CHAPTER 2

CURRENT ISSUES IN BANKING SUPERVISION

The purpose of this chapter is to discuss some of the most important regulatory and supervisory trends, both locally and internationally, during the year under review.

CORPORATE GOVERNANCE

The focus on corporate governance, being the whole legal and internal control framework within which companies (including banks) operate and are managed, has continued to intensify. In this regard, the role of the external auditors of banks and their relationship with the Bank Supervision Department have become matters of particular importance.

Reliance on auditors

roles of bank supervisors and the external auditors of banks are complementary

Banks play a central role in every economy, and the stability of the banking system is recognised as being a matter of general public interest. For this reason, in the interests of promoting their financial soundness, banks are subject to supervision. The financial statements of banks are, however, also subject to examination by external auditors, whose opinions lend credibility to such statements and, thereby, assist in promoting confidence in the banking system. Thus, there is no doubt that the roles of bank supervisors and the external auditors of banks are complementary. In a paper entitled "The relationship between bank supervisors and external auditors", issued jointly by the Basle Committee on Banking Supervision and the International Auditing Practices Committee, in July 1989, recognition is given to this complementarity of roles, and a whole range of relationships, which depend on the approach adopted by a particular country, is described.

supervisory approach relies on the role of the external auditors

The supervisory approach adopted in South Africa relies much more heavily on the role of the external auditors of banks than is the case in some other countries. The approach resulted from South Africa's unique situation, in which, on the one hand, there is a general shortage of the types of skill necessary to analyse banks' financial soundness, whilst, on the other, the external audit profession is very well established and highly regarded. In adopting this approach in the late 1980s, the Department had to give legal substance to its reliance on the work of auditors by formally extending the responsibilities of auditors of banks through the Banks Act, 1990. The Department has also co-operated for many years with the South African Institute of Chartered Accountants ("SAICA") in order to enhance and develop appropriate standards for bank audits, through, amongst others, "risk-management flavour-of-the-year" guidelines. The Department continues to build on its relationship with auditors of banks, through, for instance, the mechanism of regulation 37(5) of the Regulations relating to Banks reported in the previous issue of this Annual Report, as well as regular meetings with SAICA and the auditors of individual banks. As a result, the Department has been able to outsource some of the detailed on-site examination work conducted by other regulators to the external auditors of banks. The Department believes that this approach not only benefits banks, owing to lower costs and less disruption, but is also more effective, since the Department can focus its on-site work on the most critical high-level issues faced by banks, without having to spend resources on verifying the accuracy of information provided to the Department and monitoring banks' compliance with their stated internal control policies.

outsourcing to the auditors was highlighted as a potential source of vulnerability

It is this outsourcing, to the auditors of banks, of the validation of information obtained by the Department that was recently highlighted as a potential source of vulnerability in its approach. In the case of the failure of Islamic Bank Limited ("IBL"), reported in Chapter 1, the failure of the auditors to report major shortcomings in the statutory returns of IBL and

significant transgressions of the Banks Act are a matter of public record, since these formed part of the application to the High Court for a liquidation order. In this regard, it may be useful to remind all auditors of banks of the supervisory system's dependence on their verification, in terms of regulation 6 of the Regulations relating to Banks, of the risk-management information submitted to the Department. Although it is not believed that the Department's approach is invalidated by the IBL incident, it certainly served to remind all key players of the important role played by the auditor in the supervisory process. The Department intends to investigate the role of IBL's auditors and, if appropriate, to take the necessary steps in order to prevent a recurrence.

Objective criteria for the appointment of auditors of banks

necessary to make transparent the criteria

Section 61(1)(a) of the Banks Act requires the appointment of an auditor of a bank to be approved by the Registrar of Banks. In the past, the Registrar has tended to approve, as a matter of course, the appointment of large international firms and, in particular circumstances, the appointment of some smaller firms. Recently, the number of banks, especially smaller banks, has increased, whilst, at the same time, the availability of bank audit skills have become more widespread. It has therefore become necessary for the Registrar to make transparent the criteria that are used in deciding whether an auditor is considered to be suitable for a particular bank. After extensive consultation between the Department, the Financial Services Board, which has a similar approval requirement with respect to the regulated entities under its supervision, and SAICA, which also has an interest in ensuring that its members are seen to be complying with objective criteria, a set of objective criteria was recently approved by all three parties. A paper entitled "Objective criteria for assessing the acceptability of an audit firm as auditor of a regulated institution" was issued to regulated institutions and their auditors, as well as to potential auditors of regulated institutions, via SAICA. The criteria focus on the relevant auditing experience of the firm and the responsible partner in the particular regulated industry, as well as the depth of skilled resources of the audit firm in relation to the complexity and size of the audit of the regulated institution.

Requirement for joint auditors of banks

Section 61(1)(b) of the Banks Act requires a bank with total assets exceeding R10 billion to appoint not less than two auditors who are independent of each other. The reasons for originally implementing this requirement included the improved independence of auditors and the broader base of specialist skills that could be accessed with respect to a large bank's complex audit. The decision has been vindicated by the subsequent experience of the Department, which believes that a joint audit clearly results in an audit of improved quality. Recent announcements of merger negotiations between four of the largest international accounting firms have, however, once again raised the question of whether the joint auditor requirement is still necessary in the South African context. Reasons for questioning the requirement are the reduced choice of firms if the proposed mergers take place, the higher cost of joint audits and the apparent international trend of moving away from joint auditor requirements.

joint auditor requirement is being investigated

The joint auditor requirement is currently being investigated by the Department and is also the subject of debate amongst the large audit firms, SAICA, The Banking Council South Africa and the Department. Although many compelling arguments exist to support the retention of the requirement, in view of South Africa's special circumstances, the cost factor cannot simply be ignored. Possible alternative approaches that may reduce the cost to banks, whilst retaining some of the benefits of joint audits, include review of the above-mentioned threshold of R10 billion and the possibility of requiring only one of the joint firms to qualify in terms of the above-mentioned objective criteria. Although this would make it possible for banks to assist emerging firms to obtain experience in bank audits, it would necessarily mean that the auditing profession would have to resolve issues such as the manner in which the fee and liability arising from a joint audit would be divided.

Material malfunction in terms of regulation 37(5) of the Regulations relating to Banks

As explained in some detail in the 1996 Annual Report, regulation 37(5) of the Regulations relating to Banks requires the directors of a bank to report annually to the Registrar of Banks on various aspects of the bank's system of internal controls. Amongst other things, directors are required to report whether anything has come to their attention to indicate that any material malfunction has occurred in the functioning of the aforementioned internal controls. In this context, a material malfunction means a malfunction as defined and documented by the board of directors and submitted to the Registrar.

During the year under review, the Bank Supervision Department held many discussions with banks regarding an appropriate definition of material malfunction. The Department avoided suggesting any definition, since it believed that the process of arriving at a definition that would satisfy the board of a bank would be not only in the interests of, but an essential part of, the corporate governance communication of a bank. Many different definitions were received, and although the definitions of some banks' boards are still outstanding, it is now possible to provide some information on the nature of the definitions received.

Common elements of the definitions of a material malfunction

Common elements of the definitions devised by the boards of banks are that a material malfunction is a breakdown in, an overriding of, a non-existence or an inadequacy of a control, procedure or system-

- which has resulted in, or had the potential to result in, material losses, contingencies or uncertainties;
- where "material' means anything that would influence the correctness of the value or classification of any asset or liability, or the correctness of the annual financial statements or any statutory return, by more than a threshold; and
- where the threshold is either a fixed amount specified, or a percentage of some factor such as net shareholders' funds or profit after tax.

matters to be reported regardless of monetary materiality

Some banks' boards have enhanced the qualitative aspects of their definitions by specifying matters requiring to be reported regardless of monetary materiality, such as:

- Any fraud or attempt at fraud.
- Any non-compliance with a statutory requirement.
- Any event that is likely to alter significantly the directors' assessment of the risks facing the bank concerned.

Some boards of banks have interpreted the requirement to mean that the definition of material malfunction to be reported to the Registrar should differ from that of a material malfunction to be reported to the board. None the less, the Registrar is in general satisfied that the primary intention of this aspect of regulation 37(5) has been met, in that the various boards of directors of banks have applied their minds to defining the types of matter that they require to be reported to themselves, and that this has been communicated to the management of banks. The Registrar would therefore like to take this opportunity to thank the directors and management of banks for their co-operation in this regard.

Personal account trading

Several factors have given rise to concern about personal account ("PA") trading by bank employees. Firstly, banks have become major participants in all financial markets. Secondly, the establishment of a number of foreign bank operations in South Africa has increased the demand for competent traders in financial instruments, resulting in remuneration packages that often include freedom for employees to trade for their personal account.

Thirdly, in view of the international attention being focused on South African financial markets, preservation of confidence in the integrity of these markets has become of paramount importance. Finally, the reliance of the Bank Supervision Department on the qualitative aspects of a bank's corporate governance system compels the Department not only to examine the methods of controlling PA trading, but also to influence the level of control established.

industry-wide standard for PA trading

The Department has therefore observed, with great interest, the recent efforts of certain market players to establish an industry-wide standard for PA trading. The position of the Department has been to allow financial markets to develop their own guidelines in this regard, and to avoid, if possible, the imposition on banks of rules that may not be followed by other participants. The time may, however, have come for regulators to work together and to take specific actions in order to ensure the establishment of a reasonable standard for PA trading. Therefore, the Department has entered into discussions with the Financial Services Board in order to co-ordinate the possible imposition of common rules towards a standard on PA trading.

LEGAL RISK

Banks are subject to various forms of legal risk. This can include the risk that assets will turn out to be worthless or that liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank, a court case involving a particular bank may have wider implications for the banking sector and may involve costs for the bank concerned and many or all other banks, and laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering into new types of transaction and when the legal right of a counterparty to enter into a transaction is not established.

In order to enhance awareness of the characteristics and pitfalls of the legal risk inherent in banking business, a workshop on legal risk relating to banks was held at the South African Reserve Bank on 12 November 1997. Topics that were addressed included the following:

Regulatory framework in South Africa and the legal risk inherent in banking business

Certain infrastructural fundamentals should be present in order to enable effective bank supervision. The system of business legislation, including the law of contract, should be comprehensive and relevant, accounting standards should enjoy wide international acceptance and law enforcement should be effective, consistent and impartial.

role lies in maintaining and adapting banking legislation

The role of the Bank Supervision Department in the management and control of legal risk lies in the Department maintaining and adapting this country's banking legislation, in order to ensure that it remains effective, focused, topical and relevant to the needs of the community at large, whilst upholding the principles of free enterprise and effective competition. Before South Africa can be regarded as a financial centre of international class, the country has to meet first-world standards.

Therefore, as reported in Chapter 1 of this Annual Report, an independent evaluation of the Department's degree of compliance with the 25 core principles issued by the Basle Committee on Banking Supervision was commissioned. Deficiencies that were identified will be addressed, and improvements will be implemented once any necessary changes to the legislation have been effected.

part of ongoing assessment of risk appetitite

Although increased competition encourages innovation, it also enhances legal risk. Furthermore, the internationalisation of banking activities increases contagion and the risk of systemic failure. The recognition and management of legal risk should therefore form part of the ongoing assessment of the risk appetite of individual banks and the manage-

ment thereof. The legal divisions of individual banks should develop policies that are approved by the board of directors and senior management, in much the same way as for the other banking risks. There should also be consultation between a bank's legal division and its risk managers. The Basle Committee recommends that, as a minimum, guidelines and processes should exist, in order to ensure the enforceability of counterparty agreements.

Legal implications of financial intermediation and legal risk emanating from related banking contracts

paragraph (ff) provides for an agent to open an account in the principal's name

For purposes of effecting a money-lending transaction between a lender and a bank, the provisions of paragraph (ff) of the definition of "the business of a bank" in section 1 of the Banks Act, 1990, allow an agent to perform such a service for and on behalf of the agent's principal. The said paragraph (ff) provides for an agent to open an account with a bank in the principal's name and to pay into the account an amount of money belonging to the principal, thereby bringing about a bank/client relationship between the bank and the agent's principal.

contract of *mandatum*

A bank/client relationship is a contractual relationship between a creditor and a debtor and may further be described as a contract of *mandatum*. Based on the agreement in terms of which the customer lends money to the bank on a current account, the bank undertakes to repay such money on demand, by honouring cheques drawn on it, and to perform certain other services for the customer, such as the collection of cheques and other instruments. The agent is not a party to the aforementioned bank/client relationship, and the bank will have a duty towards the principal to act in accordance with the principal's instructions. The principal of the agent ostensibly has a duty towards the bank to draw cheques in a manner that prevents fraud.

provisions of paragraph (gg) allow acceptance and depositing of money into an account maintained by the mandatary

For purposes of effecting a money-lending transaction with a bank, the provisions of paragraph (gg) of the definition of "the business of a bank" in section 1 of the Banks Act allow a mandatary to accept money from a mandator and to deposit such money into an account with a bank maintained by the mandatary. Such money may be deposited together with other mandators' money.

In such a transaction, two separate contracts come into existence. One contract involves the owner of money ("the mandator") conferring authority upon another ("the mandatary") to invest money in a bank account, on behalf of the mandator. This contract determines the nature and ambit of the mandate conferred by the mandator upon the mandatary. The other contract involves the mandatary, in the execution of the mandatary's duty towards the mandator, entering into a bank/client relationship with a bank. Consequently, a separate contract of *mandatum* comes into existence between the mandatary and the bank in question, resulting in a creditor/debtor relationship between the bank and the mandatary, in the mandatary's capacity as the account holder. The mandator is not a party to that contract.

pool of funds acquires a new legal identity

If one mandator's money is deposited in a bank account maintained by a mandatary together with the money of other mandators, the money becomes the property of the bank, and the mandatary has a claim against the bank for the amount. Funds belonging to different owners lose their identity when joined to form a single amount, and such a pool of funds acquires a new legal identity. The owners of the money acquire a claim against the pool of funds coincidental to the value of the funds that each has contributed. If a mandatary collected such a pool of funds from mandators for purposes of investing the funds in a bank account, the claim of the mandators will be against the mandatary.

Authorities in South African law are inconclusive with regard to loss or damage that flows from a contract of mandate.

Legal enforceability of guarantees and security

terms of majority of deeds of suretyship are dictated by large financial institutions

It is an economic reality that, today, the terms of the vast majority of deeds of suretyship are dictated by large financial institutions. These deeds of suretyship are drafted with all the skilled legal advice available and, inevitably, favour the creditor in almost every respect. In the light of the inherent potential inequities that may flow from standing surety for someone else's debt, there have throughout the ages been many attempts to lighten the burden of surety.

Until some time ago, it could be argued that a defence existed to protect a surety when a creditor sought to use a contract of suretyship for a purpose never envisaged by the parties when they entered into the contract. In *Bank of Lisbon and South Africa Ltd v De Ornelas & Another*, a case reported in 1988, the Appellate Division of the Supreme Court of South Africa, however, ruled that such a defence does not form part of South African law.

In today's commercial world, in which prospective debtors are commonly required to provide sureties on terms that creditors dictate, a potential for conflict is created. It is therefore almost certain that litigants will seek other ways in which to resist the enforcement of unconscionable bargains.

One of the requirements for the validity of a contract is that the agreement must be lawful. Agreements are prohibited by common law if they are against public policy or are against good morals. In *D Engineering Company (Pty) Ltd v Morkel and others*, the Court considered a deed of suretyship that contained a wide range of clauses designed, inevitably, to improve the position of the creditor at the expense of the surety. The Court, in a full bench decision of the Supreme Court of South Africa (Transvaal Provincial Division), held that such clauses went "beyond the reasonable business requirements of suretyship" and, accordingly, found the suretyship to be unenforceable. Not surprisingly, the Court's decision was avidly seized upon by other sureties bereft of any other defence against claims by banks, financial institutions and others.

It was suggested that the whole question of public policy and good morals may have been misconstrued in the context of suretyship and that it was certainly not conducive to legal certainty if each individual clause in a deed of suretyship would have to pass the test of public policy and good morals. Both of these concepts not only are extremely difficult to define, but change constantly.

It appears that, in the course of this century, the concepts of freedom and sanctity of contract have increasingly come under attack as a result of, *inter alia*, rampant inflation, monopolistic practices giving rise to unequal bargaining power, and the large-scale use of standard form contracts. Extreme individualism was short-lived all over the world, and a transition from freedom of contract to social responsibility is being witnessed.

statutory reform to the problem of unfair contracts

Current proposals by the South African Law Commission are aimed at introducing statutory reform to the problem of unfair contracts. If adopted as legislation, these proposals will undoubtedly have a dramatic influence on the enforceability of suretyship and guarantees.

Legal risk relating to banking secrecy and the conduct of directors of banks

in certain circumstances a banker may disclose information about a client

The duty of a banker to keep the affairs of a client secret has developed in our common law. South African law has also adopted the principles of English law. In certain circumstances, however, a banker may disclose information about a client, although the banker has to be careful not to disclose more information than is necessary for the purpose in mind. Such circumstances appear to be when disclosure is under compulsion of law, when there is a duty to the public to disclose, when the interests of the bank require disclosure and when the disclosure is made by the express or implied consent of the client.

legislation that compels a bank to disclose information

Section 65(2) of the Insolvency Act, 1936 (Act No. 24 of 1936), and certain provisions of the Proceeds of Crime Act, 1996 (Act No. 76 of 1996), constitute examples of legislation that compels a bank to disclose information about a client in specified circumstances. Since the concept of a duty to the public is very wide, the facts of each case will determine whether a banker has a duty to make a disclosure in the interest of the general public. It would therefore be in the interest of a banker to seek sound legal advice before making such disclosure.

Disclosure is in order when it is in the interest of a bank, for example, when a bank intends to sue its own client for having breached the bank/client relationship. A bank, however, may not disclose information in order to enable another company in the same group to gain a commercial advantage in an unrelated transaction. Disclosure may also be made with a client's consent, which may be direct or implied.

A director of a company (including a bank) is a person who performs the functions of a director, regardless of the title assigned to the position, and stands in a fiduciary relationship to the company. This relationship may be dissected into the elements of a duty of care in the execution of the director's office and a fiduciary duty.

The duty of care means no more than the execution of the director's functions in a careful manner, always in the interest of the company. The fiduciary duty means that the director's conduct towards the company must be honest. In general, it means that a director must rule out the existence of a conflict of interest with the company, by making full disclosure of any possible conflicting interest.

Management of legal risk in banks: Recent developments affecting banking documentation

in duplum rule

The *in duplum* rule refers to the common law rule that interest exceeding the capital sum cannot be claimed. A bank contended that its client had waived the benefits of the *in duplum* rule, since the bank had agreed to grant a loan on condition that the client renounced the legal benefits and exceptions of "no valid cause of debt", "revision of accounts" and "error in calculation". In *Leech v Absa Bank Limited*, the Court ruled that the purpose of the *in duplum* rule was to protect borrowers from exploitation by lenders. Since the protection was given as a matter of public policy, the benefits of the rule could not be waived and could also not be excluded by a contractual provision.

waiver of benefit clauses should be looked at more closely

Consequently, the waiver of benefit clauses ordinarily contained in banking contracts (most commonly, suretyships, cessions and pledges) should be looked at more closely. Some of these common-law benefits may have had their common-law origins in protecting the client as a matter of public policy, which could result in waivers of such benefit clauses being declared invalid.

floorplan agreements between banks and motor vehicle dealers

So-called floorplan agreements entered into between banks and motor vehicle dealers, in order to effect some form of security for a loan, rely on a fictional form of delivery (delivery without possession), known in our common law as *constitutum possessorium*, for purposes of transferring ownership of vehicles to the bank. The matter in *Nedcor Bank Limited v Absa Bank Limited* dealt with such a floorplan agreement. Despite acknowledging the commercial need for the recognition of a form of pledge without possession, the Court ruled that our law currently does not recognise the validity of pledge without possession. The Court further held that it would be improper for a judge of first instance to attempt to create such a right.

In view of the aforegoing judgement, no security value can be placed on the stock of dealers under such floorplan agreements. Steps should therefore be taken to evaluate the risk of advances to dealers on the basis of unsecured loans. The Court's decision may also have a disastrous effect on banks' security in terms of other refinancing agreements.

Any bank is entitled to honour cheques drawn by its customer, even though there might not be a prior agreement between the bank and customer that cheques so honoured might result in the customer's account being overdrawn. Therefore, many banks provide on their deposit slips that payment by the bank against uncleared effects shall be at the bank's discretion, and the bank would be entitled to debit a customer's account with the amount of dishonoured instruments.

banks should not be allowed to contract out of what forms part of their business

As a matter of policy, banks should not be allowed to contract out of what in essence forms part of their business. When clients, however, insist on investing in high-risk high-reward investments, it may be advisable to provide contractually that such clients should assess and monitor the risks of such investments themselves. Banks may thereby exclude, or at least limit, their potential delictual liability towards clients.

CREDIT RISK

As stated in previous issues of this Annual Report, credit risk remains the most important single risk in banking. Therefore, effective management of all dimensions of credit risk, such as quality, concentration, maturity, security and type of facility, to name but a few, remains an essential component of banks' overall risk-management processes and, indeed, sound banking practice.

Deterioration of asset quality

increase in overdue accounts

During 1996 and 1997, there was an increase in the overdue accounts of many South African banking institutions, specifically in the instalment-credit area. This was the result of, *inter alia*, tightening economic conditions and a severe drop in second-hand car prices. Many banking institutions in the consumer-credit market were forced to make write-offs in respect of such loans.

increasing trend in overdue mortgage loans

Although the increase in doubtful instalment-credit loans flattened during the latter part of 1997, there was a disturbing increasing trend in overdue mortgage loans. This trend reflected not only the financial strain to which consumers were subjected during 1997 as a result of the high interest-rate environment, but also, in many cases, the unwillingness of individuals to tighten their belts accordingly. Since a home loan is typically the first commitment that an individual will service (a factor recognised by the risk weighting of 50 per cent that is assigned to mortgage loans on urban residential property), the Bank Supervision Department is obviously concerned about the downward trend in the servicing of mortgage loans. A continued downward trend might well indicate a permanent change in the attitude of individuals towards the servicing of such loans, resulting in a concomitant increase in risk to the banking sector.

Banking institutions are, however, acutely aware of this problem and are making every effort to limit losses and to assist home owners in finding solutions to their individual problems.

Capital requirements

increasing the risk weighting assigned to those portions of home loans that exceed 80 per cent of the value

As explained in the 1996 Annual Report, the Bank Supervision Department has for some time been uneasy about banking institutions' current application of the 50 per cent risk-weighting category to the full outstanding balance of a home loan. The Department has therefore been considering increasing the risk weighting assigned to those portions of home loans that exceed 80 per cent of the value of the underlying residential property from 50 per cent to 100 per cent.

During on-going discussions in 1997, the banking sector highlighted certain practical difficulties with the implementation of such a change. The Department is, however, confident that a solution will be found in the near future. The change is deemed important, since increases in property prices have in the past tended to be due largely to inflation. Since

concerned about negative equity

inflation is increasingly being brought under control by the authorities, house prices in certain areas have tended to level out and, in some instances, have declined. Consequently, the Department is concerned that negative equity could become increasingly problematical, thereby increasing risk to the banking sector. Furthermore, as reported above, there has been an increase in the extent of overdue mortgage loans on residential property. The blanket risk weighting of 50 per cent currently applied to home loans is therefore not regarded as a true reflection of the risk in this market.

It is also intended to increase the risk weighting of loans to local authorities, because it is reasonably certain that local authorities that find it difficult to repay loans will no longer be able to rely on the assistance of central or provincial government. Once again, the Department believes that it is important that the capital a banking institution is required to hold should reflect, as far as possible, the risk faced by the institution.

SYSTEMIC RISK

The rapidly growing volume of transactions and the expanding array of new and increasingly complex financial products are sources of, and transmission mechanisms for, systemic shocks. The fact that many new entrants to the financial system have global operations has resulted in new legal and supervisory concerns about the potential impact of such operations on the safety and soundness of the financial system.

systemic risk defined

Systemic risk may be defined as the risk of a sudden, unanticipated event damaging the financial system to such an extent that activity in the wider economy will suffer. Shocks causing systemic risk may include the sudden failure of a major participant in the financial system, a technological breakdown of the payments or settlement process at a critical stage and a political shock, such as the death of a prominent politician. Such events can disrupt the normal functioning of financial markets by destroying the trust that lubricates financial transactions.

When a financial shock occurs, problems in one institution can spread to other institutions, as evidenced by the current financial crisis in South-East Asia. Contagious transmission of a shock may be caused by suspected exposures of institutions - market participants are likely to suspect that those institutions least able to withstand a particular shock have been damaged thereby. Financial institutions will attempt to protect themselves by liquidating their claims on clients with suspected exposures and by moving their claims into the portfolios of clients perceived to be stronger and better able to withstand the particular shock. The result is a flight to quality.

A large proportion of serious financial problems, which may lead to systemic risk, arise from factors that banks ought to be able to control. For example, the failure of Barings and the trading losses at Daiwa Bank, Morgan Grenfell and Sumitomo Corporation could have been avoided had fully comprehensive internal control systems and stronger management oversight been in operation there.

Three of the most likely causes of a bank failure are:

three of the most likely causes of a bank failure

- Inadequate management procedures.
- Failure of internal controls.
- Undetected actions of rogue employees.

The control mechanism that banks must have in place include:

control mechanism

- An effective audit committee.
- A properly staffed internal audit function.
- Appropriate risk-management procedures.
- Knowledgeable compliance functions, including legal, regulatory and ethical procedures.

measures to prevent systemic risk from entering the financial system

The Group of Thirty recommended in a study report that the following be implemented in order to prevent systemic risk from entering the financial system:

- Establishment of a committee to review global principles for the management of risk, covering the full range of management-control functions.
- Ensuring that the full range of risks in a bank is properly managed.
- Review of the efficacy of risk-reduction strategies.
- Review of the data reported to decision makers.
- Expanded review of the worldwide operations of banks by independent external audit firms and establishment of a common format for the disclosure of financial risk information on a consolidated basis.
- Implementation of high-quality, uniform international accounting standards.
- Agreement on a lead regulator for a financial conglomerate.
- Improvement of the capabilities of supervisors to understand complex financial products, assess sophisticated risk-management systems and deal with the management of crises in financial markets.

The formulation and implementation of measures aimed at reducing the possibility of systemic risk entering the financial system are arduous and complex. The Bank Supervision Department, however, believes that if the basics are implemented and applied correctly, the possibility of systemic risk entering the financial system is reduced.

MARKET RISK

As reported in the Bank Supervision Department's 1996 Annual Report, capital-adequacy requirements have to calculated in respect of the securities trading activities of banks since January 1996. Banks conducting such activities were requested to complete the relevant returns on a pilot-project basis. The capital-adequacy requirements will be formally implemented and promulgated as regulations in 1998, and the Department faces several challenges in this regard.

from a supervisory point of view, great emphasis will have to be placed on the internal control processes and procedures surrounding the models

The Department will need to satisfy itself that the regulations are correctly interpreted and applied, so that the correct capital requirements in respect of market risk are calculated. As regards the use of internal models for the computation of banks' market-risk capital requirements, the Department has thus far not received any official requests for the evaluation of such models. It is, however, envisaged that such requests will be forthcoming as soon as banks have fully implemented internal risk models to calculate value at risk. Initially, much emphasis was placed worldwide on the internal workings of the models. Based on several external sources, it would, however, appear that, from a supervisory point of view, great emphasis will have to be placed on the internal control processes and procedures surrounding the models, and that a balance will have to be maintained in this regard.

A further initiative will be to confirm that, in the application of the regulations, there are no regulatory gaps between participants in different financial markets, and that the standards set by the Department comply with international standards at all times.

LIMIT ON FOREIGN-CURRENCY HOLDINGS

limit on foreign-currency holdings of banks abolished subject to certain restrictions

On 15 January 1998, the limit on foreign-currency holdings previously imposed on banks was abolished with immediate effect, subject to certain restrictions on the purpose and placements of such funds. This further relaxation of exchange controls requires South African banks to manage their currency-risk exposures within the parameters set by the authorities. The foreign-currency holdings of banks are also still subject to the requirements of regulation 31(6) of the Regulations relating to Banks, in terms of which a bank's effective net open position at the close of business on any one day may not exceed an amount equal to 15 per cent of its net qualifying capital and reserves.

INFORMAL AND ALTERNATIVE FINANCIAL AND BANKING SERVICES

The provision of financial and banking services by various informal and alternative means remained a topical issue in South Africa. During the year under review, particular attention was given to the feasibility of regulating the micro-lending industry and the possibility of providing banking services to rural communities in South Africa by means of financial service co-operatives, as well as the provision of banking services through retail agents.

Micro-finance

huge demand for access to finance

The micro-lending industry, which occupies a niche between informal money lenders and formal financial institutions, has grown extremely rapidly in South Africa. The emerging South African economy has generated a huge demand for access to finance by people with limited collateral. At the same time, various practices that have come to light have revealed a need for the protection of borrowers against unscrupulous operators.

micro-lending industry currently not regulated

A commonly held public misperception is that the South African Reserve Bank or its Bank Supervision Department regulates the micro-lending industry. In fact, the industry is currently not regulated. Nevertheless, the Department continues to receive frequent complaints and pleas for help from micro-borrowers. Therefore, with a view to creating a self-regulatory body for the industry, the Registrar of Banks consulted with interested parties in the micro-finance industry.

Consequently, the Department hosted a workshop on the micro-lending industry in August 1997, in order to examine developments in the industry more fully and to attempt to identify strategies and solutions. Invited speakers included representatives from Government, academia, the micro-lending industry and the formal banking sector.

Topics covered during the workshop included the following:

topics covered during workshop

- Need for the stimulation of micro-enterprise, whilst protecting consumers against economic exploitation in the light of proposals to amend the Usury Act, 1968, and to repeal the exemption of money-lending transactions of less than R6 000 and a maturity not exceeding 36 months from the said Act.
- Recommendations for, and examples of, successful micro-lending schemes for development purposes, including a proposed model for South Africa.
- Characteristics of, and recommendations for, the operation of a "formal" small loans industry in South Africa.
- Reasons for the need to regulate the micro-loan industry.
- Methods of collection of micro-loans and the micro-lending industry's experience with bad debts.
- Provision of micro-loans by the formal banking sector.
- Key players in the new National Payment System and the possible role of micro-lenders therein.
- Importance of financing micro-enterprise and recommendations for a strategy in this regard.
- A proposed self-regulatory structure for the micro-lending industry.

The primary aim of the proposed self-regulatory structure is the development of the micro-lending industry, in order to serve legitimate unserved credit needs by means of increased access to finance and protection of borrower interests. Briefly, the proposals are as follows:

proposed self-regulatory structure

- Exemptions would be created under both the Usury Act and the Banks Act, 1990, in order to accommodate all micro-lending institutions that are accredited to, and conform with the rules of, the proposed self-regulatory body.
- Members could provide finance for either development or consumption purposes.
- Micro-lenders would be able to accept wholesale deposits only (to a maximum of

R30 million). It is submitted that institutional investors would be better able to assess the risks involved, and the acceptance of retail deposits would therefore not be permitted.

- On loans not exceeding R20 000 each, micro-lenders would be able to charge rates above the limitations of the Usury Act. The threshold of R20 000 would distinguish the micro-lending sector from the formal banking sector.
- Supervision would comprise a complaints-driven component and basic compliance requirements.
- A supervisory body, which would be a company headed by a board of directors, would be established. This body would have to adhere to codes of conduct, governance, financial disclosure and risk management.
- In the event of an accredited institution losing its accreditation, such an institution would be in contravention of the Banks Act or the Mutual Banks Act, 1993, should it take further deposits.

Financial service co-operatives

savings mobilisation hampered by legal restrictions

In its final report dated 18 September 1996, the Commission of Inquiry into the Provision of Rural Financial Services (known as the Strauss Commission), whilst acknowledging that savings were a cornerstone of capital retention and many start-up investment initiatives, pointed out that difficult access to savings institutions inhibited the realisation of savings potential in South Africa's rural areas. The Strauss Commission further submitted that savings mobilisation was hampered by the inability of institutions that interacted at grassroots level, such as non-governmental organisations, to take deposits, owing to legal restrictions. Consequently, the Strauss Commission recommended that existing regulations should be reviewed, in order to remove impediments to potential smaller institutions playing a responsible and pro-active part in mobilising national savings.

provision of banking services in rural areas by means of "FSCs", or "village financial service co-operatives"

In an endeavour to address the need for the provision of banking services to persons in South Africa's remote rural areas, which are currently not serviced by commercial banks because of cost and other considerations, a pilot project was initiated in the Northwest Province. This pilot project involved the establishment of a number of financial services co-operatives ("FSCs", or "village financial service co-operatives", as they have become known), with the objective of providing the required banking services. Parties involved in the project are the National Department of Agriculture, two major commercial banks, US AID, a firm of attorneys and a self-governing body, styled the Financial Services Association.

Information presented to the Bank Supervision Department by interested parties has indicated that the FSC project is ostensibly viable and sustainable in terms of providing banking services to the targeted communities and, therefore, merits further advancement and expansion to other provinces in South Africa. This Department has therefore been requested to establish the necessary legal framework in terms of the Banks Act, 1990.

The Department has indicated its willingness to assist in providing, in terms of the Banks Act, a suitable legal framework, in terms of which FSCs would be allowed to conduct "the business of a bank" lawfully, provided, *inter alia*, that an adequate framework for the regulation of FSCs be established. In this regard, it is envisaged that the Registrar of Co-operatives could fulfil an important role, since an FSC would be required to register as a co-operative in terms of the Co-operative Act, 1981 (Act No. 91 of 1981).

no FSC may be allowed to refer to itself as a "bank"

This Department is, however, not in a position to allow any FSC to use, or refer to itself by, any name, description or symbol indicating, or calculated to lead anyone to infer, that such an FSC is a "bank". Consequently, no FSC may be allowed to refer to itself as a "bank". For sound reasons, the word "bank" is reserved strictly for use by institutions registered as banks or mutual banks.

Banking through agency business

using agency business to provide certain banking-related services

The concept of using agency business to provide certain banking-related services to members of the general public is not new in South Africa. This concept was generally used by mutual building societies before the repeal of the relevant legislation on mutual building societies and building societies in February 1991. With regard to services that may be offered by banks to the general public through agents, it may, however, be justified to conclude that the traditional business products offered by banks have undergone change and that such changes have to be taken into account.

The Banks Act, 1990 (Act No. 94 of 1990), provides for the regulation and supervision of public companies that take deposits from the public and for matters connected therewith. In terms of the Banks Act, subject to certain exceptions, only duly registered banks and mutual banks may conduct "the business of a bank", as defined in section 1 of the Banks Act. The said definition may be regarded as being based on the acceptance of deposits from the general public as a regular feature of the business in question. In addition, no persons may misrepresent themselves as a bank, or use or refer to themselves by any name, description or symbol indicating, or calculated to lead anyone to infer, that they are a bank whilst not registered as a bank in terms of the Banks Act.

When an account is opened with a bank in the name of a person, a bank/customer relationship comes into existence. The relationship is a contractual one, based on the principles of debtor and creditor. Since the bank becomes the owner of monies deposited into an account, an account holder does not own the cash in the bank, but has a claim against the bank coincidental to the amount deposited plus any agreed interest.

aim of an agent is to perform a service for and on behalf of a principal

In legal terms, the aim of an agent is to perform a service for and on behalf of a principal in circumstances in which the principal may be unable to perform the service itself, or may find it impracticable, inconvenient or difficult to do so itself. Exercise of agency power brings into being, varies or terminates a contractual relationship between a principal and a third person. The concept of banking through agency business legally entails that an agent brings about, varies or terminates a bank/client relationship between a bank and a depositor of money.

The Bank Supervision Department has become aware of a perception in the market that the supermarket group Pick 'n Pay Stores Limited ("Pick 'n Pay") "has launched a new type of savings account" and that a new division of Pick 'n Pay, styled Pick 'n Pay Financial Services, is offering certain banking services to its customers. It is therefore regarded as necessary that the so-called financial products allegedly being provided by Pick 'n Pay be regarded in the aforegoing legal perspective.

Pick 'n Pay is not a registered bank in terms of the Banks Act and may therefore neither conduct the business of a bank nor may it, directly or indirectly, represent itself as a bank. Therefore, Pick 'n Pay may not accept deposits from the general public under circumstances in which it may be said, owing to the acceptance of such deposits, that a creditor/debtor relationship exists between Pick 'n Pay and the depositor.

Boland Bank PKS Limited ("Boland") is a registered bank in terms of the Banks Act and is therefore duly authorised to accept deposits from the general public and to conduct the business of a bank. Through utilisation of the concept of agency business, the banking services provided by Boland are merely being extended, ostensibly to all Pick 'n Pay supermarket outlets. Pick 'n Pay, in its capacity as an agent of Boland, is providing a service for and on behalf of Boland by opening an account with that bank in a customer's name and, thereby, establishing a bank/client relationship between Boland and that customer.

CONSOLIDATED SUPERVISION

supervision, within a risk-based framework, of an overall group, as well as of the individual entities

Financial groups are becoming increasingly diversified, both geographically and in terms of the products that they offer, and the distinction between banking and non-banking financial business is becoming less clear. In addition, the increasing diversification and sophistication of the financial industry are resulting in new risks, which need to be identified and addressed. Consequently, supervisory authorities need to ensure that they conduct supervision, within a risk-based framework, of an overall group, as well as of the individual entities within such a group.

A directive from the Bank of England to all authorised institutions defines consolidated supervision as "a qualitative assessment of the overall strength of a group to which an authorised institution belongs, to evaluate the potential impact of other group companies on the authorised institution".

Supervision of a banking group on a consolidated basis has to be aimed at protecting the interests of the depositors of banks in the group and at ensuring the stability of the financial system. In order to be effective, supervision on a consolidated basis has to be applied to all banking groups, including parent undertakings, irrespective of the type of business being conducted.

contagion risk is one of the most important issues

Contagion risk is one of the most important issues to be considered in the performance of consolidated supervision. From a bank supervisor's perspective, contagion refers to a situation in which a bank is affected by financial problems, such as insolvency or illiquidity, arising in another group member. Contagion is of such concern that it justifies the application of supervision to all group members.

international standards

In order to be part of the international banking community, South African banks have to accept the regulatory requirements that are imposed universally. If South Africa does not conform to internationally agreed standards, South African banks wishing to diversify internationally will be penalised by foreign regulatory authorities. The Bank Supervision Department, therefore, subscribes to international standards of consolidated supervision and will ensure that all implemented procedures and policies satisfy international standards.

During the coming year, the Department plans to continue with the implementation of its manual on consolidated supervision of banking groups and with the assessment of banking groups on a consolidated basis. Attention will also be given to areas in which gaps have been identified, with reference to international standards such as capital-adequacy requirements and limits on large exposures and connected lending. International developments will be closely monitored, in order to ensure that the manual continues to reflect the latest international developments and thinking.

Consolidated supervision is an integral part of banking supervision. Although consolidated supervision does not replace solo supervision, it enhances the overall supervisory process.

Supervision of financial conglomerates

primary concerns are contagion, transparency and autonomy

In the supervision of financial conglomerates, the primary concerns are contagion, transparency and autonomy.

individual institutions in a financial group should not be allowed to undertake the undermentioned activities

When liquidity and solvency risks materialise and other problems occur, the likelihood of contagion of other members of the group is increased. Individual institutions within a financial group should therefore not be allowed to undertake the undermentioned activities:

- Accumulation of risk exposures without adequate transparency, thereby allowing risks to be disguised, or to go unreported.
- Granting of credit lines without limits to third parties, thereby allowing exposures to accumulate within the group.

- Granting of large exposures to connected parties that are in a position to influence the policies and decisions of the financial group's members.
- Conducting of high-risk business by a low-risk institution that does not have the necessary expertise to manage the specialised risk exposures.
- Double gearing of capital between financial institutions by, for example, the use of a bank's deposits in order to fund a long-term loan to a group member that is an insurance company, and which, in its turn, subscribes to a rights issue of the bank concerned. Impairment of the double-gearing of a financial group's capital may result in the net capital of the group being less than the sum of the capital of the individual members of the financial group. Double gearing thus creates a serious contagion problem.
- Operating on the assumption that surplus capital in one group member may be used to cover a capital shortage in another member, despite the capital not being mobile.

The complexity of the group structure of a financial conglomerate often reduces transparency. Supervisors, therefore, have to be furnished with the managerial structure and reporting lines within a group in order to ensure that proper reporting to the correct level is taking place. The organisational structures have to show clearly which shareholders and which managers exercise control over a group and its members and which owners have financial responsibility for providing the group with future capital. Opaque structures are typically exacerbated by:

opaque structures are exacerbated by the following

- Lack of public disclosure, which prevents rating agencies and the securities market to evaluate the financial position of a financial group.
- Use of bearer shares, whereby the ultimate ownership of a financial group is disguised.
- Instances of reporting to various supervisors being required only on a solo-plus basis, and not on a group consolidated basis.
- Application of different accounting standards and rules to, in particular, local and foreign members of a group.
- Use of different external audit firms within a group and, even, reporting on different financial year-ends by group members.
- Supervision by different regulators in the absence of common rules with regard to provisioning policy, asset valuations and treatment of off-balance-sheet items.

It is essential for the legal and moral duties of directors and managers of each part of a financial group to be clear, and for management to act in the interests of the group as a whole. The following arrangements must be avoided at all costs:

following arrangements must be avoided

- Disregard of demarcation of duties and giving of instructions down the line, whereby Chinese walls are ignored and insider trading is encouraged, potentially resulting in serious systemic risk exposures.
- Lack of clarity regarding the ultimate line of authority and responsibility in a group, as may be the case when the parent company of a financial group is a non-financial institution.
- Granting of credit to a connected party at prices below market rates by a bank in a group, resulting in a conflict of interest.
- Substantial changes to the business mix of a financial group subsequent to authorisation, resulting in major changes in, for example, ownership and management.

harmonised rules for the definition and supervision of capital in banks, insurance companies and securities traders

The Bank Supervision Department, in conjunction with the Financial Services Board, is working toward the supervision of conglomerates on a consolidated basis. In the absence of a capital requirement that can be applied to a financial conglomerate as a whole, the two supervisors have to work toward harmonised rules for the definition and supervision of capital in banks, insurance companies and securities traders. Financial conglomeration, whereby banks can offer the full range of financial services to corporate and personal clients, is feasible only when consolidated financial statements, based on a single set of valuation principles and the application of capital-adequacy rules to consolidated amounts at the holding company level, can be prepared for a financial group.

Visits to foreign operations of South African banks

As envisaged in the 1996 Annual Report, representatives of the Bank Supervision Department paid follow-up visits to certain foreign establishments of South African banks and their host regulators during the second half of 1997. The overall objective was to enable the Department to gain a comprehensive understanding of these operations and, thereby, enable it to fulfil its responsibilities as the home-country supervisor of local banks' foreign operations.

Visits were paid to Switzerland, Germany, Jersey and the United Kingdom in order, firstly, to conduct full-scale prudential meetings with the management of South African banks' establishments in those jurisdictions and, secondly, to hold discussions with their host supervisors on both bank-specific and current topical issues. Visits were also paid to the head offices of certain foreign banks that have banking operations in South Africa and in respect of which the Department is the host-country supervisor.

general impressions of the regulatory and banking environment

The Department's representatives gained the following general impressions of the regulatory and banking environment in the four countries visited:

▲ *Switzerland*

Switzerland has a very strict regulatory environment, in which much use is made of the services of external auditors. In addition to the financial reports that are normally required to be submitted, external auditors have to furnish the regulators annually with detailed reports on, *inter alia*, a bank's risk management, strategic plans and quality of management.

▲ *Germany*

The regulatory environment in Germany appears to be extremely strict. Much importance is attached to the deposit insurance scheme ("DIS"), which is extremely powerful and plays a role akin to that of a regulator. All key players place a great deal of reliance on the findings and conclusions of the work conducted by the DIS, based on which membership of the scheme is approved or declined, and the level of contributions (premiums) is set.

▲ *Jersey*

In the Jersey regulatory environment, the main emphasis is on trust business (an area in which legal risk is of particular importance), and banking activities are auxiliary thereto. An important challenge for the Jersey regulators is to ensure that a certain skill level is maintained throughout the industry. This is being hampered by the existing immigration and work-permit conditions, as well as a shortage of local skills, factors that cause the risk-management processes of banks in the Jersey jurisdiction to be more difficult and more challenging than in many other jurisdictions.

▲ *United Kingdom*

It became very apparent that London was an extremely competitive market and that German and American banks were becoming more dominant. In order to succeed (and to survive), South African banks will therefore have to focus increasingly on niche markets.

It was pleasing to note that, since the Department's previous visits, there had been a marked "maturing" of South African banks in the above-mentioned jurisdictions. All banks have become acutely aware of the competitive environment in which they are operating, and the common areas that are receiving attention are internal audit, "year 2000" compliance and focusing on niches. Feedback has subsequently been given to the senior executives of the particular banks in South Africa.

During follow-up meetings conducted with the respective host regulators, the position of the South African banks operating in a particular jurisdiction was discussed extensively. In general, the host regulators were comfortable with not only the conduct of South African banks in their jurisdictions, but also the level and competence of the supervision conducted by this Department, in its capacity as home-country supervisor.

Foreign banks in South Africa

foreign banks added significantly to the competitive pressures in the country

During the year under review, foreign banks continued to establish operations in South Africa. Although these operations added further depth and sophistication to the South African market, they also added significantly to the competitive pressures prevalent in the country, particularly in the corporate market. The resultant effect was that lending margins were placed under greater pressure, and many banks had to refocus themselves on other areas in the corporate market, often areas with a slightly higher credit-risk profile.

human resources became a competitive factor

The area of human resources also became a competitive factor. South Africa has traditionally had good-quality bank management at senior level. The recruitment of necessary skills by foreign institutions entering the South African market has, however, led to a dilution in the depth of management across the board in the South African banking sector. Since the soundness of individual banks and of the banking sector as a whole is a function of the quality and depth of management, the Bank Supervision Department will be monitoring the human-resource aspect during the forthcoming year.

MONEY LAUNDERING

lack of visible progress with the implementation of anti-money-laundering measures

During 1997, there was growing concern in South Africa about the lack of visible progress with the implementation of anti-money-laundering measures. Many of the increasing number of incidents that were brought to the attention of the Bank Supervision Department indicated that all the ingredients of possible money-laundering schemes were present in South Africa. The banking sector in particular expressed its concern that, in view of the increasing number of incidents, money launderers might already be misusing the banking system on a much larger scale than previously thought.

need for administrative legislation and a central reporting agency

The need for administrative legislation on money laundering, as well as the appointment of a central reporting agency, has therefore become critical. Besides expressing concern, several foreign regulators have indicated that the lack of anti-money-laundering measures in South Africa might impede the opening of branches and subsidiaries in certain foreign countries by South African banks. As regulator and supervisor of the South African banking system, this Department, in pursuit of its mission, will therefore be seeking all possible means to promote the speedy implementation of such measures in 1998.

SCRIP LENDING AND BORROWING

Since the deregulation of the Johannesburg Stock Exchange ("the JSE") in 1995, there have been a number of structural changes in South Africa's equities market. Foreign securities traders have become active traders in the market, mainly through joint ventures with local securities traders, and new trading techniques have been introduced. One of these techniques is the use of arbitrage between price differentials in different markets, through the purchase of securities or derivatives in the South African market and the sale of similar instruments in foreign markets, or *vice versa*. In order to facilitate not only delivery against the short positions taken by foreign securities traders in the market, but also orderly settlement, the JSE requires sufficient scrip to be delivered to the market, which scrip is often borrowed for this purpose.

South African banks have become active facilitators of scrip borrowing by foreign securities traders

As a result of the growth in this market, South African banks have become active facilitators of scrip borrowing by foreign securities traders. By way of example, a bank will approach institutional investors that hold shares on a long-term basis in order for the scrip to be released and lent to foreign participants in the market. A borrower of such scrip is charged

a fee, based on the market value of the securities thus borrowed. Furthermore, the borrower has to deposit cash, to the market value of the securities, with the particular bank, as security for the scrip borrowed. The bank, on the other hand, guarantees the return of the scrip to the lender (owner) thereof.

Such a scrip-borrowing transaction affords the owner of the scrip the opportunity of enhancing the return on the investment through the fee earned, whilst retaining the full risk and reward of ownership, in that the owner is fully exposed to market movements in the securities concerned. Apart from the aforementioned price risk, the owner is exposed to a counterparty risk, in that the bank might fail to fulfil its guarantee to return the scrip. When the borrower, however, fails to return the scrip, the bank is required to buy in the securities, utilising the previously deposited cash security, and to deliver the securities to the lender (owner). The bank, therefore, has to ensure that the scrip-borrowing contract is legally enforceable.

Department intends to regularise these activities

The Bank Supervision Department intends to regularise these activities by including scrip lending in the definition of repurchase agreements during the coming year. The Department will also hold discussions with the Financial Services Board, in order to ensure that institutional investors that enter into scrip-lending transactions disclose the extent of such activities in their financial reports, including statutory returns to the authorities.

Proper disclosure will ensure that all participants in these activities are sensitised to the risks inherent therein and that procedures for the proper management of these risks are implemented.

CONTRIBUTION TO SOCIAL UPLIFTMENT BY THE BANKING SECTOR

"Development-sensitive" lending

"Development-sensitive" lending has become an accepted practice in the United States of America, where legislation specifies that:

- It is unlawful to discriminate against any application for credit on the basis of race, religion, ethnicity, gender, marital status, age or the applicant's reliance on a public-assistance programme.
- Credit terms have to be disclosed meaningfully.
- Certain lending institutions have to make home-loan data available for public scrutiny. This is, however, not intended to force deviation from sound lending practices or sound allocation of credit.
- Federal financial supervisory agencies have to "encourage" financial institutions to help meet the needs of their marginalised communities, consistent with safe and sound banking practices.
- Each lending institution has to produce an annual Community Reinvestment Act ("CRA") Statement, identifying its community and the types of credit offered, and inviting public comment, which will be available for public scrutiny.
- The supervisory agencies have to prepare CRA ratings, based on universal and predetermined criteria. These ratings, which are published, are considered when various applications by a particular institution for the establishment of a branch, a merger or the formation of a holding company are assessed.

possible introduction of some form of credit-extension disclosure requirement

The possible introduction of some form of credit-extension disclosure requirement in South Africa has been raised in a discussion paper, which was prepared, in June 1997, by the Standing Committee on Housing and Land Affairs of the Gauteng Legislature, with inputs from the banking sector. The loans under consideration include financing for housing, consumer spending and small and medium-sized enterprises. It is, however, generally agreed that further research on the following aspects would be necessary before any policy can be implemented in South Africa:

further research on the following aspects would be necessary

- The relationship between the South African Reserve Bank and the banking sector.
- Current banking legislation.
- South Africa's Constitution (which provides for, inter alia, the right to privacy, freedom of trade, occupation and profession, housing and access to information).

The discussion paper argues that the introduction of social responsibility and disclosure legislation in South Africa would not be completely without precedent, in that such measures are already being mooted or implemented with regard to employment policies and contract allocations.

A three-tiered banking disclosure model, comprising the following sectors, is envisaged in the discussion paper:

three-tiered banking disclosure model

- A "good business" (developed) sector.
- A subsidised sector (the "marginally eligible" or "eligible" sectors of low-income earners, who could also rely on Government subsidy assistance), which is the primary beneficiary of the suggested disclosure requirements.
- The unbanked sector, comprising households that earn less than R1 000 per month, estimated at 49 per cent of South African households. The proposed legislation would not address the needs of this "ineligible" sector. In this regard, it may become optional for banks to disclose their support for the ineligible sector and "thereby give added weight to their social responsibility performance assessments", since the Housing White Paper of 1994 identified a declining role for the State with regard to this sector, over time.

The discussion paper suggests three parties that could evaluate the social responsibility performance of banks and lending institutions:

- The Registrar of Banks, in terms of the Inspection of Financial Institutions Act, 1984 (Act No. 38 of 1984), as amended.
- The National Housing Finance Corporation.
- The community.

Issues that have been raised by the banking sector include the following:

issues raised by the banking sector

- The requirements should be as inclusive as possible, extending to both foreign and local banks and all custodians of public money, including life assurers and pension funds.
- Should a responsible "alternative lending sector" be created, the formal banking sector could provide support to alternative lenders with regard to social responsibility.
- Borrowers should be made aware of their own rights and responsibilities towards lending institutions.
- The disadvantaged require training in life skills, particularly in dealing with the formal credit-extension and banking process.
- Pressure on banking institutions to extend credit will force them to raise interest rates in order to compensate for increased risk.
- Other innovative options should be sought in order to overcome the housing backlog and to supplement the proposed obligations on lending institutions.
- The roles played by various parties in other areas of the credit-granting process, including administration and collection, should be considered.
- The implementation of the suggested legislation should not be coercive or counter-productive.

It is envisaged that a wide range of interested parties, ranging from individual banks to organised civil society and local, provincial and national government, will provide input into the design of the proposed disclosure policy, legislation and regulations. A task team may be established in order to advance the process.

The Bank Supervision Department is well aware of the hardships experienced by citizens in the "subsidised" and "unbanked" sectors. As reported in this issue and previous issues of this Annual Report, the Department has already taken a number of steps in order to address these sectors' need for access to loans:

steps taken by Department

- Promulgation of the Mutual Banks Act, 1993 (Act No. 124 of 1993), in order to foster community banking.
- Exemption of common-bond savings groups, such as stokvels and savings co-operatives, from compliance with the provisions of the Banks Act, under certain conditions.
- Participation in the signing of the 1994 Record of Understanding that launched the Mortgage Indemnity Scheme.
- Holding of workshops in order to identify problems and constraints, and to explore alternative strategies, with regard to informal financing and micro-lending. The Department will in all likelihood be represented on the proposed supervisory body for the upliftment of standards and ethics in the micro-lending industry.

Care will have to be taken that the proposed social responsibility and disclosure legislation does not result in banks in South Africa being forced to deviate from sound lending practices.

REGIONAL CO-OPERATION

During the year under review, co-operation with other bank supervisors in the Southern African region mainly took the form of technical assistance through the presentation of training courses.

East and Southern Africa Banking Supervisors Group

fourth course in banking supervision for ESAF

From 8 to 19 September 1997, the Bank Supervision Department successfully hosted the fourth course in banking supervision for member countries of the East and Southern Africa Banking Supervisors Group ("ESAF"). An important objective was the promotion of co-operation between supervisors, as well as harmonisation of supervision in the region, by arranging opportunities for the participants to interact, exchange views and become better acquainted.

Thirty-nine participants from 20 countries attended the course: 30 from 15 of the 16 ESAF member countries; two from Angola; five from the Ivory Coast, Ghana and Nigeria, representing the West African Monetary Union; and two from the National Bank of Agricultural and Rural Development in India.

The first part of the course was in the form of a one-day seminar, which, as in previous years, provided an update on the latest trends in banking supervision. The audience of some 180 people, including representatives of the banking sector, external auditors, the financial press and the central bank, was addressed by speakers from the Bank for International Settlements, the Federal Reserve Bank of New York, the Financial Services Board, the International Monetary Fund, the South African Reserve Bank and the World Bank.

The second part of the course, which concentrated on the key players and banking risks, consisted of 29 modules, as well as case studies. Visits were also undertaken to the SA Bank Note Company, the SA Mint Company and Sun City.

The South African Reserve Bank has indicated its willingness to host the course again in 1998, as part of its initiative to assist central banks in Africa with technical bank supervisory training.

technical assistance, in the form of on-site training

Technical assistance to the Bank of Mozambique and the Bank of Namibia

During 1997, the Bank Supervision Department continued providing technical assistance, in the form of on-site training, to the Bank of Mozambique.

Following discussions, the Department agreed to provide technical assistance and training to the bank supervisors of the Bank of Namibia, on the basis of providing time and training material by means of an initial three-day technical training course. The course, which was attended by 12 persons, was held in Windhoek, Namibia, from 18 to 20 November 1997 and consisted of 11 modules, discussion periods and case studies. One of the case studies was modelled on the reports and graphs produced by the Department for presentation to South African banks' management and directors.

INVESTOR AWARENESS

first investor-awareness programme was launched

During the latter part of 1997, the first investor-awareness programme was launched by means of a booklet titled "Money", which was distributed widely. The booklet, which was made available in all 11 official languages of South Africa, contains basic financial information on a number of topics pertaining to individual money matters. Specific emphasis is placed not only on the care that has to be taken before monies are entrusted to persons and institutions, but also on the dangers of investing in pyramid or "get-rich-quick" schemes. Other matters addressed in the booklet include inflation and the importance of saving.

Reports received after the launch indicated that the booklet was very well received by the public. This is borne out by the Bank Supervision Department subsequently receiving numerous requests for additional copies.

Investor awareness will continue to be a matter of importance, since investors are constantly exposed to the risk of losing their hard-earned money. In this regard, the Department has taken note of other authorities' special endeavours to address this problem by means of specific legislation.

INFORMATION TECHNOLOGY

Ongoing developments and innovations in the use of information technology by the banking industry continue to present both challenges and risks.

Developments with regard to the South African National Payment System

As reported in previous issues of this Annual Report, the need to contain systemic risk and to address other shortcomings in the South African National Payment System ("NPS") resulted in the NPS reform project, a collaborative effort between the South African Reserve Bank ("the SARB") and the banking industry. During 1996 and 1997, various banking industry projects were initiated for the successful implementation of the NPS reform strategy that was accepted by the SARB and the banking industry in November 1995 and, more specifically, the new online interbank settlement system that is to be implemented during 1998.

twenty-two banking institutions will participate in the South African Multiple Option Settlement system

Twenty-two banking institutions, comprising banks and branches of foreign banks, have indicated that they will participate in the South African Multiple Option Settlement ("SAMOS") system implemented on 9 March 1998. These banking institutions will have access to not only the interbank settlement facilities offered by the SARB, but also the intraday and end-of-day accommodation facilities that are available for settlement purposes.

Participating banking institutions will have to familiarise themselves with the connectivity to the SAMOS system and, more specifically, will have to ensure the system's integration with their in-house applications and business processes. A practical training course conducted during 1997 provided delegates with the opportunity to experiment with the SAMOS system and to familiarise themselves with technical concepts, such as the system's security architecture and arrangements.

In order to provide a secure transaction environment for high-value interbank fund transfers, the SARB has established a SAMOS certification authority ("CA"). For purposes of unique and secure identification, the SAMOS CA will provide digital certificates, which will ensure complete confidentiality and security of interbank fund transfers through the SAMOS system.

three options by which to participate

Banking institutions will initially have three options by which to participate in SAMOS: personal computer-based SAMOS front-end external application software ("SAMEX"), which has been developed by the SARB; their own SWIFT-based application; or an in-house interface utilising the MQ series protocol. SAMEX will provide banking institutions with settlement and collateral-position monitoring facilities in order to optimise liquidity needs. Furthermore, SAMEX will allow banking institutions to view statements and to download information to their in-house systems for processing and auditing purposes. SWIFT-formatted account statements will also be provided to SWIFT users.

changes to current end-of-day settlement

The new settlement system will result in changes to the current end-of-day settlement practice. All South African registered banking institutions will be eligible to open settlement and loan accounts at the SARB, which accounts will enable the institutions to participate directly in the interbank settlement process. Funds will be obtainable through interbank transfers or via intraday or end-of-day SARB loans under the planned repurchase-agreement tender and marginal lending facilities. A banking institution wishing to obtain an intraday or overnight loan will have to have the required collateral available in the central depository or the financial instrument register at the SARB's Johannesburg branch.

introduction of an averaging principle

The introduction of an averaging principle means that each bank will have to ensure that the average daily balance in its cash-reserve account over the month, that is, from the fifteenth business day of the reference month to the fourteenth business day of the following month, complies with the cash-reserve requirements. This will allow banks to use their reserve balances for intraday-settlement purposes and clearing transactions. Banks will thus be allowed to use these cash-reserve holdings as working balances, and these holdings will become the operational accounts in the SAMOS system.

phased approach to implementation

In order to ensure the smooth implementation of the new settlement arrangements, a phased approach will be followed. In the initial phase, from March 1998 to September 1998, the dynamic collateral-management system will be utilised to ascertain the intraday collateral requirements and to secure overnight loan positions. As from 9 March 1998, the current manual end-of-day interbank settlement and accommodation process will be replaced by the automated SAMOS system. Although, initially, final and irrevocable settlement will still be effected the following morning, banking institutions will have the opportunity to assess the impact of the new settlement system on their payment practices and liquidity and collateral needs. As from 9 March 1998, the SAMOS system will, however, be the only mechanism used by the SARB to make transfers to banking institutions, and for banking institutions to make transfers to the SARB in respect of the settlement of specified money-market transactions when the SARB and private banking institutions act on their own behalf. In October 1998, final and irrevocable intraday settlement will be implemented, and it is planned to introduce same-day settlement for retail payments during September 1999. From October 1998, banking institutions will be able to achieve final and irrevocable settlement on a continuous basis, thereby complying with international standards for real-time gross settlement of large-value payments.

stringent operational requirements

During 1998, banking institutions will have to focus on the SAMOS system's integration with their business processes and on the enhancement of intraday liquidity and collateral management. Participation in the settlement system will bring with it stringent operational requirements, and banking institutions have to ensure that they can make and receive payments timeously. It is envisaged that an NPS Act will be promulgated during 1998. The main aim of the Act will be to provide for the management, administration, operation, regulation and supervision of payment, clearing and settlement systems in the Republic of South Africa and, specifically, to ensure finality and irrevocability of interbank settlement.

overall reduction of systemic risk

The intraday liquidity and collateral monitoring facilities of the SAMOS system will enable banking institutions to manage settlement risk more efficiently and, coupled with a formal legal framework and management structures, will culminate in the overall reduction of systemic risk in the payment system. These factors will reduce the probability of contagion in the South African financial system and, thereby, enhance the country's standing in the international financial and banking arena.

Electronic transfer of statutory information

electronic system to enhance the efficiency of data transfer

As mentioned in the 1996 Annual Report, the Bank Supervision Department is implementing an electronic system in order to enhance the efficiency of data transfer between banking institutions and the Department.

During April 1997, six banking institutions were requested to take part in a pilot project, in order to enable the Department to resolve any system problems prior to full implementation of the electronic submission of statutory DI returns by banking institutions. The institutions that participated in the pilot project, and whose co-operation is gratefully acknowledged, are, in alphabetical order:

ABSA Bank Limited.
First National Bank of Southern Africa Limited.
Investec Bank Limited.
Nedcor Bank Limited.
Société Générale.
The Standard Bank of South Africa Limited.

Once the Department was satisfied that it could successfully receive and decrypt encrypted statutory DI returns, a circular, requiring all banking institutions to implement systems enabling them to submit DI returns in an electronic format, was issued in August 1997.

As individual banking institutions complete the development of their systems and successfully submit encrypted DI returns to the development environment of the South African Reserve Bank ("SARB"), such institutions will be furnished with the SARB's production environment address, to which DI returns will then have to be submitted electronically.

full implementation in March 1998

The latest date for full implementation of the electronic data-transfer system was the fifteenth working day of March 1998, when the information for the period ended 28 February 1998 had to be submitted.

To date, all banking institutions, except one, have decided to use the Internet and PSMP encryption, which complies with the PGP standard, for the submission of their statutory DI returns.

The Department believes that the new data-transfer system will enable it both to receive and to release more timely and accurate banking sector information.

"Year 2000" compliance

In the 1996 Annual Report, the steps taken by the Bank Supervision Department in order to ensure timeous "year 2000" compliance by banking institutions were discussed.

During 1997, the progress made with the implementation of "year 2000" compliance projects was discussed with individual institutions during the regular prudential meetings that are held as part of the Department's supervisory programme. In addition, a circular, requesting each banking institution to complete a questionnaire regarding the institution's "year 2000" preparedness, was issued in September 1997. The questionnaire had to be completed in respect of not only the local operations, but also the foreign operations, of an institution.

special prudential meetings on "year 2000" compliance

The Department is currently analysing the responses received from banking institutions, in preparation for special prudential meetings on "year 2000" compliance, to be held with each banking institution during the first quarter of 1998.

Virtual banking

The banking industry was an early user of information technology for purposes of electronic commerce, as evidenced by banks' introduction of the automated teller machine as a cost-cutting and convenience service to customers.

As a result of the Internet revolution, technology is being used to add further dimensions to customer service, through, for example, online banking, one-stop shopping, smart cards and electronic data-interchange devices. Online banking does not constrain banks to geographical boundaries and enables them to offer the convenience of home banking to customers. Not only are such services being offered by an ever increasing number of banks, but a new breed of bank, termed a virtual bank, which exists only on the Internet, is making its appearance. The increasing availability of smart cards and smart-card readers that are connected to home computers, together with their growing acceptance by vendors worldwide, will no doubt contribute to the predicted boom in electronic commerce.

provision of banking services on the Internet

When embarking on Internet-based electronic commerce, a user has to consider not only the technological aspects, but also the impact on the business as a whole. In the case of the provision of banking services on the Internet, it is of crucial importance for a bank to:

- Conduct its business in a prudent manner.
- Maintain adequate accounting and other records of business and, possibly even more importantly, adequate systems of control in this regard.
- Conduct its business with integrity and with the professional skills appropriate to the nature and scale of its activities.

important issues still need to be resolved worldwide

Because of the borderless nature of electronic commerce on the Internet, a number of important issues still need to be resolved worldwide. These issues relate to, *inter alia*, the collection of taxes on Internet-traded goods and services by governments, the enforcement of exchange-control regulations, the accounting treatment of fund transfers via the Internet and the potential for contravention of banking legislation by virtual banks.

The single most important concern for both banks and users of virtual banking systems, however, relates to security - security of data transmission and payment mechanisms, as well as authentication of the identity of transacting parties. The encryption system used for financial transactions on the Internet, therefore, has to provide the means to offer confidentiality, non-repudiation and data integrity.

A technique worth noting in this regard is key encryption, which uses a pair of keys, instead of a single key, for the encryption of messages to be transmitted. The keys, called the public/private key pair, are a matched set that is assigned to each individual user - what one key encrypts, only the other can decrypt. A digital signature, using key encryption, may be regarded as being superior to a conventional signature, since the former encrypts both the content of a message and the identity of the sender.

The Bank Supervision Department will continue to monitor developments in Internet banking services, in order to ascertain the need for amendments to existing banking legislation, particularly the need for regulations in this regard.

Internet homepage

homepage at
http://www.resbank.co.za

The homepage of the South African Reserve Bank ("SARB") on the Internet, at address http://www.resbank.co.za, greatly assists in the wide dissemination of timely information. The Website, for which a search facility is available, is visited frequently - on average, 26 500 pages of information are requested per month.

Useful information on the SARB's homepage includes the following:

- Background information on the SARB, including its address, telephone and telefacsimile numbers.
- Financial information regarding the SARB.
- Details of the Governor, Deputy Governors and managers of the various departments.
- Information on the national economy, including publications, statistics and financial data, such as that submitted on a monthly basis, by means of the DI 900 forms, by individual banks.
- The National Payments System's framework and strategy, as well as publications and progress made with the development of the new system.
- Exchange Control manual and regulations, as well as authorised dealers in foreign exchange.
- Information emanating from the Bank Supervision Department includes:
  - The current and two previous annual reports.
  - Lists of the following categories of banking institution registered in South Africa, including their postal addresses, telephone and telefacsimile numbers and names of chief executive officers:
    - Banks (both locally and foreign controlled).
    - Branches of foreign banks.
    - Mutual banks.
    - Representative offices of foreign banks.