CHAPTER 1

REGISTRAR'S REVIEW

South African banking sector remarkaly resilient

The year under review was characterised by global financial turbulence and banking crises in many countries. In general, the South African banking sector showed itself to be remarkably resilient in this turmoil. Although interest rates in South Africa rose to record levels in 1998, they started declining again towards the end of the year.

During 1998, the Bank Supervision Department placed particular emphasis on the continued implementation of the Core Principles for Effective Banking Supervision, which the Basle Committee on Banking Supervision issued in September 1997 and on which I reported extensively in the 1997 Annual Report. Other important focus areas included co-operation with other regulators and supervisors, further refinement of the Department's approach to consolidated supervision and full implementation of capital-adequacy requirements in respect of banks' securities trading activities, as discussed in Chapter 2 of this report.

During the year, I had the privilege of participating actively in the work of the Core Principles Liaison Group. Much of this work related to assessing the compliance with the Core Principles by different countries, as reported below. Other topics reviewed below include, amongst others, actions required to strengthen the international financial system, the entry criteria and exit process for banks in South Africa, and the recommendations arising from an Article IV review of the Department's supervisory practices by the International Monetary Fund.

BASLE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

endorsed by international community

The Basle Committee's Core Principles for Effective Banking Supervision were endorsed by the international community during the annual meeting of the International Monetary Fund (IMF) and the World Bank in Hong Kong, in October 1997. During October 1998, the International Conference of Banking Supervisors (ICBS) held in Sydney, Australia, also endorsed the Core Principles and pledged to contribute actively to their implementation, whilst requesting more comprehensive guidance from the Basle Committee.

objective of Core Principles

The objective of the Core Principles is to provide the international financial community with a benchmark against which the effectiveness of bank supervisory requirements can be assessed. The Core Principles thus spell out the basic features of an effective bank supervisory regime.

growing international pressure to implement

Because of heightened concern about financial-sector stability, banking supervisors around the world are under pressure to ensure the effective supervision of banks. In particular, this has been reflected in growing international pressure to urge countries to implement the Core Principles.

The need to strengthen the supervision of banks has been stressed as a major priority, since it is now widely recognised that, of late, imperfections in the functioning of banking systems have often been at the core of financial crises in many countries. Since the current banking crises affect many countries, the monitoring of banking systems has become critical and very challenging for supervisors.

steps taken

Improvement of banking supervision requires tenacity and continuous effort over a long period, in order to meet the high expectations. It is of the utmost importance that adequate steps are taken in order to:

- Identify weaknesses in the supervisory system.
- Address the most urgent weaknesses, since considerable effort will be necessary to achieve comprehensive improvements.
- Obtain a clear commitment from all the players involved to support the implementation of the Core Principles fully.

In interpreting or revising the Core Principles, the Basle Committee will be working closely with the IMF, World Bank and member countries within the Core Principles Liaison Group.

assessment of compliance

The process of implementing the Core Principles has to start with an assessment of compliance therewith. Such an assessment will allow the supervisor to initiate a meaningful strategy, which may result in significant improvements in the supervisory process.

In April 1998, the Basle Committee, therefore, initiated a survey on compliance with the Core Principles, with a view to preparing information for consideration by the ICBS, in October 1998. The Basle Committee distributed a questionnaire to 140 countries and requested supervisors to undertake a rigorous assessment of their supervisory systems, in order to determine the extent to which there was compliance with the Core Principles in their jurisdictions.

work of Core Principles Liaison Group

As indicated in the 1997 Annual Report, the work of the Liaison Group is directed at effecting the successful implementation of the Core Principles in individual member countries. At its third meeting in London, in September 1998, the Core Principles Liaison Group, therefore, discussed the results of the above-mentioned compliance survey. The quality of the self-assessments was uneven, and the degree of candidness varied markedly. The results indicated that a lack of skilled human resources was the main impediment to full implementation. In certain areas, such as criteria for granting banking licences, most countries appeared to comply with the Core Principles. Areas that still presented significant challenges to many supervisory authorities included connected lending, co-ordination between on-site and off-site supervision, exit procedures and, in particular, consolidated supervision. There was also a definite need for training in many areas, specifically in the assessment of market and country risks and in consolidated supervision.

significant challenges

provide general guidance

Since the Core Principles were designed to provide general guidance, they allow flexibility in the design and implementation of concrete measures. Assessment of compliance with the Core Principles by the IMF, World Bank, rating agencies, consulting firms, etc., is likely to result in different interpretations and, perhaps, inconsistent advice in some instances. Without some consistency, however, comparability between assessments becomes impossible.

methodology for more detailed criteria

To this end, the Basle Committee undertook to design a methodology providing more detailed criteria for making assessments. This methodology will give guidance on the relevant criteria for assessing compliance with a particular principle and the relative weight that should be assigned to a particular criterion.

The Core Principles Liaison Group considered the criteria that are necessary for an assessment of compliance with minimum standards. The original criteria were extended to include criteria for ensuring best practice in order to improve financial stability and effective supervision.

An assessment should culminate in a rating of the degree of compliance with the Core Principles. The assessment should be reached on a qualitative basis, since a major shortcoming in any crucial criterion could raise serious doubts about compliance. Furthermore, the assessment should include a summary of specific areas of non-compliance and changes that are being made or contemplated in order to address specific shortcomings, as well as a timetable for effecting such changes.

EXCESSIVE SPECULATION IN FINANCIAL MARKETS

The current dynamic changes in the sphere of banking, resulting from uncertainty and the risks that emanate from unexpected market volatility, are nothing new. In 1873, Walter Bagehot wrote, "Every great crisis reveals the excessive speculations of many houses which no one before suspected".

speculative activities and poorly managed exposures

The trend to invest in high-yielding investment banking activities has seen many banks, locally and abroad, using guaranteed deposits to support highly speculative activities in the securities markets. Banks have allowed themselves to enter into large, poorly managed exposures to institutions engaged in highly leveraged securities activities. Unfortunately, when "the going gets tough", the sophisticated mathematical models used by banks often cannot cope with the stress. Despite the use of models devised by highly regarded scientists, some banks have lost billions of dollars.

statistical models work on simple premises

The statistical models used by many of the world's most sophisticated financial institutions work on a set of very simple premises. Techniques such as modelling of value at risk (VAR) assume that markets behave according to normal probability distributions and that there are predictable correlations between market movements. Unfortunately, during abnormal times (which are too infrequent to form part of an estimate of probability), these models tend to break down.

unmeasurable risks may have been neglected

Uncertainty has to be regarded as being quite distinct from the notion of risk. It would appear that measurable uncertainty differs greatly from an unmeasurable one and that a measurable uncertainty is in effect not an uncertainty at all. Banks, however, have tended to devote their risk-management effort to the quantification of risks. Consequently, unmeasurable risks, which do not fit into the existing risk-management paradigm, may have been neglected.

In periods of uncertainty in the financial markets, the statistical models in use have been found wanting. The techniques used by banks, such as VAR models, are only as good as the assumptions that underpin them.

change in credit culture

It is undoubtedly true that banking has seen a profound cultural change in the past two decades. This has been associated with a change from a culture of credit being limited to one of credit being in plentiful supply. Consequently, the role of banks has changed from being the rationers of credit to being its marketers. This change in credit culture has, however, tended to be coupled with neglect of the basic principle that banks are, in the final instance, the custodians of other people's money.

The current financial volatility serves to remind bankers that they have a fiduciary responsibility toward depositors.

INTERNATIONAL FINANCIAL ARCHITECTURE

importance of action in three key areas

In response to the financial crisis in Asia, the finance ministers and central bank governors of a number of systemically significant economies met in Washington, DC, in April 1998, in order to examine issues related to the stability of the international financial system and the effective functioning of global capital markets. In their discussions, the ministers and governors stressed the importance of strengthening the international financial system through action in three key areas: enhancement of transparency and accountability, strengthening of domestic and international financial systems and management of international financial crises.

Three working groups were formed in order to contribute to the international dialogue on how to proceed in these key areas. Each working group consisted of representatives of finance ministries, central banks and international organisations. Contributions and views were also sought from other international groups, countries not represented on the working groups and the private sector.

Working Group on Transparency and Accountability

importance of tranparency and accountability

The international financial crisis that began in Asia demonstrated the importance of transparency and accountability. The lack of transparency and accountability exacerbated financial weaknesses at both the institutional and the national level and complicated efforts to resolve the ensuing crisis. Transparency and accountability would have helped to prevent the build-up of financial and economic imbalances, induced a prompter adjustment in policies and limited contagion. In short, transparency and accountability help to improve economic performance.

transparency

Transparency refers to the process that makes information about existing conditions, decisions and actions accessible, visible and understandable. Transparency contributes to the efficient allocation of resources by ensuring that market participants have sufficient information to identify risks and to distinguish one institution's or one country's circumstances from another's. Moreover, transparency helps to inform the market and to form expectations, thereby helping to stabilise markets during periods of uncertainty, whilst also contributing to the effectiveness of announced policies. In determining the appropriate degree of transparency, one has to balance the benefits against the costs.

accountability

Accountability refers to the need to justify and accept responsibility for decisions taken. Since accountability imposes discipline on decision-makers, it helps to improve the quality of decisions taken. Transparency helps to promote accountability by obliging decision-makers to make known their decisions and the reasoning behind them.

The elements and objectives of disclosure in the private sector are:

elements and objectives of disclosure

- **Timeliness:** Information of material importance should be disclosed on a periodic and timely basis, using internationally accepted accounting standards.
- **Completeness:** Financial statements should cover all relevant transactions, both on and off balance sheet.
- **Consistency:** Accounting policies and methodologies should be applied consistently over time. Any changes should be identified, and related effects should be disclosed.
- **Risk management:** The strategies used to manage risks should be disclosed.
- **Audit and control processes:** Banks must have effective systems of internal control, and the financial statements must be reviewed annually by an independent auditor.

data on international exposures

The crisis in Asia highlighted the importance of improving data on the international exposures of banks and institutional investors. High-quality, comprehensive creditor data permit assessments of the vulnerability of a domestic financial system to financial crises abroad, are useful as early-warning signals of weaknesses in debtor countries, improve the quality of debt statistics and balance of payments data, and facilitate efforts to restructure outstanding debt when a country is at risk or in default.

disclosure standards

Disclosure standards help to highlight the importance of transparency. Improvements in transparency depend on implementation and compliance with recognised standards. The benefits inherent in transparency provide the strongest incentive for compliance. This incentive can be strengthened through monitoring, for example, by means of an independent assessment of a bank's or country's observance of recognised disclosure standards.

Working Group on Strengthening Financial Systems

The financial crisis clearly demonstrated the importance of robust and efficient domestic financial systems. Weak banking systems and poorly developed capital markets contributed to the misallocation of resources that led to the crisis. Key to the strengthening of domestic financial systems is the implementation of sound supervisory, settlement, accounting and disclosure practices.

implementation of sound practices

Implementation of sound practices requires, firstly, that there are standards on what constitutes sound practices. In the areas of banking supervision and securities regulation, minimum principles or standards have been established. The Basle Committee on Banking Supervision has produced the "Core Principles for Effective Banking Supervision", whereas the International Organisation of Securities Commissions has produced the "Statement of Objectives and Principles of Securities Regulation and International Disclosure Standards for Cross-border Offerings" and "Initial Listings by Foreign Issuers".

corporate governance

The Working Group regarded the development of sets of sound practice in the area of corporate governance as essential. Individual firms have to formulate and pursue prudent business strategies, establish and apply effective systems of internal control, and monitor and manage the full range of financial commercial risks to which they are exposed. The Working Group attached particular importance to the elements of corporate governance and the structure relating to risk management and control – notably, the management of liquidity and foreign-exchange risk. The mismatch between the maturity of foreign-currency assets and liabilities in national banking systems should not be allowed to become too far out of line with the capacity of the domestic authorities to supply foreign-currency liquidity from official reserves and any contingent financing that may be available.

safety-net arrangements

Explicit safety-net arrangements help to reduce the risk of indiscriminate extension of public guarantees. The Working Group stressed the importance of identifying criteria for determining appropriate limits on the extension of public guarantees. A well-designed framework for the resolution of future systemic crises is likely to alter the expectations of the public and international investors and may help to enhance financial stability. Depositor-protection schemes are also part of the financial safety net. The most important goals are to increase the stability of the financial system by reducing the risk of bank runs and contagion and to assist small depositors, who, typically, do not have the capacity to monitor the soundness of banks.

insolvency regimes

Insolvency regimes are also an important part of an economy-wide safety net. They serve to make it easier for all parties involved to quantify the risks and consequences of a failure of a corporate entity, whilst decreasing the potential for *ad hoc, ex post facto* assistance or guarantees, which distort incentives. The Working Group, therefore, developed key principles and features of effective insolvency regimes for commercial entities.

market discipline

Market discipline should be employed to promote the implementation of sound practices. Such discipline, however, does not function properly without adequate transparency and appropriate incentives. The lack of international consensus on sound practices for loan valuation, loan-loss provisioning and credit-risk disclosure seriously impairs the ability of analysts and regulators to understand and assess the risks inherent in a bank's activities.

access to major financial markets

Access to major financial markets for emerging-market institutions is an important element in the effort to strengthen financial systems. International consensus on concrete criteria to be used by national authorities when determining conditions for market access could help to ensure equitable conditions for market entry. Official oversight is another way in which implementation of standards can be encouraged. The particular types and combinations of oversight mechanism (surveillance, peer review, comprehensive technical assistance programmes) that will be the most suitable for enhancing financial stability will vary from country to country.

fragmentation being addressed

At present, supervision of the global financial system is fragmented, both geographically and functionally, whereas global markets are becoming increasingly integrated. Geographical and functional fragmentation are, however, being addressed through co-operation among different international groupings of functional supervisors and among international groupings of banking, securities and insurance supervisors, respectively.

Working Group on International Financial Crises

vulnerability to contagion

The larger scale and greater diversity of recent capital flows to emerging markets have been of immense benefit to both emerging-market countries and the world as a whole. But these capital flows have allowed crises to erupt and spread more quickly and with greater force than in the past. These new risks make it more essential than ever for countries to pursue sound domestic policies in order to minimise their vulnerability to contagion. The number and depth of recent payment crises have also highlighted the critical importance of adopting policies to reduce the frequency and to limit their severity of such crises.

role to government

Implicit or explicit access to government resources on subsidised terms distorts market incentives and may encourage private debtors and creditors to take excessive risks. The Working Group, however, recognised the role of government in protecting smaller bank depositors and the overall integrity of the payments and financial system. Preservation of the stability of the financial and payment system does not, however, require that individual banks, their managers or their equity owners are protected from the risk of failure.

Recent events have highlighted the continued vulnerability of many emerging markets to external shocks and the consequent need for prudent management of their external liabilities. Arrangements that could provide more flexibility in payments and greater risk sharing among debtors and creditors include:

- Pre-negotiated options that would allow the debtor to extend the maturity of certain obligations automatically.
- Debt instruments under which repayments would be reduced in certain precisely and contractually defined circumstances.
- Other insurance-type contractual arrangements that would provide assured new financing or guaranteed liquidity in the event of market volatility, such as a contingent credit and liquidity facility.

assistance and support in the context of policy adjustments

In the opinion of the Working Group, the assistance and support of the International Monetary Fund and other international financial institutions in the event of a crisis, in the context of a strong programme of policy adjustments, remain important.

ENTRY AND EXIT CRITERIA FOR BANKS

In the interests of transparency and disclosure, the Bank Supervision Department, however, deems it necessary to give a brief overview of the various criteria, policies and processes for a bank's entry to, and exit from, the banking sector in South Africa.

application to establish a bank

The format of an application for authorisation to establish a bank is prescribed by the Banks Act, 1990, and the Regulations thereto. Many details are required in a specified form, and a complete and comprehensive application in terms of the Banks Act usually results only from a carefully planned and diligently executed project, often involving consultants who specialise in this field. The Registrar often requests additional information from an applicant in order to assist in the evaluation of such an application. Processing of an application entails not only an analysis of the application, including financial projections, but also consultation with other regulators and authorities. The time required – usually, some three to four months – can thus not be condensed, not even when the applicant regards the matter as extremely urgent because of business considerations.

Entry criteria and licensing policy

Since the banking system plays an important role in the South African economy, there is a need to maintain the stability of the banking system. Consequently, an applicant for authorisation to establish a bank has to meet the high entry criteria and prudential standards set by the Bank Supervision Department. The entry criteria may be summarised as follows:

▲ *Public-interest considerations*

worthwhile contribution

The establishment of a bank should be in the public interest. Applicants are therefore expected to make a worthwhile contribution to banking services and competition in South Africa, and not merely add to the number of banks. Although applicants do not have to offer a full range of banking services, they are expected to maintain a significant presence in South Africa and to add some depth to the local banking sector.

▲ *Ownership and control*

no single shareholder (or group) should exercise undue influence

A bank should pay appropriate regard to the interests of its depositors. Therefore, no single shareholder (or group) should be in a position to exercise undue influence over the policies or operations of a bank. The shareholding structure should not be a source of weakness and should minimise the risk of contagion from activities conducted by shareholders' other entities. Banking and non-banking activities should be separate, with appropriate divisions between them.

▲ *Fit and proper management*

ability and integrity

experience and skills

Banks should be governed and managed only by directors and management with proved ability and integrity to pursue the interests of shareholders without harming the interests of depositors. The proposed management and directors should have the relevant banking experience and skills to conduct the proposed business. For example, if a bank proposes to trade in financial derivatives, the senior management and board should have sufficient specific experience in the management of the risks arising from these products.

▲ *Corporate governance, audit and internal control*

systems to monitor and limit all risk exposure

A bank applicant has to demonstrate the ability to maintain appropriate corporate governance, management, internal control and risk-management systems, including internal audit and a compliance officer, in order to monitor and limit all the risk exposures of the bank as from the commencement of business. The operating controls and risk-management procedures have to be consistent with the proposed strategy of the bank. The proposed bank has to be capable of producing all required statutory and prudential information in an accurate and timely fashion as from the commencement of banking operations.

internal structure

The proposed bank's internal structure should be sound in terms of generally accepted management principles, and the proposed group structure should not be detrimental to the bank or to effective supervision of the bank. Amongst other issues, a foreign bank wishing to establish a locally incorporated bank, or branch, should be subject to acceptable supervisory arrangements in its country of origin and be in good standing with that supervisor.

▲ *Capital and financial condition*

financial strength

adhere to prudential requirements

A bank should be established with financial strength in terms of adequate capital and sustainable profitability. An applicant should hold, as a minimum, a threshold amount of capital. Initial capital should be from a known and legitimate source, and should not be borrowed money. Furthermore, a proposed bank has to adhere to capital-adequacy, cash-reserve and liquidity ratios, as well as all other prudential requirements.

Therefore, an applicant has to submit an acceptable business plan, incorporating realistic and sustainable projections of the scope, scale and specialisation of operations, cash flows and earnings for the first three years of the proposed bank's operations.

Of paramount importance in reviewing an application is an assessment of whether the applicant demonstrates the commitment and ability to establish a bank and to ensure its viability against intense market competition.

Exit policy and process for managing distress in banks

The procedures for handling distress in banks differ significantly in many respects from those embodied in ordinary company and insolvency laws. The rationale for this differential treatment arises from three broad considerations relating to the nature and functions of banks:

nature and functions of banks

- Firstly, as custodians of the public's savings and as a central element of a country's payment system, banks perform functions of a public nature that are intrinsically different from those of most other industries.
- Secondly, the intermediation function is necessary in order to facilitate savings flow in the economy, but causes banks to take a risk posture that is systemically adverse in nature. In the intermediation process, banks acquire liquid and certain liabilities (deposits) and create illiquid and uncertain assets (bank loans). The nature of banks' business contracts is, therefore, such as to create major systemic risks.
- Thirdly, the maintenance of public confidence in the stability of the banking system is the cornerstone of the process of financial intermediation. The emergence of liquidity or solvency problems in a particular bank can threaten confidence not only in that particular bank, but also, because of the possibility of contagion, in the safety and stability of the system as a whole.

objective is to resolve problems

These considerations have led to the notion that banks deserve special protection in times of crisis. It has to be stressed that the Bank Supervision Department's policy is not aimed at a zero failure of banks. Instead, the objective is to resolve problems in banks effectively and to ensure that depositors with failing banks recover as much of their deposits as possible, in order to maintain the confidence of investors in the banking system. If a bank has to exit from the banking system, this has to occur with the minimum market disruption possible.

insolvent bank should exit

In essence, the policy is that a bank with temporary liquidity problems may be assisted provided it is solvent. An insolvent bank, however, cannot be allowed to continue as a bank, since its problems are very likely to become worse. Such a bank should exit from the system in an orderly, efficient manner, which minimises losses to depositors and which does the least harm to confidence in the banking system.

corrective action

At the first signs of a bank potentially experiencing difficulty with complying with any aspect of the prescribed prudential requirements, corrective action is taken. The exact type of action differs from case to case, and is not prescribed in any detail in the Banks Act. Actions may range from discussion of the area of concern at a routine or special prudential meeting with senior management to formal sanctions and fines, prohibitions on further expansion of activities and increases in the capital requirement. The ultimate sanction would be withdrawal of the banking licence.

special investigation

temporary liquidity assistance

In order to establish beyond doubt whether a bank has a liquidity or a solvency problem, the Department will call for a special investigation by an investigating accountant (from an accounting firm other than the auditors of the bank) in terms of section 7 of the Banks Act. If the bank's liquidity shortage is of a temporary nature and does not affect its solvency, the Registrar will advise the South African Reserve Bank (SARB) that the bank has liquidity problems, but is solvent. The SARB will then decide, in the interests of the stability of the banking system, whether or not to provide temporary liquidity assistance against appropriate security provided by the bank. A possible next step would be to recommend to the Minister of Finance that the bank be placed under curatorship. The Minister will appoint a curator to a bank only if he deems it desirable in the public interest, after consultation with, and with the written consent of, the chief executive officer or the chairman of the board of directors of the bank concerned. The outcome of a bank under curatorship depends on the particular circumstances. In all cases of distress in banks in South Africa, during the 1980s and 1990s, all small depositors have substantially been reimbursed.

If, however, the bank is insolvent, then the internationally accepted course of action is clear – no bank can be allowed to continue operations while it is insolvent.

STANCE TOWARDS DEPOSIT INSURANCE

implied deposit insurance

As stated above, in cases of distress in banks in South Africa, small depositors were substantially reimbursed. Large depositors may have lost some money, and shareholders have certainly lost money. In both cases, however, these parties would have been adequately compensated by receiving higher returns on their investments. Only rarely were depositors' funds completely frozen, and depositors could always access badly needed funds even when a bank was under curatorship. The perception has therefore evolved that deposits with banks are in fact guaranteed. Despite South Africa not having a formal deposit-insurance scheme, it can be said to have implied deposit insurance.

danger of adverse selection

Once there is a perception that deposits are guaranteed, there is a danger of adverse selection. In other words, risk decisions will be distorted, and depositors will seek the highest interest rates without regard to the soundness of a bank. It should be remembered that although one of the objectives of supervision is to protect depositors' interests, depositors cannot be safeguarded against all risks. Supervision does not provide any guarantees that regulated banks will always be able to meet their commitments - the principle of "let the buyer beware" will always remain valid.

function of a deposit-insurance scheme

In essence, the function of a deposit-insurance scheme is to provide a safety net for bank depositors, thereby increasing public confidence in banks and making the financial system more stable. A safety net may also limit the potential effect of problems in one bank on other, healthier banks in the same market, thereby reducing the possibility of contagion or a chain reaction within the banking system as a whole. Consequently, many countries have established deposit-insurance schemes in order to protect small depositors.

department supports limited scheme

In view of the above, the Bank Supervision Department supports the establishment of a limited deposit-insurance scheme in South Africa, whereby, say, 90 per cent of deposits of less than, say, R50 000 per bank client would be reimbursed in the case of a bank failure. The objective would be, firstly, to safeguard the deposits of ordinary bank customers who do not have the ability to monitor the riskiness of the banks with which they place their funds, and, secondly, to ensure financial stability. The premium rates for the funding of such a scheme should vary in accordance with the risk attached to each insured bank. Alternatively, it may be easier to charge banks flat premiums and to allow certain rebates to those that exceed certain predetermined prudential ratios. Such a fund should provide protection only for deposits with an original term to maturity of five years or shorter made with insured banks domiciled in the Republic of South Africa.

The Bank Supervision Department believes that the benefit of increased confidence in the banking system would exceed the direct or indirect cost of a deposit-insurance scheme to the banking sector.

SUPERVISORY APPROACH

The Bank Supervision Department has always followed a supervisory approach that combines off-site supervision and on-site supervision, with the emphasis on the former. Although this approach has been effective thus far, supervisory developments around the world and the Basle Committee on Banking Supervision's issue of the Core Principles for Effective Banking Supervision made the Department aware of a need to reassess its supervisory methods. The Department concluded that it would have to extend the current on-site component of its supervision. As a start, a newly formed market-risk team visited all trading banks during the course of 1998, with a view to benchmarking each trading bank against best industry practice. The team will follow up the findings of this survey with each of these banks during the course of 1999.

market-risk benchmarking

expand on-site supervision

Currently, South Africa is one of a few countries in the world that does not verify the quality of bank assets by means of on-site supervision. In order to remain at the forefront of international supervisory practice, the Department, therefore, has to take steps to expand its on-site supervision, particularly in the area of counterparty risk. Although the Department is currently considering the actual form and intensity of such on-site work, it envisages that reviews of asset quality, as well as of systems and controls, will form an integral part of the process.

ARTICLE IV REVIEW BY THE INTERNATIONAL MONETARY FUND

During the second quarter of 1998, the International Monetary Fund (IMF) conducted Article IV consultation discussions with South Africa. As part of the programme, the IMF held extensive discussions with the Bank Supervision Department and the banking sector.

overall opinion

Overall, the IMF was of the opinion that the Department was conducting its business competently, proactively and efficiently. The IMF viewed the Department as being capable of detecting problems at an early stage and of taking appropriate action to deal therewith. The Department's modern, risk-based supervisory framework, based on and largely complying with the Basle Committee's Core Principles for Effective Banking Supervision, was viewed as having been instrumental in minimising not only the challenges facing the banking system from continued foreign competition, cycles of economic activity and changes associated with social and economic reforms, but also the implications for systemic risk arising from high levels of concentration in the banking sector. The IMF, however, highlighted the following areas as requiring action:

On-site supervision and reliance placed on external auditors

The IMF was of the opinion that the system of using external auditors instead of on-site inspections limited the Department's supervision. Since an external auditor acts both as a bank's private agent and as the Department's proxy, a conflict of interest may impair the timeliness and quality of information furnished by an external auditor, even though an external auditor is under a legal obligation to inform the Department of any situation that might endanger depositors' interests.

recommended more active on-site inspections

The IMF recommended that the Department should consider conducting more active on-site inspections, at its own initiative and discretion and using its own resources. Because of current limitations on resources and expertise, the IMF recommended a gradual approach. The Department was advised, as a first step, to include its staff in the external auditors' teams and, initially, to conduct on-site inspections with a limited focus, targeting specific areas. Such an approach would enable the Department gradually to build up the expertise and resources necessary to undertake a high level review of asset quality of each bank.

Large exposures

In the past, lenient regulations with respect to large credit exposures may have been justified on the grounds that international sanctions and exchange controls had effectively isolated the South African economy from the rest of the world. It was therefore unavoidable that, firstly, highly concentrated corporate ownership structures would arise and, secondly, that these would turn to local banks for their financing needs. This situation is, however, changing rapidly: the economy has opened up, and South African banks and corporations compete actively in the global marketplace. As explained in Chapter 2 of this Annual

Report, this requires banks to abide by internationally agreed prudential limits on exposures. Therefore, formal guidelines complying with international best practice standards are needed in order effectively to constrain large credit exposures of local banks. Although the new guidelines should be phased in, the fact that large credit lines are not fully used should make implementation easier.

formal guidelines needed

Loan provisioning

should implement explicit rules

In South Africa, loan classification and provisioning practices differ from bank to bank and are left to the discretion of each bank. In view of this discretion and given some recent deterioration in asset quality, the risk of banks relaxing their loan-classification and provisioning policies when confronted by distress should be minimised. Accordingly, the IMF recommended that the Department should implement explicit and mandatory loan classification and provisioning rules that would trigger prompt correct-ive action automatically and prevent risky practices. The IMF endorsed the Department's initiative to review the capital risk weightings attached to mortgage financing, reported in Chapter 4 of this report.

Consolidated supervision

important to address practical arrangements

The IMF recommended that the Department should give high priority to the development of formal framework for consolidated supervision. It was stressed that the focus should not be on the required institutional structure for effective consolidated supervision, that is, whether the Department and the Financial Services Board (FSB) should continue to exist as separate institutions or whether they should be merged. Instead, the IMF deemed it important to address the practical arrangements required. These include issues such as statistical reporting to the Department and the FSB by financial conglomerates, sharing of confidential information, measurement of capital and definition of capital adequacy for institutions belonging to a financial conglomerate, harmonisation of licensing and prudential requirements, on-site inspections of financial conglomerates, and the prin-ciples that would guide joint administration of possible distress cases, including the nom-ination of the lead supervisor. As reported in Chapter 2, the memorandum of understanding between the Department and the FSB will serve to facilitate implementation of these re-commendations.

Exit policy

clear and precise rules should be formulated

The IMF recommended that clear and precise rules should be formulated to deal with the aspects that are common to all cases of bank failure. Such rules should specify, for example, whether the South African Reserve Bank or the Department of Finance should take the lead in cases of bank distress, whether a bank in distress should be restructured or liquidated, who should finance such a restructuring or liquidation and what the limits of the South African Reserve Bank's financial responsibility are.

As explained elsewhere in this chapter, when a curator is to be appointed to a bank, the Registrar will make a recommendation to the Minister of Finance, who may appoint a curator provided, amongst other issues, that the bank concerned has given its consent. The IMF has recommended that the Registrar should be able to institute curatorship arrangements at his own initiative in order to prevent a situation of a bank refusing to consent to curatorship, at the expense of affected third parties.

Deposit insurance

limited scheme should be introduced

In the IMF's view, there was a need to operate in an environment with clear rules and to protect small and unsophisticated depositors. Since the South African banking system is generally sound, the IMF deems it appropriate that a limited, well-designed and adequately financed deposit-insurance scheme should be introduced. The institutional structure of such a deposit insurance scheme and its relationship with the Bank Supervision Department and the lender-of-last-resort function of the South African Reserve Bank would have to be established by legislation. Such legislation would clearly have to specify the sources of funding of any potential financial gap between accumulated bank contributions and the scheme's financial obligations.

The Department has considered all these recommendations carefully. As indicated elsewhere in this report, the Department is already giving attention to many of the recommendations, as part of its on-going strategic and operational developments. The Department envisages implementing the recommendations in the Banks Act, the Regulations thereto and in the Department's policy, as appropriate, after consultation with appropriate and affected parties.

COMMISSION OF ENQUIRY INTO THE AFFAIRS OF THE MASTERBOND GROUP AND INVESTOR PROTECTION IN SOUTH AFRICA

criticisms relevant to the supervision of banks

In the 1997 Annual Report, it was noted that the Commission of Enquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa (generally known as the Nel Commission) had published its first report. During the year under review, the Bank Supervision Department devoted considerable resources to addressing some of the criticisms in the report that were relevant to the supervision of banks. These criticisms related primarily to two areas:

Inadequate regulation and supervision in some respects

working relationship between the Department and the Financial Services Board has been strenthened

As regards the Nel Commission's comments on certain regulatory and supervisory shortcomings, it should be noted that the working relationship between the Bank Supervision Department and the Financial Services Board has been strengthened considerably in the years following the Masterbond incident. In 1998, this working relationship was further formalised by the development and signing of a memorandum of understanding (MOU). The MOU, which is discussed in more detail elsewhere in this report, addresses, amongst other issues, the basis for exchanging information in cases of a financial institution such as Masterbond failing. It is believed that the practical measures now in place will ensure that an operation such as Masterbond will in future not escape the regulators' prompt action.

Shortcomings in auditing procedures and the auditing profession

ongoing efforts to enhance corporate governance

The Bank Supervision Department places considerable reliance on the auditors of banks as a key player in the supervisory process. This reliance on auditors, which was comprehensively explained in the 1997 Annual Report and which is also discussed elsewhere in this report, is the reason for the Department's interest in the Nel Commission's comments on shortcomings in auditing procedures and the auditing profession. In the Department's view, these shortcomings have become less prevalent in the banking sector, because of the Department's ongoing efforts to enhance corporate governance. For example, the Department made compliance with many of the recommendations of the King Commission on Corporate Governance mandatory long before this was common in other sectors. During 1998, the Department participated in a working group of the South African Institute of Chartered Accountants (SAICA), which formulated a comprehensive response to the Nel Commission's comments on weaknesses in the auditing process. More recently, the Nel Commission also circulated a consultation paper on the role of the auditor and the elimination of the expectation gap, to which the Department has responded via SAICA.

In view of the time that has passed and the developments that have taken place since the occurrence of the events that were investigated by the Nel Commission, the seemingly different context from which the findings arose has tended to call into question the significance of the Commission's findings. The Department, however, believes that the Nel Commission's findings should be viewed in a positive way and that any implied or specific recommendations should continue to be addressed as constructively as possible.

DIVERSIFICATION OF THE STAFF COMPLEMENT

better use of diversity

The need to transform the environment and staff complement of the Bank Supervision Department in order to make better use of diversity has been a strategic issue for the Department for, at least, the past three years. The Department's objectives are to attain a staff mix that is at least as representative as that of the supervised banks and to plan succession proactively, in order to ensure that competent members from the target groups will be available for consideration for key management and specialist positions.

Department's responsibilities

The unavailability of skills in banking supervision in general, combined with the heavy burden of training new entrants, whilst still discharging the Department's responsibilities in terms of the Banks Act, 1990, presents a major challenge. The Banks Act is specific about the responsibilities of the Office for Banks and activities such as regular prudential meetings with each bank. The issues and matters discussed at each meeting dictate that an assessment be made of the adequacy of the risk-management functions in each bank. An incorrect assessment can have considerable consequences. It may, for example, lead to the imminent demise of the quality of a bank's risk management going undetected, with grave potential consequences for depositors of the bank concerned, as well as the banking system as a whole.

Besides having to make judgements on the adequacy of banks' risk management, the Department is faced with a growing number of new entrants to the South African banking sector and expansion of South African banks' offshore operations. This leaves little excess capacity for training purposes. It is common wisdom in international banking supervision circles that analysts need some six months of on-the-job training before they can begin to contribute as team members and an average of two years before they can work independently.

development and training

A full-time professional development and training manager in the Department plans and co-ordinates all professional development programmes, and gives internal training. All new staff members undergo a structured training course, which is also presented annually to regional and other banking supervisors. All other staff members annually undergo an average of ten working days of professional development interventions suited to their career developmental needs.

professional development

Professional development has been integrated with performance management. Whenever performance problems are identified, appropriate interventions are made in order to help to equip the staff member with the desired attributes. This also aids early identification of potential. Considerable success has been achieved with development opportunities to help to accelerate the development of target group members with management potential.

The Department is committed to implementing the transformation policy of the South African Reserve Bank. The challenge will be to maintain a healthy balance between transformation on the one hand and continued fulfilment of the Department's responsibilities in terms of the Banks Act on the other hand.

ISSUES THAT WILL RECEIVE PARTICULAR ATTENTION DURING 1999

During 1999, the Bank Supervision Department will focus on, amongst others, the following issues, which are discussed in more detail elsewhere in this report:

focus areas

- Drafting of amendments to the Banks Act, 1990, and promulgation and implementation of draft amendments to the Regulations relating to Banks, in order to ensure the relevance and currency of the banking legislation.
- Continued participation in the work of international and regional supervisory bodies, particularly as regards implementation of the Core Principles for Effective Banking

Supervision and harmonisation of supervisory standards.

- Further refinement of the Department's consolidated supervision procedures, including co-operation with the Financial Services Board as regards supervision of financial conglomerates, development of consolidated returns on capital adequacy, large exposures and intragroup exposures, and formulation of consolidated capital requirements and large-exposure and connected-lending limits.
- Increased focus on banks' asset quality and market-risk management, including more emphasis on the on-site component of supervision and joint on-site examinations with external auditors.
- Greater focus on the measurement and monitoring of operational risk, including escalation of efforts to ensure the year 2000 preparedness of banks, with special emphasis on industry-wide co-operation, encouragement of disclosure of preparedness status and integration testing.
- Development of responses to weaknesses in financial markets, such as possible reporting requirements for banks' scrip-lending activities in order to monitor the build-up of risk arising from certain derivative activities, and monitoring of capital flows in order to assess banks' vulnerability to a sudden withdrawal of international funding.
- Possible introduction of capital requirements for banks participating in the STRATE (Share Transactions Totally Electronic) system to be implemented by the Johannesburg Stock Exchange, in order to address banks' exposure to tainted scrip.
- Further research on, for example, bank-failure prediction models for South Africa.
- Hosting of a workshop on internal auditing.
- Hosting and presentation of courses in banking supervision for members of the East and Southern Africa Banking Supervisors Group and other supervisors.

CONCLUSION

Once again, I wish to record my sincere appreciation to both the Minister and the Deputy Minister of Finance, for their valued inputs to requests in terms of statutory requirements, and for the co-operation and support received from the Chairman of the Policy Board for Financial Services and Regulation, the Governor and Deputy Governors of the South African Reserve Bank, the Chief Executive of the Financial Services Board and his staff, the senior executives of banking institutions, The Banking Council South Africa and the banking associations, the Standing Committee for the Revision of the Banks Act, 1990, the staff of the South African Reserve Bank and the many organisations and individuals, locally and internationally, with whom this Department has had contact during the past year. I wish to extend a special word of thanks to my staff who continued to handle their workload with dedication.

My staff and I look forward to receiving the continued co-operation of everyone involved in the banking industry, both in the private and the public sector, locally and abroad, in order to enable us to meet the diverse challenges that lie ahead.

C F Wiese
Registrar of Banks, and General Manager: Bank Supervision Department