CHAPTER 2

# CURRENT ISSUES IN BANKING SUPERVISION

This chapter contains an overview of some of the most important regulatory and supervisory trends and developments, both locally and internationally, during the year under review.

## INTERNATIONAL REGULATORY DEVELOPMENTS

initiatives taken by the Basle Committee

During 1998, turbulence in global financial markets threatened the banking systems of many countries. This has again highlighted the special role that the supervisory community plays in the maintenance of financial stability. Some of the initiatives being taken by the Basle Committee on Banking Supervision, in concert with other regulators where appropriate, are of interest. These initiatives include the following:

### Continued elaboration of the Core Principles for Effective Banking Supervision

The Basle Committee has continued to elaborate on the Core Principles by producing papers on key topics, thereby augmenting and updating the set of relevant papers - known as the Compendium - that the Committee has issued over the years. During the past year, for example, the Basle Committee published papers on:

Basle Committee papers on key topics

- Internal control systems for banks.
- Interest-rate risk management.
- Operational risk.
- Transparency.
- Loan valuation, loan-loss provisioning and credit-risk disclosure.

Discussion documents on credit-risk management, corporate governance, trading and derivative-risk disclosure, internal audit and banks' interactions with highly leveraged institutions have been issued.

### Continued research to understand the frontiers of financial developments

work on the future of capital-adequacy requirements

evaluating own capital adequacy and dynamically allocate capital

The most significant example of the Basle Committee's continued research to understand the frontiers of financial development is its current work on the future of capital-adequacy requirements. Although the Committee is well aware of the value that the so-called Basle Capital Accord has had in strengthening capital standards throughout the world, the Committee has recognised that advances in risk management and financial practice are beginning to erode the relevance of the Accord for the most technically sophisticated banks. As banks develop new methods of evaluating their own capital adequacy under reasonable stress scenarios, and even dynamically allocate capital to different business areas in which the risk-return ratio is better, supervisors have to consider whether these approaches provide new tools for assessing capital adequacy from a risk perspective. It is believed that new thinking on a minimum capital rule and the supervisory evaluation of capital adequacy will emerge in due course.

## Establishment of the Institute on Financial Stability

training to senior supervisors

The Institute on Financial Stability was established as a joint effort of the Group of Ten central bank governors, the Basle Committee, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The purpose of the Institute is to provide training to senior supervisors in the application of basic supervisory principles to their national supervisory systems. The Institute will also act as a clearing house for the co-ordination and provision of technical assistance by central banks and supervisory bodies.

## Establishment of the Joint Year 2000 Council

year 2000-related information

The Joint Year 2000 Council was established as a joint effort of the Basle Committee, the Committee on Payment and Settlement Systems, IOSCO and the IAIS, with the purpose of providing year 2000-related information to the world's financial market authorities. Examples of the Council's activities include various regional meetings of financial market regulators, such as the meeting of the African region hosted by the South African Reserve Bank, in Pretoria, in January 1999.

# INTERNATIONAL AND REGIONAL REGULATORY INVOLVEMENT

ongoing refinement of environment

The Bank Supervision Department is committed to compliance with international standards and the ongoing refinement of the regulatory and supervisory environment in which banks operate. Therefore, the Department is continuously extending its contact and co-operation with other regulators at the international, regional and domestic level.

## Representation on the Core Principles Liaison Group

development and further refinement of international supervisory standards

In the 1997 Annual Report, the Bank Supervision Department reported on its adoption of the Basle Committee's Core Principles for Effective Banking Supervision as a benchmark for assessing the ongoing effectiveness of the Department's supervisory processes. During the year under review, the Department continued its commitment to the development and further refinement of international supervisory standards by, amongst other activities, participating in the work of the Core Principles Liaison Group. The Registrar, who attended three meetings of the Liaison Group in Europe, reports on the Liaison Group's work in his review, in Chapter 1 of this report. He has also committed resources to research certain aspects of the detailed implementation and further refinement of the Core Principles.

## International Conference of Banking Supervisors

The Registrar and Deputy Registrar reaffirmed their commitment to international co-operation by attending the tenth International Conference of Banking Supervisors (ICBS) in Sydney, Australia, during October 1998. The conference, organised by the Basle Committee on Banking Supervision and hosted by the Reserve Bank of Australia, in co-operation with the Australian Prudential Regulation Authority (APRA), was attended by representatives of the banking supervisory authorities of 120 countries, as well as representatives of several international organisations.

co-operation among national authrities

The ICBS, which has been held at two-yearly intervals since 1979, is designed to promote co-operation among national authorities in the supervision of international banking, and to enable senior representatives of supervisory authorities from a large number of countries to exchange views on a range of current issues of common concern. The two main themes of the conference on this occasion were the Core Principles and operational risk.

challenges in implementing the Core Principles

operational risk

On the first day, participants considered the challenges with which they were faced in fully implementing the Core Principles. There was general endorsement of the Core Principles, and participants unanimously pledged to promote the implementation thereof at a national level. On the second day, six different aspects of operational risk were discussed, including the year 2000 problem. These discussions resulted in a number of practical recommendations to assist banks to protect themselves against operational risk. As regards the year 2000 problem, currently the most prominent risk of this type, it was noted that, in most countries, the banking sector was making good progress. Supervisors, however, should continue to alert banks to the necessity of giving high priority to testing and contingency planning in particular.

## Co-operation with other bank supervisors

During the year under review, the Bank Supervision Department continued its policy of active co-operation with other bank supervisors, particularly in the Southern African region. Activities included the following:

- *Courses in banking supervision*

hosted two courses

The Department successfully hosted two courses in banking supervision. The first course was held in Pretoria, from 13 to 24 April 1998, at the request of the National Bank for Agriculture and Rural Development (NABARD) in India. Nineteen participants from five countries, including 11 participants from India, attended the course. The second course, being the fifth annual course for member countries of the East and Southern Africa Banking Supervisors Group (ESAF), was presented from 7 to 18 September 1998, also in Pretoria. Thirty participants from 15 of the 16 ESAF countries and two participants from NABARD in India attended this course. The courses, which consisted of 29 modules and case studies, concentrated on the role of the key players in the management of banking risks.

update on latest trends

As in previous years, a one-day seminar, providing an update on the latest trends in banking supervision, preceded the ESAF course. The audience of some 170 people included representatives of the banking sector, external auditing firms, the financial press and the central bank. Speakers from the Bank of International Settlements, the Bank of Israel, the Federal Reserve Bank of New York, the Financial Services Authority, the Financial Services Board, the International Monetary Fund and the South African Reserve Bank addressed topics that are largely mirrored in this Annual Report. The topics included:

topics included

- The Basle Committee's recent work, with specific reference to the implementation of the Core Principles, current developments regarding capital adequacy, market transparency, and risk management and controls.
- Lessons for supervisors from the East Asian banking crisis and lessons learned by the International Monetary Fund, with particular reference to the link between macro-economic policy and banks.
- Lessons to be learned from mergers and acquisitions to form "bancassurance" groups. In view of past and possible future mergers in South Africa, this topic was of particular interest.
- Changes in banking supervision and the way ahead, with particular reference to the experience in the United Kingdom and the formation of the Financial Services Authority.
- Key features of robust banking systems, the features being competition, stability and efficiency. The formal measurement models that were presented re-emphasised the validity of the Department's increased emphasis on developments in supervisory tools and techniques.
- Regional co-operation, particularly within the Southern African Development Community.

As part of its initiative to assist central banks in Southern Africa with technical bank supervisory training, the South African Reserve Bank has indicated its willingness to host the course again in 1999.

▲ *Projects of the Southern African Development Community (SADC)*

harmonise supervisory and accounting standards

Progress was made with two projects, partly funded by a grant from the World Bank, to harmonise the supervisory and accounting standards in the SADC region. The ultimate consequence of the project on harmonisation of supervisory standards will be the ability to share common systems architectures. The result of the accounting standards project will be a comparative study of the de facto bank auditing and accounting standards of each member country, and recommendations for improvement where appropriate.

regional body of non-bank financial regulators

The Department also attended a meeting convened by the Financial Services Board, with the intention of establishing a regional body of non-bank financial regulators. Most of the SADC countries were represented at the meeting, which resolved that the proposed regional body would report directly to the Council of Finance Ministers of SADC, and not through the Committee of Central Bank Governors in SADC.

▲ *Projects of the ESAF Executive*

The Registrar attended three meetings of the ESAF Executive. Projects under the auspices of the Executive include:

projects include

- A survey of the implementation of the Basle Committee's Core Principles. The results of a framework of responses completed in October 1998 showed that the average implementation in ESAF member countries was 67 per cent.
- Co-operation on anti-money-laundering measures, in order to promote the implementation thereof.
- Harmonisation of licensing standards, in order to ensure that banks in the region meet certain standards. The individual member countries' licensing standards will form the basis for the development of a regional standard, to be presented to all ESAF member countries for adoption.
- Harmonisation of provisioning standards and of accounting and auditing standards, in order to establish regional standards.
- Development of a regional early-warning system based in the individual member countries' systems.
- Consideration of an off-site surveillance computer program developed by the World Bank, with a view to adopting the program for the region.
- Development of an ESAF directory and Website.

▲ *Other ESAF meetings*

The Third ESAF/IMF/Worldbank Heads of Supervision Workshop was held in Swakopmund, Namibia, in June 1998. Special attention was given to the lessons from the South-East Asian crisis. In October 1998, the Sixth Annual General Meeting of ESAF was held in Sydney, Australia, to coincide with the ICBS. Topics discussed included the ESAF Website information, new logo and the above-mentioned World Bank computer program to assist with off-site surveillance.

## Domestic regulatory co-operation

Active liaison and co-operation between the Bank Supervision Department and the

Financial Services Board (FSB), the regulator of financial institutions other than banks in South Africa, has become of particular importance because of the increase in universal banking activities and the growing emphasis internationally on matters such as consolidated supervision. The Department and the FSB formalised the basis for such co-operation by signing a memorandum of understanding (MOU) on 8 December 1998.

memorandum of understanding with FSB

salient features of the MOU

In terms of the MOU, the Department and the FSB agreed on mutual assistance and exchange of information, and to co-ordinate supervision of financial conglomerates involving banks, mutual banks and financial institutions within the jurisdiction of the FSB. The salient features of the MOU are:

▲ *Mutual assistance and exchange of information*

salient features of the MOU

Each party will provide the other with the fullest possible measure of mutual assistance, subject to the relevant legislation and its overall policy. This assistance may include one party providing access to its information and records to the other party, questioning or taking testimony of persons, conducting inspections and obtaining specified information and documentation from persons.

▲ *Provision of unsolicited information*

Should one party come into possession of information that would be likely to assist the other in administering or enforcing the laws for which it is responsible, the former will endeavour to notify the latter of the existence of that information.

▲ *Referrals*

Should it become apparent to one party that a matter falls within the jurisdiction of the other party, or that some joint action is required in dealing with the matter, it should be referred to the other party.

▲ *Permissible uses and confidentiality of information*

Each party will endeavour to provide relevant information, including confidential information, to the other. This information will be used for the purposes for which it was requested. Thereafter, all documentation and copies thereof will be returned to the party from which the documentation was obtained.

▲ *Supervision of financial conglomerates*

A co-operative approach to the supervision of financial conglomerates will be followed. In particular, the parties will liaise with a view to reaching a common position when a problem affecting any entity, whether regulated or not, in a financial conglomerate is considered to have the potential to affect adversely other financial institutions in the conglomerate.

▲ *Day-to-day liaison*

There will be regular liaison at officer level, as well as senior executive level, on operational and policy matters of mutual interest, in particular concerning financial conglomerates.

aimed at better co-operation and more effective consolidated supervision

In essence, the MOU is aimed at better co-operation between the Department and the FSB and more effective consolidated supervision of financial institutions. The MOU will also enable the Department to give greater effect to its commitment to participate in the refinement of the regulatory environment.

## CONSOLIDATED SUPERVISION

During the year under review, the Bank Supervision Department paid particular attention to consolidated supervision and the ongoing refinement thereof in line with international developments and internationally accepted standards. The Department has allocated specific resources to this project, and has made progress with developing procedures for assessing the overall strength of a banking group. In order to effect compliance with the Basle Committee's Core Principles for Effective Banking Supervision, the Department has been paying particular attention to the areas that an independent evaluation had in 1997 identified as requiring improvement.

## Consolidated supervision defined

essential element of banking supervision

In terms of principle 20 of the Core Principles, the ability of the supervisors to supervise a banking group on a consolidated basis is an essential element of banking supervision. Accordingly, supervisors must be able "to review both banking and non-banking activities conducted by the banking group, directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign offices". Supervisors thus have to bear in mind that a bank's or group's non-financial activities may pose risks to the bank.

effective only if applied to all banking groups

Supervision on a consolidated basis may be defined as an overall evaluation – both quantitative and qualitative – of the strength of a group to which a bank belongs, in order to assess the potential impact of other group companies on the bank. Consolidated supervision will be effective only if it is applied to all banking groups, and if supervisors have the necessary legal powers to conduct supervision on a consolidated basis.

## Framework for consolidated supervision

solo supervision will remain the main focus

The Bank Supervision Department is committed to the principle that the supervision of authorised institutions should be conducted on a consolidated basis whenever such institutions are members of a wider group. Solo supervision will, however, remain the main focus of the Department.

framework to provide a more consistent and systematic approach

The Department has therefore drawn up a framework for the supervision of banking groups on a consolidated basis. The main objective is to provide a more consistent and systematic approach to the Department's supervisory process, in order to ensure the effective performance of consolidated supervision. Implementation of the framework will place the Department in a better position to assess the control environment in which a banking group operates.

entities that will be subject to consolidation

The entities that will be subject to consolidation, for purposes of consolidated supervision, are a bank controlling company and its subsidiaries (including, of course, any banks). Consolidated supervision thus extends to all the companies in a banking group - the bank controlling company, its subsidiaries, joint ventures and companies in which the bank controlling company or its subsidiaries have a participation.

In its consolidated supervision, the Department will address both quantitative issues and qualitative issues. Quantitative consolidated supervision is based on a number of sources of information, amongst others:

quantitative consolidated supervision

- ▲ Consolidated statutory returns.
- ▲ Management accounts.
- ▲ Consolidated financial statements.

A qualitative assessment of a banking group includes aspects such as:

qualitative assessment

- ▲ Group legal structure.
- ▲ Capital resources.

- Transparency of the group.
- Corporate governance.
- Fit-and-proper tests.
- Risk management.
- Control environment.
- Group management structure.
- Structure of business activities.
- Disclosure requirements.

## Collection, review and analysis of information

statutory returns for capital adequacy, large exposures and intragoup exposures

In terms of principle 18 of the Core Principles, "banking supervisors must have means of collecting, reviewing and analysing prudential reports and statistical information from banks on a solo and consolidated basis". The Department is giving high priority to developing statutory returns for banks regularly to report their capital adequacy, large exposures and intragroup exposures on a consolidated basis. These consolidated returns will allow the Department to monitor several aspects of the financial condition of a banking group on a quantitative and regular basis. In this regard, all indications are that the Department will be in a position to consult with all interested parties during the coming year.

## Consolidated capital requirements

The Basle Committee recommends that supervisors should apply the minimum capital-adequacy ratio of 8 per cent to all internationally operating banks on both a solo and consolidated basis. A key element of consolidated supervision is that it is essential to ensure that a banking group is adequately capitalised in order to sustain both the banking and the non-banking operations of the group. All South African banks are required to maintain adequate capital at all times. The required capital ratio set on a consolidated basis will normally be the same as that set on a solo basis.

## Large-exposure limits

In terms of principle 9 of the Core Principles, "banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within a portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers". Large exposures on a consolidated basis refer to exposures of a defined group to a single third party or a group of related borrowers. In effect, this means that the exposures of all entities in a group to a single counterparty or a group of related counterparties will be aggregated in order to obtain the group's exposure to that counterparty or those counterparties.

subject to Registrar's approval on a solo and a consolidated basis

Certain large exposures will be made subject to the Registrar's approval on a solo and a consolidated basis. Safeguarding against excessive concentration of risk is one of the most important components in any system for the supervision of banking groups. Concentration of risk cannot be eliminated; concentrations will arise through the specialisation of banks for reasons of competitive advantage and expertise. This risk can and must, however, be contained by ensuring that a bank's exposure is diversified. In terms of international standards, a banking group may not incur an exposure to an individual borrower or a group of closely related borrowers that exceeds 25 per cent of the banking group's qualifying capital and reserves, and the total of all large exposures may not exceed 800 per cent of qualifying capital and reserves.

## Intragroup exposures

intragroup exposures may pose a contagion risk

According to a recent World Bank report, it will become broadly accepted to apply capital-adequacy requirements, large-exposure limits and connected-lending limits on a consolidated basis to all group financial entities. The Bank Supervision Department has added intragroup exposures to this list, because intragroup exposures, especially exposures to unregulated entities, may also pose a contagion risk to the group as a whole.

## Contact with other regulators

co-operating closely with FSB

The Bank Supervision Department is co-operating closely with the Financial Services Board (FSB) on consolidated supervision. As reported elsewhere in this chapter, the Department and the FSB have signed a memorandum of understanding, which will serve to facilitate even better co-operation in this regard. During 1998, very successful visits were also paid to the Bank of England, De Nederlandsche Bank and the Institut Monetaire Luxembourgeois, whose assistance is greatly appreciated. The objective of the visits was to learn more about other regulatory authorities' approach to consolidated supervision, in order to assist the Department in refining its methodology for conducting consolidated supervision.

## Visits to foreign operations of South African banks

home-country responsibility

In line with the prescriptions of the Basle Committee on Banking Supervision, the Bank Supervision Department, in its capacity as home-country supervisor, has a responsibility for the foreign operations of local banks. In order to gain a comprehensive understanding of the nature of the business of the foreign establishments of South African banks and to form an opinion on their management of risks and their corporate governance practices, the Department visits these establishments and their host regulators.

prudential meetings with management of South African banks

discussions with host supervisors

During November 1998, members of the Department visited the United Kingdom, Singapore, the People's Republic of China, Hong Kong and Taiwan. The Department not only conducted full-scale prudential meetings with the management of South African banks' establishments in those jurisdictions, but also held discussions on bank-specific and topical issues with their host supervisors. 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. The three main themes common to all jurisdictions were:

three main themes

- A strong commitment to follow, as closely and as practically as possible, the guidelines published from time to time by the Basle Committee on Banking Supervision, specifically the Core Principles for Effective Banking Supervision.
- An extremely vigilant approach to the monitoring of banks' activities, particularly as regards credit extension, following the financial crisis in the region during the past twelve months, in order to be well prepared for any future developments in this regard.
- Year 2000 (Y2K) readiness.

The Department has established sound relationships and good supervisory co-operation with the relevant supervisory bodies in the above-mentioned jurisdictions. This should stand South African banks in good stead in their interaction with those authorities and as regards future business plans.

In general, the respective host regulators were comfortable with the conduct of South African banks in their jurisdictions. The Department has subsequently also given feedback on these visits to the senior executives of the particular banks in South Africa.

## Inquiry into the regulation and supervision of financial conglomerates

During the latter part of 1997, the Policy Board for Financial Services and Regulation commissioned an inquiry into the regulation and supervision of financial conglomerates. The objectives of the appointed Task Group were threefold, namely, to:

objectives of Task Group

- Set out the key issues involved in the regulation and supervision of financial conglomerates.
- Outline why these issues are important.
- Propose a general approach to the regulation of financial conglomerates in South Africa.

The ultimate focus was that regulation and capital requirements had to address the totality of risks within a financial conglomerate.

trend towards international harmonisation

According to the Task Group, whose final report was tabled in 1998, the general trend was towards international harmonisation of regulation, and for the international regulatory community to expect all major countries to conform with internationally agreed approaches to the regulation and supervision of financial institutions. The Task Group identified several key issues and made detailed recommendations on aspects that needed to be addressed. It also re-emphasised the importance of South Africa aligning itself with internationally agreed standards on capital adequacy, large exposures and connected lending.

As part of its consolidated supervision project, the Bank Supervision Department is already addressing not only the detailed recommendations of the Task Group, but also the minimum standards set by the Basle Committee on Banking Supervision.

## Demarcation of banking and insurance business

consensus has been formalised

The complex issue of fairly demarcating the business of banks, life insurers and unit trusts remains topical. In the 1996 Annual Report, it was reported that consensus was emerging on how such demarcation could be achieved. Subsequently, this consensus has been formalised, and legislation to give effect to the recommendations is currently being drafted. The complexities causing the delay centre on two issues. The first relates to competition and the prudential adequacy of the life-insurance industry's regulatory system, given that, in terms of the proposed solution, life insurers would be permitted to issue short-term investment products. The agreed solution:

agreed solution

- Will allow life insurers to issue products that are comparable to the products of unit trusts, thereby removing the competitive disadvantage about which the life-insurance industry has complained.
- May require an adjustment to the prudential regulatory system of insurers in order to provide for the unforeseen risk that may arise as a result of mismatching.
- Will preclude the life-insurance industry from competing with banks through comparable products.
- Will not create opportunities for regulatory arbitrage between the industries.
- Will require amendment of section 54 of the Long-term Insurance Act, 1998, which provides for a minimum investment term of five years for life-insurance products.

The second complexity relates to the unique tax system of life insurers. Under the trustee principle and "four funds" approach, this system holds several tax-arbitrage opportunities, fifth fund for life insurers

to the competitive disadvantage of the other industries. The agreed solution involves the addition of a fifth fund - the max tax fund - to the four funds currently operated by life insurers in terms of section 29 of the Income Tax Act, 1962. The fifth fund will accommodate investment business of life insurers for terms of less than five years and will be subject not only to taxation at the highest rate of personal tax applicable at any given time, but also to restrictions on the movement of policies between funds.

A committee is currently drafting detailed amendments to the Insurance Act and the Income Tax Act, and these will be circulated for comment in the ordinary course. It is believed that this will achieve a pragmatic and workable demarcation, which will satisfy the various parties concerned, as well as the Bank Supervision Department from a prudential and systemic point of view.

## CROSS-BORDER INSOLVENCIES

draft Bankruptcy Bill

Locally and internationally, insolvency legislation is currently under review. During 1998, the South African Law Commission's work in this regard culminated in the publication for discussion of a draft Bankruptcy Bill, which will replace the current Insolvency Act, 1936.

Following the collapse of Barings Bank in 1995, the Group of Thirty, in co-operation with the International Insolvency Practitioners Association (INSOL International), initiated a process of examining the possible effects of the insolvency of a multinational financial institution. The insolvencies of some major national emerging market financial institutions resulting from the recent Asian crisis further underlined the need for wider recognition of the possible effects of the insolvency of a globally active financial institution.

insolvency legislation is lagging behind supervisory co-operation

Primarily responsible for dealing with the insolvency of a financial institution is the local supervisor, who has to protect the soundness of a financial system and whose approach has to be consistent with the relevant national insolvency laws. Different countries' laws, however, differ substantially with regard to protection of creditors, borrowers, employees and shareholders. Also, few insolvency laws give attention to the cross-border implications of an insolvency and, therefore, offer no mechanism for dealing with matters outside a national jurisdiction. Worldwide, insolvency legislation is lagging behind the supervisory co-operation that has developed as a result of the internationalisation of financial institutions. There is thus a substantial risk that the insolvency of a major financial institution could cause significant difficulties for the global financial system. The Asian crisis has focused attention on the need for improvement of insolvency legislation worldwide. Should the year 2000 computer problem, for example, effect the failure of a global financial institution, preparedness in this regard will be of paramount importance in order to limit the global effect thereof.

### Model law of the United Nations Commission on International Trade Law

model legislative provisions on judicial co-operation

In 1997, the United Nations Commission on International Trade Law (UNCITRAL) produced model legislative provisions on judicial co-operation, access to courts for foreign insolvency administrators and recognition of foreign insolvency proceedings. It is expected that many United Nations member countries will adopt these provisions. In the United States of America, for example, the House of Representatives has already approved a bankruptcy reform bill that contains provisions adopting the UNCITRAL model law.

In South Africa, a subcommittee of the South African Law Commission has recommended either the enactment of the UNCITRAL model law as a separate statute or the incorporation of its provisions in a separate chapter of the proposed Bankruptcy Act. The Bank Supervision Department supports the incorporation of the UNCITRAL model provisions into South Africa's legislation.

## Recommendations of the Group of Thirty and INSOL International

In 1998, the Group of Thirty, in co-operation with INSOL International, produced a study group report containing recommendations for reducing the systemic and contagion risk associated with insolvencies of globally active financial institutions. The theme of the recommendations is one of preparedness, in order to ensure a smooth process in the wake of an insolvency, and not one of preventing such an event. The recommendations were based on five principles that would have to be observed in order to reduce systemic risk, namely, immediate action, co-operation, availability of information, curtailment of potential losses, and standardisation of policy and practice.

theme of preparedness to ensure a smooth process

The recommendations are not limited to banks, but cover, amongst others, regulators, legislators, the financial sector as a whole insolvency administrators, and are relevant to both developed and emerging economies.

recommendations are not limited to banks

In essence, internationally active financial institutions are encouraged to take into account the legal enforceability of financial contracts, close-out netting and the effectiveness of both home-country and host-country insolvency laws, as part of their risk-management processes.

Since the recommendations are wide ranging, implementation thereof will require co-operation among many market participants. In view of events in the global financial markets in recent years, the recommendations are, however, timeous. It will take time for minimum standards to be developed, agreed and reflected in national supervisory practice. Adoption of the recommendations would, however, create an incentive for the improvement of insolvency regimes.

implementation will require co-operation

The Bank Supervision Department is aware of the need for appropriate mechanisms to resolve cross-border insolvencies, both from a regulatory and a corporate governance perspective, and encourages market participants and banks to take note thereof. The Department will continue to monitor the work of the Group of Thirty, INSOL International, UNCITRAL and others in this regard. The Department will also continue its involvement in discussions on new insolvency legislation for South Africa.

need for appropriate mechanisms

# CORPORATE GOVERNANCE

Corporate governance may be described as a system of business management and disclosure of information to stakeholders, within a paradigm of management accountability. Since the Bank Supervision Department regards sound corporate governance in banks as crucial, the Department hosted a seminar on corporate governance on 28 August 1998. The main theme of the seminar was the critical importance of effective corporate governance in banking, especially in turbulent times.

main theme of seminar

## Responsibilities and desirable characteristics of directors

It is widely accepted that corporate governance requires board members to act with enterprise and to strive to increase shareholders' value. At the same time, directors of a bank have to take into account the interests, demands and expectations of other stakeholders, that is, all persons or organisations whose welfare is tied to the bank, including employees, depositors and the bank's host community. Current thinking on corporate governance highlights the new challenges of ethical behaviour and social responsibility of banks, including quality of employment, the environment and community enhancement, without compromise of commercial autonomy.

new challenges

The seminar highlighted the need for board members to have professional qualifications and relevant operational experience. In this regard, board committees can be very effective. The Banks Act, 1990, and the Regulations thereto require the establishment of certain board committees, which would require specialised members. Board members should

qualifications and experience

enhancing skills and capabilities

technological systems

also be able to exercise independent judgement.

It was suggested that banks in South Africa should be actively committed to enhancing the skills and capabilities of prospective bank directors who are members of the transformation process target groups. This would not only prepare future directors for their responsibilities, but would also sensitise a bank's board to the needs of the bank's host community.

Nowadays, banks rely greatly on technological systems. Therefore, board members should clearly understand the operation and management of the risks inherent in technological systems, especially in the light of the year 2000 computer problem.

## Reasons for failure of corporate governance and suggestions for improvement

The seminar highlighted some of the reasons for the failure of corporate governance in banks and the consequent failure of banks themselves. These reasons included:

reasons for failure of corporate governance

- Directors lacking time to carry out their duties owing to other responsibilities.
- The competitive environment.
- South Africa's lack of skills.
- Boards being too large and not sufficiently cohesive to enable them to work towards a common goal.
- The documented information presented to directors at board meetings being too complex.
- Chief executive officers often being too powerful and, therefore, able to prevent non-executive directors from carrying out their monitoring functions effectively.

Some practical suggestions for improving corporate governance in banks included that:

practical suggestions for improving corporate governance

- A balanced board should consist of no more than fifteen diverse directors, with a ratio of at least two non-executive directors for each executive director.
- New board members, who should not serve on too many other boards, should be appointed regularly.
- Boards of directors should meet at least bimonthly, and sufficient time should be allowed for preparation and committee sessions.
- Board meetings should focus on strategic planning, capital allocation, long-term goals, succession planning, performance appraisals, and compliance with regulatory and ethical standards, including anti-competitive practices.
- The roles of the board chairman and chief executive officer should be separated. Alternatively, a board with an executive chairman should be balanced by processes and structures designed to empower non-executive directors.
- In order to enable them to measure business performance effectively, board members should receive broader information than that contained in financial reports.
- In order to recognise contributors and non-performers, directors should be subject to performance evaluations, as should the functioning of the board itself.
- The non-executive directors should review the chief executive officer's performance in terms of an agreed process.

- Meetings should be held with some of a bank's larger institutional shareholders, in order to enable directors to provide information to investors and to be informed of investors' concerns.
- Board committees should include at least one non-executive director, and committee members should be rotated at least every three years.
- Audit committees should address, for instance, the year 2000 computer problem, the European Monetary Union, ethical issues, fraud, money laundering, regulatory reporting and self-assessment.

## Legal liability for corporate governance

Banks Act and Regulations contain certain directive

The seminar also focused on the possible legal liability of directors to ensure sound corporate governance in banks. In this regard, the Banks Act, 1990, and the Regulations relating to Banks contain certain directives. These include the directives in regulation 37(5), which were discussed in the 1996 Annual Report and which, in essence, require directors to submit an annual report to the Registrar of Banks. The consequences of non-compliance with the banking legislation or the furnishing of inaccurate information could be severe - in terms of section 23(1), read with section 24, of the Banks Act, the Registrar could cancel or suspend a bank's registration. In terms of section 60(2)(b), read with section 90(1)(b), of the Banks Act, a breach of fiduciary duty by a bank's director could include the sanctions prescribed in section 90(3) of the Act. Similarly, section 91(2) of the Banks Act criminalises certain actions of directors. Directors should therefore not only be aware of the possible severe consequences of non-compliance with the above-mentioned provisions, but should also familiarise themselves with the requirements of regulation 38 and section 60(3) of the Banks Act.

consequences of non-compliance

directors' liability for debts

Directors of banks in South Africa should also take note of the recent Supreme Court of Appeal decision in the matter of Philotex (Pty) Limited and others v Snyman and others 1998(2) SA 138 (SCA), regarding directors' liability for debts of a company trading recklessly, in terms of section 424(1) of the Companies Act 1973. The court held that the standard of measuring a director's conduct is an objective one, but that subjective considerations such as a particular director's additional knowledge, experience or qualifications may be taken into account. The test is what a reasonable businessman with such additional knowledge, or with access thereto, would have done in the same circumstances.

possibility of legislature becoming prescriptive

The report of the King Committee on Corporate Governance already morally obliges directors to comply with good corporate-governance practices. Although self-regulation is seen as an acceptable goal, the seminar explored the possibility of the legislature becoming prescriptive should self-regulation not seriously address all aspects of corporate governance, including the interests of stakeholders. Such statutory provisions may embody a single corporate governance model for all banks. This may include the common law duties of care, skill and diligence, together with a statutory business judgement rule. Such provisions may bring certainty for banks and directors of banks regarding the extent of their duties and could provide creditors with more effective remedies against directors guilty of reckless or insolvent trading.

## Lessons of the East Asian crisis

need to understand local and global economy

Lessons learned from the East Asian financial crisis and the evident failure of corporate governance include the need for boards of directors to understand both their local and the global economy, as well as the impact thereof on a corporation's competitiveness. Specialist generalised managers should understand the finance, accounting, capital market, governance and regulatory functions.

regulatory standards should incorporate existing best practices

From a corporate-governance perspective, the lessons for regulators were that regulatory standards should incorporate existing best practices of corporate governance, and that regulation should obviate systemic risk, not merely ensure compliance for the sake of compliance. Creation of a secure and stable business environment requires quality and speed of administration and reform processes, maintenance of a sound ratio of wages, productivity and taxation, investment in human resources, investment in both traditional and technological infrastructure, promotion of private and domestic investment, development of international export markets and means to attract foreign investment that would add value to the economy.

Because of ongoing changes in both the business environment and legislation, there are continuous developments in corporate governance worldwide. Directors of banks will therefore have to view their responsibilities in a serious light, and boards of directors will have to fulfil their responsibilities in a structured and disciplined way.

## Reliance on auditors

importance of the relationship between the Department and the auditors

The Bank Supervision Department's policy of placing reliance on the external auditors of banks as one of the key players in the supervisory process was comprehensively discussed in the 1997 Annual Report. Although the department is planning to extend the on-site component of its supervision, there has essentially been no change in the Department's philosophy. The following developments have again highlighted the importance of the relationship between the Department and the auditors:

- As reported in Chapter 1, the Article IV Consultation Report of the International Monetary Fund, although recognising the validity of the approach of placing reliance on the auditors of banks, recommended that the Department supplement its onsite activities with a review, undertaken jointly with the auditors, of the quality of banks' assets.
- Co-operation between the Department and the auditors will be especially important in view of the expected credit problems for banks as a result of the prolonged period of high growth in credit extension, exacerbated by the recent high real interest rates.
- Auditing firms have evidently been experiencing unprecedented professional staff losses, which could cause concern in specific geographic areas and specialised teams.
- The continuing mergers of auditing firms have highlighted the need to reaffirm the existing requirement for large banks to have joint auditors.
- The Nel Commission's report was critical of the independence of auditors and their apparent emphasis on serving management, instead of the various stakeholders.

The Department, therefore, held a special meeting with most of the senior personnel involved in bank audits, in order to discuss the way forward. Amongst other things, it was agreed that:

special meeting

- A special working group would develop programmes for joint reviews of the asset quality of banks by auditors and regulators. There should be a clear distinction between the responsibilities of auditors and supervisors. In addition, the working method should emphasise efficiency and should eliminate duplication.
- The Department, banks and their auditors would develop and enter into a tripartite agreement, which would specifically help to address the various expectation-gap problems.
- The Department and the auditors would co-operate more in training auditing clerks and bank staff in the completion of DI returns.
- The criteria for a joint auditor requirement would be amended to include not only the existing monetary threshold, but also risk and complexity factors.

- The need to make a distinct separation between consulting and auditing functions would be stressed within auditing firms in order to ensure that the profession is seen to be independent.

It was also decided that the meeting would become an annual event.

## Personal account trading

variety of policies

As part of the process of assessing the adequacy of internal controls over the trading activities of banks, the Bank Supervision Department conducted a survey on the extent and control of personal account (PA) trading in banks. In general, PA trading poses a problem for trading banks, which have a variety of policies. On the one end of the scale, some banks have no rules about PA trading, whereas, on the other end, some banks do not allow PA trading at all. Most banks, however, have some rules, ranging from prior written approval to full transparency. In many banks, management is reluctant to enforce strict rules, because of the possibility of losing competent staff to banks that treat PA trading as part of the benefits of employees.

minimum industry standard should apply

Regulators around the world have definite concerns about allowing employees of financial institutions to trade for their own account. Among these concerns are the apparent conflict of interest, insider-trading opportunities and division of loyalty. It is, however, recognised that the decision whether to allow PA trading and how to control it should be left to each individual bank, but that a minimum industry standard should apply. To this end, the Department and the Financial Services Board have developed a joint position statement on the regulators' preferred approach to PA trading, including suggested guidelines for minimum industry standards. The regulators hope that the various industry co-ordinating bodies, such as The Banking Council South Africa and the Johannesburg Stock Exchange, will take note of the regulators' position when issuing minimum standards with which their members have to comply.

## BANK-FAILURE PREDICTION MODELS

need for early-warning models

The increase in international speculative capital flows has caused banking and currency crises in many countries. These crises can be extremely costly for the countries concerned. Since 1980, there have been more than a dozen banking crises in developing countries, and recent studies place the cumulative total of bail-out costs at roughly US$250 billion. The dramatic increase in individual banking difficulties and systemic banking-sector problems during the 1980s have highlighted the importance of, and the urgent need for, a system of early-warning models. Some regulators already use such models to aid in the identification of potential problem banks, and to understand the connection between banking-sector fragility and the economy. Supervisors could use such information to allocate on-site examination resources to the banks predicted to be vulnerable to problems.

indicators to provide early warning

Regulators in some countries have constructed sets of indicators to provide an early warning that a particular bank is likely to experience difficulties. These indicators consist principally of bank-specific information derived from the reports that banks make to the supervisory authority. Supervisors often use such data in conjunction with complementary statistics from other sources and qualitative indicators, many of which are based on supervisory inspections. Some regulators have constructed more complex econometric models in order to identify where severe problems are likely to develop. These empirical models identify factors that raise or reduce the probability of a bank failure in any period. The relevant characteristics are mostly bank specific, but may also incorporate sectoral and macroeconomic information.

Early-warning models have many uses and could be of great value to regulators. The accuracy of early-warning models, however, varies over time, and an appropriate set of early-warning signals will also vary across countries. Supervisors also have to take into account the limitations of applying a single bank-failure prediction model. The exposures of banks are very wide, and no single model can possibly make provision for the evaluation of all these exposures. A possible solution to this inherent weakness is to use a combination of indicators in different models covering different areas of exposure of banks. The model or combination of models used also has to capture changing bank-market conditions. Because of developments in international markets – such as globalisation, the rapid pace of deregulation of financial markets and institutions, increased international capital flows, and the growing number of market and instrument innovations – an early-warning system must have adaptive properties.

limitations of a single model

researching possible implementation

The Bank Supervision Department is researching the possible implementation of a bank-failure prediction model for South Africa.

## DEVELOPMENT-SENSITIVE LENDING

Government's intention to pass legislation similar to Community Re-investment Act

The Minister of Housing in South Africa has recently indicated Government's intention to pass legislation with a similar intent to the Community Re-investment Act (CRA) of 1977 of the United States of America.

The CRA, which is aimed at the promotion of private investment in disadvantaged communities, formed part of a package of legislation that was passed in the United States, in the 1960s and 1970s, as part of the civil rights movement aimed at preventing discriminatory practices. The package of legislation included the Fair Housing Act of 1969, the Equal Credit Opportunity Act of 1974 and the Home Mortgage Disclosure Act of 1975.

A South African delegation undertook a study tour to Washington, DC, under the auspices of the United States Agency for International Development, from 9 to 17 May 1998. The objective was to investigate CRA-type legislation and to explore the applicability of the experience in the United States to the current investment environment in South Africa.

Department will be monitoring developments

The Department of Finance has evidently accepted responsibility for the realisation of the study tour's findings, and the possible enactment of CRA-type legislation in South Africa. The Bank Supervision Department will be monitoring developments, since it will have to play a role should such legislation be enacted in South Africa. Care should be exercised not to allow directed lending.

## MICRO FINANCE

In recent years, South Africa has seen much growth in the micro-lending industry. Most players in that market, however, appear to provide much needed services to a portion of the market that has no access to formal banking services.

client profile

The client profile that gave rise to the informal finance sector typically includes those clients that are not engaged in the formal sector, that cannot offer any collateral for loans and that have an erratic income stream. Therefore, the formal financial sector, which has a responsibility to protect depositors' funds, tends to perceive the default risk of micro enterprises as being too high for the formal sector to service. Without access to finance, however, micro enterprises cannot sustain their activities. The existence of the informal financing operator is therefore due largely to the formal sector not meeting these financing needs.

micro-lending industry not regulated

Since the object of the Banks Act, 1990, is to regulate deposit taking and since micro-lenders ostensibly do not take deposits, neither the South African Reserve Bank nor the Bank Supervision Department regulates the micro-lending industry. Furthermore, since micro-lending transactions normally do not exceed R6 000, they are also not subject to the provisions of the Usury Act, 1968, and the industry is thus not regulated at all.

imperative to introduce a suitable framework for regulation

Concerns were raised about the funding of such micro-lenders and the high interest rates imposed on borrowers. It became imperative to introduce a suitable framework for the regulation of such micro-lenders in order to:

- Protect the public, especially borrowers and wholesale depositors.
- Protect the financial system against possible systemic risk.
- Build capacity by accommodating the micro-lending industry's development, in order to increase access to finance.
- Enhance the sustainability of the industry.

In an effort to create a suitable regulatory framework, discussions were held with interested parties. It became clear that the most suitable framework for the regulation of micro-lenders would be one based on the principles of self-regulation. The framework identified by the parties concerned entails, amongst others:

most suitable framework entails

- An association not for gain, styled the Small Loans Regulatory Council (SLRC), will be incorporated in terms of section 21 of the Companies Act, 1973.

  Designated officials of the interested parties referred to above, as well as an official of the Bank Supervision Department, will be appointed as directors of the SLRC for regulatory purposes. Micro-lenders will be required to register with the SLRC in order to enable them lawfully to conduct their business, including taking of wholesale deposits.

- The Registrar of Banks, with the approval of the Minister of Finance, will issue a notice under paragraph (cc) of the definition of "the business of a bank", in section 1 of the Banks Act, designating micro-lenders that are affiliated to the SLRC as persons that are authorised, subject to appropriate conditions, to take deposits from the wholesale market.

  Micro-lenders that are not affiliated to the SLRC would therefore not be allowed to take wholesale deposits in South Africa, and it would be possible to action against such non-affiliated micro-lenders. This implies that micro-lenders that are affiliated to the SLRC should conduct their business subject to a code of conduct, suitable conditions and a regulatory framework.

proposed exemption notice in terms of Usury Act

In a related development, the Minister of Trade and Industry intends to raise the loan ceiling for registered moneylenders that comply with laid-down conditions from R6 000 to R50 000, by exempting money-lending transactions that do not exceed R50 000 from the ambit of the Usury Act. In addition, the intention is to eradicate certain harmful practices. A proposed exemption notice in terms of section 15A of the Usury Act was published in *Government Gazette* No. 19457 on 13 November 1998, inviting comment and representations. This will not only enable the micro-lending industry to increase its lending activity, but also help to put a stop to some of the harmful practices of the industry.

## CREDIT RISK

most important risk

The events of the past year have again emphasised that credit risk remains the single most important risk that banks face. It is therefore vital that banks continue to exercise prudent credit-risk management, especially in an increasingly competitive environment.

### Asset quality

In the 1997 Annual Report, the Bank Supervision Department expressed its concern about the increase in overdue accounts of many South African banks, especially in the instalment-credit area. During 1998, overdue accounts continued to increase at a rate that was of concern to the Department. The area that is most affected is the "other loans and advances" area, that is all loans and advances, except for instalment and mortgage loans. Therefore, and because of the effects of the East Asian crisis and the sharp increase in interest rates to record levels in the middle of 1998, the Department placed particular emphasis on the quality of assets during the latter half of 1998 and will continue to do so during 1999.

particular emphasis on the quality of assets

The South African banking sector has, however, proved to be remarkably resilient against the global financial turmoil and its impact on local economic conditions. Several banks introduced innovative products to ease the increased burden that the record high interest rates would have on, for example, home owners, who have for many years had to bear high interest rates. The psychological effect of the increase in interest rates on the consumer should not be underestimated, since all indications were that interest rates were on the decline before the sharp mid-year increases.

Interest rates, however, again declined to some extent in the last quarter of 1998. It is hoped that this trend will continue and, thereby, ease the pressure on consumers and slow down the increase in overdue and arrear accounts.

### Maximum usury rate

maximum usury rate was increased in mid-August 1998

During June 1998, the prime overdraft interest rate rose by 5 percentage points, because of the currency crisis. Amongst many other consequences, banks could in many cases not speedily raise their rates because of the ceiling placed on interest rates by the Usury Act, 1968. Until the maximum usury rate was increased in mid-August 1998, higher risk debtors were paying the same interest rates as lower risk debtors, thereby distorting the credit-risk management process and cost structure of banks.

In considering the increase in the maximum usury rate, the Minister of Trade and Industry indicated that the formula used in the calculation of the usury rates would be reviewed. The new rate would be based on the market cost of capital to the banking sector, rather than on the prime rate. The data would be obtained from the Bank Supervision Department's database, and the maximum finance charges would be adjusted quarterly.

formula not yet finalised

The currently applicable data on the cost of funding of the banking sector have been supplied to the Department of Trade and Industry. The formula used to arrive at a quarterly maximum finance charge rate has, however, not yet been finalised. Since the South African Reserve Bank's Economics Department developed the original formula after extensive research, the Department of Trade and Industry has requested the Reserve Bank to propose an amended formula. Because of the change in conceptual approach, however, some further research is necessary. The Bank Supervision Department will facilitate the process and recommend a revised formula that can be justified on scientific grounds.

## BANKS' MARGINS

independent study into bank margins

During the year under review, a wave of criticism was directed at the level of profitability of the local banking industry in the face of high interest rates threatening to push the economy into recession. In July 1998, the South African Reserve Bank, therefore, commissioned an independent study into bank margins. The study, entitled "Bank margins and related profitability in South Africa", was undertaken by KPMG and was approved by the Ministry of Finance. The findings were reported to the Registrar of Banks in November 1998.

determinants of bank interest margins and profitability

The report covered the determinants of bank interest margins and profitability, based on empirical research of banks in 80 countries, including 15 banks in South Africa, covering the period 1988 to 1995. Amongst other things, the report focused specifically on bank margins and the relationship to profitability of the four major banks in the South African market. Since return on equity (ROE) was identified as being the significant performance measure, the banks' profitability was reviewed on that basis. The study established that South African banks were currently not achieving excessive ROEs.

banks not achieving excessive ROEs

The individual components of the ROE calculation were then reviewed in more detail, in order to identify the factors contributing to the current profit levels. Because the components of ROE are interrelated, one cannot focus on an individual component and ignore the others. One has to review the size of interest margins in the context of, firstly, the levels of credit losses influenced by the high interest-rate environment and significant levels of unemployment and, secondly, high operating costs. The high cost structures of South African banks are due in large part to the high crime rate - cash heists, robberies and white-collar crime are costing banks over R1 billion per annum. In addition, South African banks maintain large infrastructures in the form of extended and geographically spread branch networks, which are costly to establish and maintain.

high cost structures and large infrastructures

It became clear that the four major banks in South Africa were achieving returns close to the minimum returns required by the CAPM (capital asset pricing model). If banks were to decrease their interest margins, these minimum returns would not be achieved unless banks' non-interest income increased, their operating costs decreased or their bad-debt write-offs decreased.

return required drives the size of the interest margin

These results are consistent with the findings of an international empirical study on the determinants of bank interest margins and profitability conducted by the Development Research Group of the World Bank. The margins of South African banks also remain fairly stable under varying interest-rate scenarios. This indicates that it is not the interest-rate environment, but rather the return required to service the providers of capital, that drives the size of the interest margin. It follows that the traditional intermediation function of banks is not profitable, mainly because the net interest margins of banks are not sufficient to cover operating expenses.

bank margins reflect the risks

As regards interest margins in other countries, it should be borne in mind that it is not appropriate to compare the margins of South African banks to those of certain large banks in the United States of America and Europe. Bank margins reflect the risks to which banks are exposed. The South African banking sector operates in an emerging market and is exposed to higher inherent risks, leading to a risk premium. This, in turn, results in wider margins than those in stronger, more stable economies. The margins of South African banks, however, compare favourably with those in comparative countries. When one compares interest margins in South Africa with those in other emerging markets – for example, Argentina (5,0 per cent), India (3,5 per cent) and Mexico (4,4 per cent) – South Africa is at the lower end of the scale, with margins averaging below 4 per cent.

South African banks compare favourably with comparative countries

## SCRIP LENDING AND BORROWING

scrip lending and borrowing might amount to between R5 billion and R15 billion.

Scrip lending and borrowing are an essential element in every liquid stock exchange. In fact, without scrip lending and borrowing, stock exchanges would find it very difficult to maintain smooth flows of trading activity. In recent years, a number of South African financial institutions have entered the business of acting as agents in facilitating scrip-borrowing transactions. Although there has been a considerable amount of research on scrip lending in South Africa, it is not yet possible to obtain full details of the extent thereof. The consensus, however, is that scrip lending and borrowing might on average amount to between R5 billion and R15 billion. The majority of these transactions involve stockbrokers borrowing scrip to make up a delivery quantity in order to manage their cash flow.

The current rules on scrip borrowing or lending on the Johannesburg Stock Exchange (JSE) prescribe only the circumstances under which a member of the JSE can use clients' scrip in a borrowing transaction. These rules are currently being reviewed, and the proposed revised rules would provide for:

model legislative provisions on judicial co-operation

- Scrip-borrowing contracts to be standardised in a form approved by the JSE Committee.
- Scrip-borrowing transactions to be processed through the JSE clearing house and centralised computer systems and to be clearly identified as scrip-borrowing transactions.

▲ Scrip-borrowing transactions to be restricted to transactions between members or transactions involving institutions registered by the Financial Services Board (FSB) or the Registrar of Banks.

▲ The borrower to provide cash security of no less than 110 per cent of the value of the underlying securities.

lenders retain the full risk and rewards of ownership

In a scrip-borrowing transaction, lenders retain the full risk and rewards of ownership in that they fully participate in the market movement of their investment and are compensated for any dividend payments. Lenders do, however, run the risk that their scrip will not be returned to them on conclusion of a transaction or when they call for the return of their scrip. Such situations would arise if intermediaries fail to perform under their guarantee and if borrowers fail to return the scrip. If borrowers fail to perform, the intermediaries are required to buy in the securities, from the collateral security (including margin) that they are holding, and to deliver to the lenders. Lenders, therefore, have to satisfy themselves as to the creditworthiness of an intermediary or borrower or, preferably, both. In addition, lenders have to ensure that a scrip-borrowing contract is legally enforceable. It is suggested that scrip borrowing by institutions is an acceptable business practice on condition that such institutions properly manage the consequential risks.

disclosure of scrip-lending positions

As regards disclosure of scrip-lending positions, there is general agreement that institutions should disclose these positions in their financial reports. Opinions on the form and extent of such disclosure, however, differ. Since this matter needs to be resolved, it may be necessary for the accounting profession to issue guidance in this regard. The South African Institute of Chartered Accountants has undertaken to issue guidelines on such disclosure shortly.

additional regulations early in 2000

In line with a call for limited regulatory changes by the Joint Year 2000 Council of the Bank for International Settlements, the Bank Supervision Department intends to implement additional regulations early in 2000, in order to monitor the extent of banks' scrip-lending and scrip-borrowing transactions. It is envisaged that banks will be required to furnish the Registrar with information on securities lent to, and borrowed from, banks and non-banks, respectively. A distinction would also be made between residents and non-residents. Once more information on scrip lending and borrowing is available, possible further regulatory measures might be developed should this be dictated by possible systemic risk.

## MARKET RISK

As reported in the 1997 Annual Report, banks conducting securities trading activities were requested to calculate capital-adequacy requirements in respect of such activities on a pilot-project basis, as from 1 January 1996. On completion of the pilot project, the Regulations relating to Capital-adequacy Requirements ("CAR") for Banks' Trading Activities in Financial Instruments were promulgated in *Government Gazette* No. 19165 on 21 August 1998.

CAR Regulations with effect from 1 October 1998

In terms of the CAR Regulations, trading banks have been required to calculate and report capital-adequacy requirements with effect from 1 October 1998. The Bank Supervision Department will continue to satisfy itself that the CAR Regulations are interpreted and applied correctly, in order to ensure that banks calculate and report the correct capital requirements in respect of market risk.

evaluation of internal models

Thus far, the Department has received only a few official requests for the evaluation of internal models for the calculation of banks' capital-adequacy requirements, and has given only one bank permission to use such an internal model. The Department, however, envisages that it will receive more such requests during the coming year.

evaluated the risk-management procedures and internal controls

As part of its supervisory duties, the Department evaluated the risk-management procedures and internal controls that have been instituted by banks trading in securities in South Africa. During the first half of 1999, the Department will evaluate the valuation and risk-aggregation models used by these trading banks. The objective is to identify any deficiencies in the trading-bank industry and to take corrective action in order to eliminate systemic risk.

objective is to identify any deficiencies

The Department will also place more emphasis on on-site supervision, as well as ongoing surveillance, of banks' market risk. In this regard, the Department envisages introducing a procedure of surveillance that would require banks to report their trading positions to the Department on a daily basis.

ongoing surveillance

The Department will continue to ensure that there are no regulatory gaps between the different regulators, and that the standards set by the Department comply with international standards at all times.

## OPERATIONAL RISK

The Bank Supervision Department's risk-management approach to supervising banks involves unbundling the risks of a bank into various categories and analysing each category in order to assess the risk to the system. One of the risk categories is operational risk, which was the topic of the annual trilateral discussions between the Department, each individual bank and its external auditors in respect of the 1994 calendar year. At the time, operational risk was defined very widely to mean all risks, except liquidity risk, interest-rate risk, market (price) risk, credit risk (including counterparty risk) and currency risk. In terms of that definition, operational risk would have a mainly indirect financial impact on an institution. The Department did not expect a bank to identify more than five components of operational risk or to include detailed issues. The process, however, enabled the Department to gain a better understanding of the operational risk to which banks are exposed and how these risks are managed.

becoming an important feature

Operational risk remains an important topic in the overall management of banks' risks. Since management of operational risk is becoming an important feature of sound risk-management practice in modern financial markets, the Basle Committee on Banking Supervision initiated research in that regard. The Basle Committee identified the most important types of operational risk to include breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failures to perform in a timely manner, or cause the interests of the bank to be compromised in some other way. Other aspects of operational risk include major failure of information technology systems – one need think only of the year 2000 computer problem – or events such as major fires or other disasters.

include breakdowns in internal controls and corporate governance

In September 1998, a working group of the Basle Committee published a report on operational-risk management. The working group interviewed approximately thirty major banks from different member countries about the management of operational risk. Several common themes emerged during these discussions:

common themes

- Awareness of operational risk among bank boards and senior management was increasing. Virtually all banks were assigning primary responsibility for the management of operational risk to the business line head.
- Although all banks surveyed had some framework for managing operational risk, many banks indicated that they were only in the early stages of developing an operational-risk measurement and monitoring framework. Most of the banks surveyed had only recently become aware of operational risk as a separate risk category.
- Many banks had identified significant conceptual issues and data needs, which would need to be addressed in order to develop general measures of operational risk. Unlike market risk and, perhaps, credit risk, operational-risk factors are largely internal to a bank, and there is no clear mathematical or statistical link between individual risk factors and the likelihood and size of operational loss.

The working group also looked into management oversight, risk measurement, monitoring and management information systems, policies and procedures, internal controls and the possible role of supervisors. The Bank Supervision Department will continue to monitor developments.

measurement and monitoring

The Department regards operational risk as an important factor in the overall risk-management process of a bank. Ongoing emphasis will be placed on the measurement and monitoring of operational risk in the coming year, in order to raise and sustain the level of awareness thereof, particularly with regard to the year 2000 problem, discussed below.

## YEAR 2000 COMPLIANCE

business continuity risk

The Bank Supervision Department's risk-management approach to supervision, discussed above, explains the Department's relatively early involvement in the year 2000 (Y2K) preparedness of banks. The risks inherent in a bank not being Y2K compliant may be seen as a subcategory of operational risk, namely, business continuity risk.

### Efforts to ensure the Y2K compliance of banking institutions

activities of three types

The activities of the Department in ensuring the Y2K compliance of banks have to date been primarily of three types: enhancing awareness of the problem and its possible implications, providing guidelines on how the problem might be managed, and monitoring the progress of banks in ensuring their readiness for the date change. The Department issued the first circular on Y2K compliance, Banks Act Circular 12/96, in September 1996. The objective was to ensure that all banking institutions were aware of the problems posed by the year 2000 date change, and to require banks to implement the necessary measures to manage the technological risk. Generally, banks were already aware of the Y2K problem. In the few cases of banks not yet having taken action, the circular served as a catalyst to escalate the priority given to the issue and to initiate proper change-management projects.

special Y2K prudential meetings

The second Y2K circular, Banks Act Circular 8/97, was issued in September 1997. It required banking institutions to complete a questionnaire on their Y2K preparedness. The analysis of the results of this survey, together with the special Y2K prudential meetings held with the management of each banking institutions throughout the first quarter of 1998, showed that most banking institutions, in isolation, were likely to be in a position to continue with business as usual after 1 January 2000, provided that critical utility services were available. This still left the question of the external interfaces of banks' systems.

guidance on testing and contingency planning

During September 1998, the third Y2K circular, Banks Act Circular 9/98, was issued. In this circular, the Department gave guidance on, amongst other issues, testing and contingency planning, and required the boards of directors to furnish a number of reports. The circular also explained the Department's internal system to rate the preparedness of banking institutions, and mentioned some possible outcomes and enforcement measures to be considered by the Department in cases of a banking institution being rated as less than satisfactory and not making sufficient progress towards correcting the situation.

Department will continue micro-level activities

During 1999, the Department will continue, and even intensify, the above-mentioned micro-level activities. The Registrar has reaffirmed his commitment to protecting the system from being adversely affected by any bank that is not prepared, and he will not hesitate to take whatever action is necessary to remove an errant bank from the system before the risk materialises.

will broaden activities to include micro-level involvement

The Department will broaden its Y2K-related activities to include macro-level involvement in issues such as:

- Facilitation of non-competitive co-operation between banks, and between banks collectively and other industries. Based on anecdotal evidence, there are considerable opportunities for lessening the risk if banks, their clients and their service providers are prepared to co-operate for the good of the system.

- Encouraging disclosure of information on the Y2K preparedness of individual banks and the industry. The Department will consider making disclosure mandatory, but is conscious of the value of voluntary disclosure as a counter to market speculation at the slightest sign of bad news. The Department firmly believes that full disclosure, even of bad news, will result in a less dramatic effect on the system than unavailability of information and the market, therefore, assuming the worst.

- Facilitation of testing programmes between market participants in the financial sector, and other sectors of the economy. The Department is conscious of the need for integration testing on the one hand and the danger of inertia on the other as participants contemplate the complexity of somehow providing deep integration testing - for instance, testing of a transaction from point to point, even through the shared payment systems.

wishes to monitor progress

In the above regard, the Department wishes to stress that it will not take over the responsibility of any national or other Y2K initiative. The Department merely wishes to monitor progress and, in the interest of the system, apply its resources as a catalyst to get the process started in those cases in which it seems to be stalled.

### Bank Supervision Department's own Y2K preparedness

all mission-critical systems found to be Y2K compliant

In the interest of open voluntary disclosure, the Department is pleased to report that, by the end of November 1998, all its mission-critical systems had been identified, remedied, and tested and found to be Y2K compliant in terms of the internationally accepted definition of Y2K compliance.

external testing of the electronic data-interchange system

External testing of the electronic data-interchange system for the exchange of statutory supervisory data with banking institutions will commence in January 1999. Like all other users of technology, the Bank Supervision Department is dependent on internal and external service providers. The Department is satisfied that the South African Reserve Bank's internal service providers are meeting their targets and are likely to deliver a full service throughout the critical period. As regards dependencies on external service providers, negotiations are still ongoing. The Department is, however, in the fortunate position of having the necessary contingency plans to enable it to continue for an extended period using alternate means of processing data in support of its key functions.

### Other functions of the South African Reserve Bank

availability of currency

This report is not the appropriate forum to address the Y2K preparedness of the South African Reserve Bank as a whole or its ability to continue with its functions throughout the changeover period. The function of providing legal tender is, however, such an emotive issue amongst the general public that the Department would like to take this opportunity to allay some fears about the availability of currency in the build-up to the year 2000. The bank-note print orders have already been placed, and make ample provision for the worst-case scenario of significant flight to cash. As an additional measure, the Reserve Bank also has the option of modifying note-sorting quality parameters – that is, the point at which a note is replaced by a new one. This alone can ensure that the notes that are held ready for reissue will be sufficient for any eventuality.

## MODERNISATION OF PAYMENT SYSTEM

During 1998, the South African banking industry implemented further aspects of the broad National Payment System (NPS) strategy, which was accepted in 1995. In order to enhance the national payment system and to address the risk of contagion, various payment-system practices and organisational arrangements, such as the introduction of settlement-risk-reduction measures, the adoption of a legal framework and the enhancement of the functioning of the monetary-policy process, were addressed. The Payments Association of South Africa also implemented further self-regulatory structures, as well as arrangements and agreements, which enable it to manage and control payment-related aspects.

SAMOS system

One of the major components of the payment-system modernisation initiative was the introduction of the South African Multiple Option Settlement (SAMOS) system on 9 March 1998. The SAMOS system is an electronic real-time interbank settlement system, providing for immediate gross settlement options. The gross settlement option, called the real-time line, provides for immediate finality and irrevocability of payment once interbank transactions are settled. As from 5 October 1998, immediate intraday finality of payment between banks has been ensured through the "immediate finality window". For this purpose, the banks' settlement accounts have to be prefunded, that is, before a bank transmits a settlement instruction to the SAMOS system, funds have to be available in the settlement account of such a bank. A bank has a number of funding options available for its settlement account. A bank can:

immediate intraday finality of payment

funding options

- Borrow from the interbank market.
- Utilise its own funds.
- Borrow against acceptable collateral from the South African Reserve Bank (SARB), on the SAMOS loan account.
- Utilise its required cash-reserve funds or liquid-asset holdings as collateral to obtain funds from the SARB.
- Acquire funds under the repurchase-agreement mechanism, which is the mechanism that the SARB uses for the execution of monetary policy.

require amendments to the Banks Act

These funding options require amendments to the Banks Act, 1990, regarding, for example, the instruments that qualify as liquid assets of a bank and arrangements for the pledging of instruments that qualify as liquid assets in order to obtain funding, as discussed in Chapter 4 of this report.

National Payment System Act, 1998

The National Payment System Act, 1998 (Act No. 78 of 1998), was promulgated on 28 October 1998, after it had been tabled in Parliament earlier in the year and had been considered by the Portfolio Committee on Finance, as well as the Select Committee on Finance of the National Council of Provinces. The NPS Act ensures finality and irrevocability of settlement and provides the SARB with, amongst other matters, the statutory powers to oversee the safety and soundness of the payment system.

strategic framework for the financial markets' infrastructure

During the year under review, officials of the SARB, securities markets and banking industry started drafting a strategic framework for the financial markets' infrastructure, along the lines of the NPS strategy. The infrastructure strategy will enable the trading and settlement of financial instruments in South Africa in accordance with best practices in leading international financial markets. An important aim is to achieve delivery versus payment in the securities markets and, thereby, reduce market-settlement risk.

same-day settlement in 1999

One of the remaining obstacles to full payment-system modernisation in South Africa is the practice of "next-day settlement". Currently, final end-of-day settlement takes place only on the morning following the overnight clearing process. The intention is to implement same-day settlement in 1999. Same-day settlement refers to the settlement of high-value interbank settlement obligations on the same calendar date.

The payment-system modernisation initiatives will not only enhance South Africa's standing in the global economy, but will also bring the financial system infrastructure in line with international standards. At the same time, these initiatives will also enhance the management and containment of systemic risk.

## ELECTRONIC SETTLEMENT OF SHARE TRANSACTIONS

physical handling

Currently, both the transfer of shares and the settlement of share transactions in South Africa are paper based. The physical handling of share certificates and transfer deeds, therefore, plays an important role. Broadly speaking, attempts in international jurisdictions to reduce the physical movement of paper involve immobilisation or dematerialisation of share certificates and the electronic acquisition of membership and transfer of ownership of securities.

implementation of STRATE system

book entries would represent shareholdings

A significant development during the coming year will be the implementation of the STRATE (Share Transactions Totally Electronic) system of the Johannesburg Stock Exchange. The STRATE system will provide a secure electronic settlement environment for share transactions. There will thus be no need for share certificates, ownership transfer deeds and cheque payments, thereby eliminating a significant source of fraud. In terms of the proposed section 91a to be inserted in the Companies Act, 1973, certificates that have been deposited in the Central Securities Depository (CSD) would be cancelled. Instead, book entries in the accounts maintained by the participants that act for the relevant depositors would represent shareholdings.

The accounts maintained by participants would be statutorily recognised as subregisters and would form part of the main register of the company in which shares are held. In this manner:

- Entries in the accounts maintained by participants would be equivalent to entries in the main register of the company.
- Depositors would be regarded as members of the company and would not lose their direct rights in the company by depositing shares in the CSD.
- Acquisition of membership and transfer of ownership would be effected electronically.
- A depositor would have the option to deposit shares either in the name of a nominee account in the records of a participant, or in an account in the depositor's own name. In the former case, the nominee would be recognised as a member of the company in the same manner as registered nominees are currently so recognised.

banks are primary participants and banks will benefit

The STRATE system will have an impact on banks, because they are the primary participants in the system. Banks will benefit directly because of efficiencies, fraud-risk reduction, and cost reduction, and indirectly because of increased volumes as the secure settlement environment of the securities market becomes a regional phenomenon.

operational risk and the risk of tainted scrip

Banks will be affected negatively if they do not manage the risks appropriately. The primary risks are operational risk and the risk of tainted scrip being introduced into the system. In the first case, banks will have to satisfy themselves that the necessary contingency measures are in place in the event of the system not functioning. As regards the second risk, both banks and their regulators will have to ensure that sufficient capital is allocated to banks' securities activities to cover any potential losses that may result from tainted scrip being introduced into the system.

Banks Act exclusion

In terms of section 78(1)(d)(iii) of the Banks Act, 1990, "a bank shall hold all its assets in its own name, excluding any asset falling within a category of assets designated by the Registrar by notice in the Gazette as a category of assets which may be held in the name of another person". In order to prevent the possible contravention of the aforementioned section by banks, the Registrar of Banks issued Government Notice No. 631, published in *Government Gazette* No. 17949 on 3 May 1997. In terms of the exclusion provided for in paragraph 2(b) of the notice, a bank may now deposit its own securities with the CSD and may register such securities in the name of that CSD or a wholly owned subsidiary thereof that has been approved by the Registrar of Financial Markets. A bank may also deposit its own securities with a depository institution or a participant for safe custody. Such securities may be registered in the name of a wholly owned subsidiary of such institution or participant, provided the Registrar of Banks has approved the subsidiary in writing. If, however, a bank holds securities on behalf of its clients, the approval of the Registrar of Banks is not necessary, since the bank holds such securities in the normal course and scope of its business.