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

G10/2012

2012-11-30

To: All banks, controlling companies, branches of foreign institutions, eligible institutions and auditors of banks or controlling companies

Guidance Note 10/2012 issued in terms of section 6(5) of the Banks Act, 1990

Meetings to be held during the 2013 calendar year with the boards of directors of banks and controlling companies

Executive summary

This guidance note serves to inform all banks and controlling companies of the flavour-of-the-year topics for the discussions to be held with the respective boards of directors during 2013.

A. Meetings with boards of directors

1. Introduction

In order to assist the Office of the Registrar of Banks (this Office) to discharge its supervisory responsibilities, the scope of the meetings to be held with banks' boards of directors during the 2013 calendar year will consist of a discussion of the following flavour-of-the-year topics:

1.1 impact of Basel 2.5[1] and Basel III[2] on banks' business models and strategy;*
1.2 recovery planning – Phase 2;** and
1.3 anti-money laundering and combating the financing of terrorism (AML/CFT) controls of locally registered banks, inclusive of the foreign operations of such banks.

* Topic not applicable to mutual banks and registered local branches of foreign banks.
** Topic not applicable to registered local branches of foreign banks.

[1] The Basel 2.5 framework comprises "Enhancements to the Basel II Framework", "Revisions to the Basel II Market Risk Framework" and "Guidelines for Computing Capital for Incremental Risk in the Trading Book", issued in July 2009.
[2] The Basel III framework comprises "A Global Regulatory Framework for More Resilient Banks and Banking Systems" and "International Framework for Liquidity Risk measurement, Standards and Monitoring", issued in December 2010 and revised in June 2011.

2. Format of the meetings to be held with banks' boards of directors

All banks' boards of directors will be required to engage in discussion on the above-mentioned flavour-of-the-year topics. Whilst no time limit is prescribed per topic, it is intended that the discussion on each topic should cover only the key elements of the relevant topic. This Office also requires to be furnished with a copy of the document to be tabled for discussion of each topic at least two weeks prior to the meeting with the relevant bank's board of directors. The three flavour-of-the-year topics for 2013 are discussed in greater detail below.

3. Impact of Basel 2.5 and Basel III on banks' business models and strategy

3.1 Background

In determining the optimal business strategy, banks have to consider a wide spectrum of matters, including the regulatory environment in which they operate. Basel 2.5 and Basel III (hereinafter collectively referred to as 'Basel III'), which are essentially consequential outflows of the global financial crisis, establish more stringent banking regulation and standards in order to address a wide spectrum of matters related to both bank-specific and systemic risks.

The most notable reforms introduced under Basel III, which are to be phased-in over the period 2013 to 2019, include the following:

a) higher quality regulatory capital requirements (quantitative and qualitative);
b) greater risk coverage (for example, raising capital requirements in respect of the trading book, complex securitisations and counterparty credit risk, and standards for central counterparties);
c) a leverage ratio as a supplementary measure;
d) a countercyclical capital buffer;
e) a liquidity coverage ratio;
f) a net stable funding ratio;
g) a capital conservation buffer;
h) measures to address the procyclicality of provisioning requirements;
i) measures to address interconnectedness and systemically important banking groups; and
j) measures addressing reliance on external credit rating agencies.

The aforementioned Basel III reforms fundamentally impact banks and require an integrated treatment of products and risk profiles by banks in a comprehensive optimisation model. In addition, these reforms are being implemented in the wake of a prolonged period of weak economic growth, both internationally and domestically, whilst the prospects for global economic recovery remain subdued.

It is imperative that banks' and banking groups' boards of directors assess the impact of these reforms on their business strategies, models, systems and processes. Such assessment should include a comprehensive capital and liquidity planning and optimisation process, considering, among other things, the economic outlook, the optimal balance-sheet mix, organic capital generation and appropriate risk mitigation strategies.

3.2 Format of discussion

The chairperson of the capital and risk management subcommittees (or equivalent) will be required to lead a discussion on the impact of Basel III, based on the following proposed generic strategies of the bank:

3.2.1 High-level overview of strategic focus areas, including the adaptation of past, current and future strategies in order to align them with Basel III requirements.

3.2.2 Adjustments to the bank's liquidity and funding strategies.

3.2.3 Capital management, covering *inter alia* the following aspects:

a) The impact of Basel III on the banking group's capital targets and board-approved capital buffers.
b) Sources of capital and the potential for raising capital under Basel III, specifically non-common equity tier 1 capital instruments, given the new loss-absorbency requirements at the point of non-viability.
c) Raising capital in the local market versus raising capital in international markets.
d) Impact on the capital structures and capital management of the banking group given, for example, the requirements under Basel III, paragraphs 62 to 65, pertaining to minority interest and other capital issued to third parties.

3.2.3 Balance-sheet restructuring and steps taken to facilitate more effective and efficient balance-sheet management, given the impact of Basel III.

3.2.4 Business model adjustments, for example, the creation of capital- and liquidity-efficient business models, adjustments in the scope of specific business lines, shifts in the bank's client base, revised product design and mix, and changes to cost and pricing models.

3.2.5 Information technology systems enhancements or replacements and challenges in order to comply with Basel III.

4. Recovery planning – Phase 2

4.1 Background

Following on the progress made in 2012, the process of further developing recovery plans (RPs) has again been identified as a supervisory focus area for 2013.[3] In discussions with the boards of directors of banks during 2012, this Office made it clear that the development of RPs is regarded as an integral and ongoing element of banks' risk management processes. The board of directors assumes the ultimate responsibility for the quality, relevance and practicality of their bank's RP. During 2012, all banks indicated outstanding issues in their initial RPs that had to be addressed. Progress in this regard will be assessed in the normal course of this Office's supervisory programme during 2013.

---

[3] The standard elements of a recovery and resolution plan (RRP) are set out in the Financial Stability Board's "Key Attributes of Effective Resolution Regimes", which was adopted by the G-20 as an international guideline in January 2010. Banks are responsible for recovery plans in the RRPs, while the resolution authorities or regulators assume responsibility for the formulation of a resolution plan.

For the purposes of the second phase of recovery planning, RPs should be based on a reverse stress-testing approach, assuming that the bank for some reason experiences severe liquidity, capital or operational stress, irrespective of the cause. In various instances, banks' initial RPs elaborated on stress-testing exercises and results, as well as prudential buffers that were in place to prevent liquidity or capital stress. However, these elements already form part of the risk management processes of the bank and the normal prudential supervisory programme of this Office. Therefore, although it may be helpful for banks to model detailed scenarios of how such situations could evolve, the interest of this Office with regard to RPs is not so much the reasons for a stressed situation, but rather how a bank would recover from such a situation.

4.2 Format of discussion

Banks are expected to make a high-level presentation to this Office on the further development of their RPs since 2012.

In view of the fact that RPs have to be customised according to each bank's legal and business structure, this Office does not prescribe a fixed format for RPs. Banks are expected to ensure that their RPs are practical and ready for immediate implementation, if required. In various instances, the RPs are still too theoretical with limited specific, practical reference to the bank's day-to-day operations. The following are examples, and not necessarily a complete list, of additional information that may be considered, where relevant, to make banks' RPs more plausible and practical:

a) Extending the RPs to cover not only the bank, but also the banking group. This requires, as a minimum, the mapping of legal entities, business units, management structures, information systems and shared services. The objective is to identify economic, systemic and legal interlinkages that may present barriers to the separation of assets and liabilities.
b) Extending the RPs to include all foreign branches.
c) Mapping sources of committed funding to specific business entities and product lines, where applicable, and documenting legal, regulatory and operational limitations for accessing committed sources of liquidity.
d) Ensuring that practicable strategies are in place to execute an urgent sale of relevant bank assets, such as pro forma applications to the Registrar of Banks or other regulators, a management and human resources strategy, the identification of potential buyers and consideration of the possible impact of a loss of shared internal services such as information technology support, risk management and accounting.
e) Assessing the impact of planned spin-offs or asset sales on the remainder of the business.
f) Identifying the critical information that would be needed for effective decision-making during a severely stressed period, and ensuring that systems can provide this information within the required time frame.
g) Fully integrating the RP into the risk management framework of the bank and banking group.
h) More clearly identifying qualitative and quantitative trigger points and escalation processes in the RP.

i) Adhering to the requirement that the RP should not incorporate any official support over which the bank does not have discretion. For example, some banks rely on emergency liquidity assistance (ELA) in their RPs. However, normal ELA is provided at the discretion of the South African Reserve Bank (SARB), and is therefore part of resolution rather than recovery.[4]
j) Increasing the granularity of pertinent internal information, including the balance-sheet restructurings that could be undertaken and the potential barriers to resolution with regard to the list of critical functions and strategies to preserve these functions.

In addition to further developing a range of plausible recovery options for stress scenarios caused by idiosyncratic events, banks are also requested to build into their RPs reaction options for systemic stress events, for example in instances where other banks may be experiencing similar pressures or where financial markets may function sub-optimally. In addition, banks should also identify any possible adverse effects of their own recovery actions on the rest of the banking sector and the financial system, including subsidiaries in host countries.

It should also be noted that the regular assessment of RPs will become a standing element of the supervisory programme of this Office from 2013 onwards, and banks will be expected to make resources available to relevant officials to discuss elements of the RPs and to provide additional information, as requested.

5. AML/CFT controls of locally registered banks, inclusive of the foreign operations of such banks

5.1 Background

During February 2012, the Financial Action Task Force (FATF) released its revised 40 recommendations on AML/CFT (hereinafter referred to as the 'FATF Recommendations'). The FATF Recommendations form the basis for countries to meet the shared objective of preventing money laundering, terrorist financing and the financing of the proliferation of weapons of mass destruction. The FATF calls upon all countries to effectively implement these measures in their national systems, which should be built upon the principles of a more targeted risk-based approach, transparency in ownership, international co-operation, appropriate supervision and managing new threats.

In accordance with the governance principles specified in section 60B of the Banks Act, 1990 (Act No. 94 of 1990), it remains critical for the board of directors to be kept abreast of compliance with all applicable laws and regulations in respect of the bank's operations through accurate and meaningful disclosure of all relevant related matters.

[4] For clarification, if a bank has a committed liquidity facility with the SARB for which it pays a commitment fee, this facility is regarded as part of its high-quality liquid assets and can be included in the RP. However, when the discretion for assistance lies with the authorities, a bank cannot rely on such assistance in terms of its RP.

This Office thus requires the board of directors to emphasise and prioritise the nature and extent of AML/CFT controls applicable to its bank's relevant operations, including those controls that currently exist in offshore operations that require enhancement to meet a standard congruent to the FATF Recommendations.

5.2 Format of discussion

Utilising the format outlined below, the chairperson of the capital and risk management subcommittee (or equivalent) will be required to give a presentation on the following aspects:

5.2.1 Overview of the governance structures relating to AML/CFT:

a) responsibility of the board of directors;
b) role of senior management;
c) independent monitoring functions;
d) internal audit coverage; and
e) group/bank-wide AML/CFT information reported to the board of directors and senior management.

5.2.2 Overview of group/bank-wide policy on AML/CFT.

5.2.3 Overview of group/bank-wide AML/CFT programmes.

5.2.4 Overview of group/bank-wide risk-based approach to AML/CFT.

5.2.5 AML/CFT information technology systems used to identify reportable transactions.

5.2.6 Key AML/CFT issues emanating from compliance reviews as well as internal and external audits.

5.2.7 AML/CFT controls of operations in foreign jurisdictions:

a) risk classifications of branches, representative offices and subsidiaries;
b) enhanced controls for high-risk and non-co-operative jurisdictions;
c) assessment of AML/CFT legislative requirements of host countries;
d) measures to deal with legal and operational obstacles in host countries;
e) application of group AML/CFT policies;
f) extension of group AML/CFT information technology systems;
g) manner in which the bank manages data protection laws in host countries;
h) nature and extent of AML/CFT training initiatives;
i) oversight structures, including internal audit coverage;
j) reporting mechanism back to South Africa on AML/CFT matters; and
k) key AML/CFT issues emanating from compliance reviews as well as internal and external audits.

B. Acknowledgement of receipt

1. Two additional copies of this guidance note are enclosed for use by 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.

René van Wyk
Registrar of Banks

The previous guidance note issued was Guidance Note 9/2012, dated 15 October 2012.