January 2008 and contains amendments brought about by the amendments effected to the Regulations relating to Banks which, in turn, were amended to comply with the prescriptions of Basel II.

Chapter 4 and Appendix 6

In these sections of the report the trends in the South African banking sector, based on risk-based information submitted by banks during 2007, are outlined:

Balance-sheet structure

The aggregated balance-sheet size of the banking sector amounted to R2 547,0 billion as at 31 December 2007 (December 2006: R2 075,3 billion), representing year-on-year growth of 22,7 per cent. Non-bank deposits increased to R1 657,8 billion from R1 353,2 billion at the end 2006 and remained the main source of funding for the banking sector throughout 2007, and represented 65,1 per cent of total liabilities and capital at year end. Capital and reserves contributed 8,0 per cent to total liabilities and capital at the end of December 2007. Short-term non-bank deposits as a percentage of total non-bank deposits remained stable and thus continued to constitute the main source of funding for banks throughout 2007, representing 65,9 per cent of non-bank funding at the end of December 2007 (December 2006: 67,3 per cent). Total loans and advances amounted to R2 124,2 billion in December 2007, compared with R1 735,8 billion in December 2006. The increase in total loans and advances can be attributed primarily to the increase in mortgage loans (24,7 per cent year on year) and overdrafts and loans (24,8 per cent year on year). Mortgage loans, and overdrafts and loans represented 40,0 per cent and 22,5 per cent of total loans and advances, respectively, at the end of December 2007.

Capital adequacy

The banking sector's net qualifying capital increased from R153,5 billion in December 2006 to R196,1 billion in December 2007 (27,8 per cent annual increase), whereas the total risk-weighted assets increased from R1 248 billion to R1 535 billion (22,9 per cent annual increase). The capital-adequacy ratio remained fairly stable during 2007, fluctuating between 12,24 per cent and 12,79 per cent, ending the year at 12,78 per cent (December 2006: 12,29 per cent).

Profitability

Banks' profitability remained favourable during 2007, due to strong asset growth. The return on equity ratio decreased slightly from 18,3 per cent at the end of December 2006 to 18,1 per cent at the end of December 2007, while the return on assets ratio remained at 1,4 per cent at the end of December 2006 and December 2007. The efficiency ratio of the banking sector improved from 58,8 per cent at the end of December 2006 to 56,9 per cent at the end of December 2007, owing to a continued increase in total income.

Liquidity risk

The management of liquidity is among one of the most important activities conducted at banks, and has gained increased attention as a result of the international sub-prime market turmoil and the effect it had on banks' liquidity. Throughout 2007, banks' average liquid assets exceeded the minimum liquid-asset requirement. The average daily amount of liquid assets held during December 2007 represented 112,5 per cent of the statutory liquid-asset requirement, compared with 111,2 per cent held in December 2006.

Derivative contracts

Turnover in forward contracts is the main contributor to total derivative turnover in the banking sector and amounted to R2 189,5 billion for December 2007 (R1 879,0 billion for December 2006). The remainder of the turnover in derivative contracts amounted to R1 527,4 billion for December 2007 (R737,5 billion for December 2006). Total unexpired derivative contracts increased from R9 270,7 billion in December 2006 to R14 463,2 billion in December 2007.

Credit risk

The increase in interest rates, together with other adverse developments in the South African and international economic environments, contributed to the deterioration of credit risk ratios during 2007. Gross overdues increased by 56,4 per cent, from R18,8 billion in December 2006 to R29,4 billion in December 2007, while gross amounts overdue as a percentage of total loans and advances increased from 1,1 per cent at the end of December 2006 to 1,4 per cent at the end of December 2007.

Currency risk

The total aggregated effective net open foreign-currency position decreased from US$327,2 million in December 2006 to US$200,2 million in December 2007. However, it fluctuated between a high of US$532,0 million (January 2007) and US$66,6 million (November 2007), the lowest level.

Appendices 1 to 5 and 7 to 10

These appendices contain useful administrative information.

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