South African Reserve Bank
From the Office of
the Registrar of Banks

Confidential

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TO ALL BANKS, CONTROLLING COMPANIES AND BRANCHES OF FOREIGN BANKS

DIRECTIVE 5/2008 ISSUED IN TERMS OF SECTION 6(6) OF THE BANKS ACT, 1990: COMPOSITION OF BOARD-APPOINTED COMMITTEE TO APPROVE LARGE EXPOSURES

EXECUTIVE SUMMARY

Banks Act Circular 6/2007 dated 14 November 2007 regarding consultation with banks, controlling companies and branches of foreign banks in respect of directives, circulars and guidance notes refers.

The primary risk that banks incur is credit risk, that is, the risk that a counterparty to an asset or a debtor in respect of loans and advances, or the issuer of an instrument will not be able to repay the capital amount and the accrued interest when due and payable. Because a significant percentage of major bank failures have been due to credit-concentration risk of one kind or another, diversification of risk is a key condition for sound banking practice. The board of directors of a bank is ultimately responsible for the maintenance of effective risk management in the bank. In discharging its responsibilities, the board of directors has to play a critical role in overseeing, amongst other things, the credit-granting and credit-risk management functions of the bank. The aforementioned responsibility of the board of directors forms an integral part of the overall process of corporate governance in the bank. In terms of the Banks Act, 1990 (Act No. 94 of 1990 – the Banks Act) a bank may not make investments or grant loans or other credit to any person to an aggregate amount exceeding 10 per cent of the prescribed capital reserves without the approval of the board of directors or a committee established by the board and approved by the Registrar of Banks (the Registrar).

1. Introduction

Banking entails, amongst other things, the management of a series of risks. These risks can take various forms, and the extent and complexity of each risk area differ from bank to bank. The primary risk that banks incur is credit risk and banks are increasingly facing credit risk, including counterparty risk, in various financial instruments other than loans and advances. Diversification of risk is a key condition for sound banking practice since the majority of bank failures were due to credit concentration risk of one kind or another.

Experience suggests that credit concentrations can result in substantial losses without any commensurate increase in prospective returns. When a bank evaluates a credit application for approval, the bank should take into consideration potential future changes in economic conditions and should assess its credit-risk exposures under stressful conditions. The approval of large exposures as set out in section 73 of the Banks Act remains the responsibility of the board or its appointed committee approved by the Registrar. This directive provides the criteria that are applied when the Registrar considers the composition of the aforementioned committee for approval.

2. Banks Act references

In terms of section 73(1)(a) of the Banks Act, a bank "shall not make investments with or grant loans or advances or other credit to any person, to an aggregate amount exceeding 10 per cent of such amount of its capital and reserves as may be prescribed, without first having obtained the permission of its board of directors, or of a committee appointed for such purpose (for the composition of which committee the prior written approval of the Registrar has to be obtained), to make such investments or to grant such loans, advances or other credit".

In order to enhance independence and objectivity, section 60 of the Banks Act, requires the majority of the members of the board of directors of a bank to consist of non-executive directors. Furthermore an effective number of board members should be capable of exercising judgement independently from the views of management or large shareholders.

3. Regulations references

Chapter III and more specific regulations 39 to 41 of the Regulations deal with corporate governance and set out the duties and responsibilities of directors. The board of directors of a bank is ultimately responsible for the maintenance of effective risk management in the bank. In discharging its responsibilities, the board of directors has to play a critical role in overseeing the credit-granting and credit-risk-management functions of the bank and has to ensure, amongst other things, that -

(a) Credit activities are conducted within the risk strategy, policies and tolerances approved by the board.

(b) The bank operates within sound and well-defined credit-granting criteria.

(c) All extensions of credit are made on an arm's length basis.

(d) Senior management is fully capable of managing the credit activities conducted by the bank.

(e) Credit activities are subject to adequate internal controls and appropriate internal-audit coverage.

(f) The bank has adequate capital for the risks that it assumes.

The aforementioned responsibilities of the board of directors form an integral part of the overall process of corporate governance in a bank. The process should provide proper incentives for the board and senior management to pursue objectives that are in the best interest of the bank, its shareholders and other stakeholders.

Members of the board of directors, particularly non-executive directors, may be an important source of new business for the bank. The bank should, however, once a potential exposure is introduced determine, through the bank's established credit processes, how much and on what terms credit should be granted.

4. Other references

Core principle 9 of the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (Basel Committee) requires banking supervisors to be satisfied that "... banks have management information systems that enable management to identify concentrations within the (credit) portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers".

In order to ensure compliance with core principle 9, the Basel Committee has specified certain matters as essential criteria and others as additional criteria. The aforementioned criteria include the following matters:

Essential criteria

(a) Laws, regulations, or the supervisor sets prudent limits on large exposures to a single borrower or closely related group of borrowers. "Exposures" include all claims and transactions, both on-balance sheet and off-balance sheet.

(b) The supervisor verifies that banks have management information systems that enable management to identify, on a timely basis, concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.

(c) The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.

(d) The supervisor regularly obtains information that enables concentrations within a bank's credit portfolio, including sectoral and geographic exposures, to be reviewed.

Additional criteria

(a) Banks are required to adhere to the following definitions:

   (i) Ten per cent or more of a bank's capital is defined as a large exposure.

   (ii) Twenty-five percent of a bank's capital is the limit for an individual large exposure to a private-sector non-bank borrower or a closely related group of borrowers.

The purpose of the aforementioned limits is to contribute to an adequately diversified credit portfolio.

5. Directive

A bank or controlling company shall ensure that a credit committee appointed by the board of directors in order to approve large exposures shall as a minimum consist of the following members:

(a) Three non-executive directors, that is, persons who are not employees of the bank or of any of its subsidiaries, its controlling company or any subsidiary of its controlling company, and one of whom shall be the chairperson of the said committee.

(b) The chief executive officer of the bank.

(c) The bank's head of finance.

(d) The bank's head of risk or an equivalent function, such as the head of enterprise-wide-risk-management.

(e) The bank's head of credit.

When the board-appointed credit committee requires specific input from particular business units in respect of a proposed credit exposure, the committee may invite the relevant executive director or executive officer to make such required presentations to the committee.

The decisions on large credit exposures made by the board-appointed committee shall be recorded in writing and shall be tabled at the board meeting immediately following the meeting of the said committee, for the board's review and ratification.

The credit committee shall also periodically assess its own performance, determine where weaknesses exist and, where possible, take appropriate corrective actions.

6. Acknowledgement of receipt

Two additional copies of this directive are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.

E M Kruger
Registrar of Banks

The previous directive issued was Directive 4/2008 dated 7 May 2008.