CHAPTER 2

CURRENT ISSUES IN BANKING SUPERVISION

As in previous years, this chapter presents an overview of some of the most important regulatory and supervisory trends and developments, at international and local level, during the year under review. Among the issues that remained particularly important were the proposed new Capital Accord, compliance with international and local standards, liaison with other regulatory and supervisory authorities, locally and elsewhere, and access to finance for all in South Africa.

FURTHER DEVELOPMENTS WITH NEW CAPITAL ACCORD

The previous two Annual Reports addressed the need for a new capital requirement and comprehensively explained the three pillars comprising the new Basel Capital Accord. Since then, the Basel Committee on Banking Supervision has made further developments towards the finalisation of the new Capital Accord.

second consultative (CP2) document

In January 2001, the Basel Committee released a second consultative (CP2) document for comment, by 31 May 2001. The Basel Committee received comments from approximately 270 sources, including financial institutions, banking and financial-industry associations, supervisory authorities, central banks, rating agencies and multilateral development banks. Among the main comments made by these institutions (other than the Bank Supervision Department, the comments of which are detailed separately below) were the following:

main documents on CP2

- In general, responding institutions supported the Basel Committee's goal of, firstly, maintaining an amount of regulatory capital (inclusive of operational risk) equivalent to the 1988 Accord for banks using the standardised approach and, secondly, providing a capital incentive for banks to move along the spectrum of approaches. Many institutions, however, strongly argued that, based on preliminary results, the current proposal did not appear to satisfy these goals. In particular, capital charges under the standardised approach would appear to exceed those obtained under the 1988 Accord. Capital requirements under the foundation internal ratings-based (IRB) approach were likely to exceed, by a large amount, those produced under the revised standardised approach. Therefore, there did not appear to be any incentive to move beyond the standardised approach.

- A significant number of institutions broadly welcomed the IRB approach as a critical step in more closely aligning the capital requirement and credit risk. The framework was also regarded as being consistent with the economic capital models used by sophisticated banks.

- A number of institutions expressed concern that the new Accord might inadvertently increase capital requirements on exposures to small and medium-sized enterprises (SMEs). An overall increase in funding costs for SMEs might be inevitable and threaten their fundamental role in many economic markets.

- In general, the institutions were positive about the standardised approach. Some, however, were of the opinion that the proposals remained overly complex for smaller, emerging-market banks to implement.
- A significant number of institutions expressed strong concern about the application of

- A significant number of institutions expressed strong concern about the application of the "w" factor for collateralised transactions. They indicated that risks addressed by "w" appeared to be captured within the capital requirements for operational risk, thereby, in effect, double counting these charges. The "w" factor was intended to capture residual risk in collateralised transactions. The residual risks relate to, firstly, the type of collateral and, secondly, the process on which the collateralised transaction is based. In both cases, however, there is a risk that the collateral may turn out to be worthless, since it may be of a type that is impossible to liquidate, or the process for realising the collateral may be subject to uncertainty. Consequently, an exposure that appears to be secured may turn out to unsecured.

- The responding institutions welcomed the recognition of a spectrum of approaches to operational risk, since this would provide banks with incentives to adopt more sophisticated risk-management practices.

- A number of institutions recognised that the absence of sufficient loss data made it difficult to calibrate each option.

- An operational-risk charge calibrated at 20 per cent of total capital would increase the overall capital requirement relative to the 1988 Accord for the average bank.

- The responding institutions generally advocated the introduction of adjustments to reflect the qualitative factors influencing operational risk, in particular a bank's internal control environment.

- The principles embodied in pillar 2, relating to a process of supervisory review, were generally welcomed.

- With respect to pillar 3, the responding institutions strongly supported more transparent bank disclosure as an essential ingredient in promoting a sound regulatory framework. A significant number, however, were of the opinion that the level of information required exceeded the amount needed to promote market discipline. They were also concerned that the disclosure requirements were likely to impose significant costs on banks.

comments of Bank Supervision Department

Besides generally supporting some of the comments on the new Accord outlined above, the comments of the Bank Supervision Department included, amongst others, that:

- The Department welcomed and strongly supported the introduction of three mutually reinforcing pillars.

- The complexity of the new Accord might prove to be problematical within the context of an emerging-market environment.

- The level of skills and the resource requirements that the new Accord imposed on the Bank Supervision Department and banks, especially within the context of a skill shortage in South Africa, were of concern.

- Insufficient data relating to credit and operational risk were available.

quantitive impact studies

Taking cognisance of the myriad of comments, the Basel Committee embarked on several quantitative impact studies (QIS), the objective being to gather the data necessary to allow the Committee to gauge the impact of the proposal for capital requirements set out in CP2. Taking the comments into consideration, together with an analysis of the results of the QIS,

various modifications

the Basel Committee considered various modifications to the new Accord. The modifications were presented in the form of several working papers, which were released for comment by interested parties. These working papers included the following, amongst others:

working papers

- IRB treatment of expected and future margin income (30 July 2001).
- Risk sensitivities approaches for equity exposures in the banking book for IRB banks (7 August 2001).
- Pillar 3 – market discipline (28 September 2001).
- Regulatory treatment of operational risk (28 September 2001).
- Internal ratings-based approach to specialised lending exposures (5 October 2001).
- Treatment of asset securitisation (12 October 2001).

additional review will focus on three issues

In line with its revised approach to finalising the new Accord, the Basel Committee plans to undertake an additional review, aimed at assessing the overall impact of a new Accord on banks and the banking system, before releasing the next consultative paper (CP3). During this review, the Committee's work will focus on three issues:

- Balancing the need for a risk-sensitive Accord with its being sufficiently clear and flexible to enable banks to use it effectively.
- Ensuring that the Accord leads to appropriate treatment of credit to SMEs, which are important for economic growth and job creation.
- Finalising the calibration of the minimum capital requirements to bring about a level of capital that, on average, is approximately equal to the requirements of the present Basel Accord, whilst providing some incentives to those banks using the more risk-sensitive IRB system.

further QIS planned

A further comprehensive QIS is also planned. The qualitative review and the QIS will form the basis upon which modifications to the new Accord will be effected. After incorporating the results, the Basel Committee will release the draft proposal (CP3) for a consultative period. The Committee, however, does not believe that its additional review process will be lengthy, and the final Accord is still expected to be released during 2002, for implementation in 2005.

detailed study to determine changes required to current bank-supervisory process

The Bank Supervision Department is of the view that the general framework of the new Accord will not change materially subsequent to modifications emanating from the Basel Committee's QIS and qualitative review. Accordingly, the Department has dedicated a staff member to the task of assessing and implementing the new Capital Accord and providing guidelines to the banking industry. Current plans are to conduct a detailed study of the new Accord and to determine the changes required to the current bank-supervisory process. It is anticipated that a comprehensive project plan will be in place when the final Accord is released.

The Bank Supervision Department is also endeavouring to engage the banking industry through quarterly seminars and by the formation of an interest group/steering committee, at which implementation issues will be discussed freely and constructively with banks. It is envisaged that this forum will be coordinated through The Banking Council South Africa.

IMPORTANCE OF GOOD CORPORATE GOVERNANCE

The importance of and focus on good corporate-governance practices have continued to increase globally during the past decade. The social responsibility of companies has also become a central issue worldwide and is increasing in significance as institutions grow larger, thereby affecting greater portions of society. Institutions should therefore be not managed purely to satisfy the needs of their shareholders, but with due regard of the interests of all stakeholders. Currently, however, the provisions of the Companies Act, 1973, in South Africa do not adequately provide for the management of a company's affairs in a manner that strikes a balance between the interests of stakeholders other than the company's shareholders. In the case of banks, in particular, it is generally held, however, that the interests of depositors should be paramount.

due regard of interests of all stockholders

As the custodians of the public's funds, banks have a particular responsibility to safeguard their integrity and credibility. The confidence of the public in the safety of their deposits and in the integrity and professional conduct of their bankers is essential to the business of all banks. This public trust means that the managers of banks bear a great responsibility towards depositors and have to ensure that their institutions are professionally managed and soundly based. The directors and management of a bank, therefore, must conduct their business with the highest level of care and skill.

confidence of the public is essential

In order not only to address the above-mentioned developments, but to provide clarification of how directors and management should conduct business, a number of reports on corporate governance were released worldwide. In South Africa, the King Committee on Corporate Governance produced a report (King 1 report) and a draft second report (King 2 report) in 1994 and 2001, respectively. The King 1 report represented a response to a worldwide demand for greater accountability and transparency by companies. The objective of the report was to promote high standards of corporate governance in South Africa. The draft King 2 report, issued for comment in July 2001, maintains this philosophy. The report, however, also takes account of developments since the release of the first report, such as socio-political transformation, legislation and the role of information technology in decision making. The King 2 report places a particular focus on risk management and the crucial responsibilities of directors in this process as a whole, including the system of internal control. Specific guidelines on risk and non-financial management are also introduced. In practising good corporate governance, companies are expected to focus not only on financial issues, but also on societal and environmental issues.

King 2 report

particular focus on risk management and responsibilities of directors

The draft King 2 report highlights seven primary characteristics of good corporate governance, namely, corporate discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. These primary characteristics of good corporate governance have far reaching implications for the manner in which the boards of directors and management of companies should conduct their business. Furthermore, the increasing emphasis that international investors are placing on good corporate governance and should not be underestimated by any country or regulatory authority. Poor corporate governance within a financial system is often given as an important reason for investors' withdrawal of their funds from a country.

seven primary characteristics of good corporate governance

In the light of the crucial role of good corporate governance in the soundness of the banking and financial systems, the Bank Supervision Department has committed itself to enhancing corporate governance in the South African banking system, in line with local and international developments. As mentioned in the previous Annual Report and elsewhere in this Report, amended Regulations relating to Banks were implemented on 1 January 2001. These amended Regulations include a chapter dealing specifically with corporate governance. Among the issues addressed are the maintenance of effective risk management by

amended Regulations include a chapter dealing with corporate governance

banks, guidelines relating to the conduct of directors, a statement relating to the attributes of serving or prospective directors or executive officers and the introduction of an independent compliance function into each bank. These measures serve as an indication of the Department's commitment to the application of good corporate-governance standards in the banking system in South Africa.

changes to the Banks Act are contemplated

A number of changes to the Banks Act are also contemplated to incorporate the application of good corporate governance into the Act. The proposed changes are further intended to provide clarity regarding the principles of good corporate governance set out in the King 2 report. The Bank Supervision Department hopes that the amended legal framework will not only promote proper corporate-governance behaviour in the directors and management of banks, but will also enable the Department to enforce such behaviour when appropriate and necessary.

LEGAL BACKING FOR ACCOUNTING STANDARDS

The report of the King Committee on Corporate Governance, issued in November 1994, recommended that there should be legal backing for accounting standards, from which there should be departure only in the interests of fair presentation. This recommendation was repeated in the draft second report of the King Committee, discussed above. The revised Listing Requirements of the JSE Securities Exchange South Africa, which became effective on 2 October 2000, also require listed companies to prepare annual financial statements and group annual financial statements in accordance with the South African Statements of Generally Accepted Accounting Practice (Statements of GAAP), or International Accounting Standards, approved by the International Accounting Standards Committee. Furthermore, local and foreign users of annual financial statements, including rating agencies, require assurance that there is compliance with accounting standards and that the force of law requires such compliance.

compliance with accounting standards

Legal opinions that the South African Institute of Chartered Accountants (SAICA) obtained in 1977 and 1987 confirmed that Statements of GAAP constituted generally accepted accounting practice. In both opinions, however, senior counsel stated that other practices not codified in Statements of GAAP might also constitute generally accepted accounting practice, since the concept of GAAP allowed for such flexibility. This dichotomy could result in unsound practices being sanctioned purely because they have been adopted by several enterprises.

The Standing Advisory Committee on Company Law, therefore, embarked on the task of providing legal backing for accounting standards and of facilitating the monitoring of institutions' compliance with the standards set out in the Statements of GAAP.

Proposed amendments to Companies Act, 1973

The steps envisaged in order to achieve legal backing for accounting standards include, amongst others, amendments to the Companies Act, 1973. Among the most important of these amendments are the following:

most important amendments

- Amendment of sections 286(2) and 286(3) of the Companies Act to require, amongst others, that annual financial statements consist of the components required by and comply with the financial reporting standards laid down by a new body, the Financial Standards Reporting Council (FSRC), under a new Act, the Financial Reporting Act (FR Act), and include a director's report and an auditor's report complying with the requirements of the Companies Act.

- Insertion of a new subsection 286(3A) into the Companies Act, requiring all financial statements or reports other than annual financial statements issued by a company to comply with the financial reporting standards laid down by the FRSC under the FR Act.

- Amendment of section 300(i) of the Companies Act to require auditors to satisfy themselves that the annual financial statements of companies comply with section 286(3) of the Companies Act.

- Insertion, in the Companies Act, of a definition of annual financial statements stipulating that, when applicable, they shall include group annual financial statements.

New standard-setting process

new Act

The proposed amendments to the Companies Act require the establishment of a new standard-setting process, as proposed by SAICA, after consultation with the Accounting Practices Board. This process will be effected through the new FR Act. The FSRC referred to above will be responsible for the setting and supervision of financial reporting standards, as well the issuing of directives and guidelines. The FSRC will also be responsible for the enforcement of compliance with these standards and for determining the appropriate sanction for non-compliance.

The Financial Services Board (FSB) is to be responsible for administering the FR Act. In the discharge of this duty, the FSB would prescribe, by notice in the *Government Gazette*, the classes of entity to which the supervision and enforcement provisions of the FR Act would apply.

LIAISON WITH OTHER REGULATORY AUTHORITIES AND WITH AUDITORS

During the year under review, the Bank Supervision Department continued to liaise and cooperate with other regulatory and supervisory authorities, at the international, regional and domestic level. The Department also initiated a structure for regular liaison with the auditors of banking institutions.

Work of Core Principles Liaison Group

The Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision and the work of the Bank Supervision Department in that regard were discussed comprehensively in the Department's past four Annual Reports. As previously reported, the objective of the Core Principles is to provide a benchmark against which the effectiveness of bank-supervisory requirements can be assessed. The work of the Core Principles Liaison Group, on which South Africa serves, is directed at the successful implementation of the Core Principles by the supervisory fraternity on a global basis.

focused on new Capital Accord

loan classification

During the past year, the Core Principles Liaison Group focused on the new Capital Accord and the impact thereof on countries' banking systems. A survey and assessment of loan-classification and provisioning practices among member countries highlighted the gaps that emerge in times of distress. Loan classification enables banks to monitor the quality of their loan portfolios and, when necessary, to take remedial action to counter any deterioration that may affect the solvency of banks. From an accounting perspective, loans should be recognised as being impaired when their book value no longer matches the amount of the expected repayments.

Because bank loans and overdrafts are not marked to market, bank management is expected to evaluate the potential losses incurred in loan portfolios based on available information. This process involves a great deal of judgement. In many instances, it was found that banks did not set aside funds to provide for doubtful loans, since such action would decrease their profitability and reduce shareholder dividends.

provisions

The lack of internationally recognised definitions and the general nature of accounting standards have allowed countries to customise their own systems. The terms "specific provision" and "general provisions" are common in regulation, but the definition and uses of these types of provision vary widely across countries.

categories based on the probability of default

As the new Capital Accord becomes increasingly accepted, the traditional concept of regulatory loan classification will become less relevant, because banks will be required to implement systems to separate loans into categories based on the probability of default. Much greater homogeneity of classification systems is expected to follow from the adoption of criteria that are less dependent on judgement and which rely more on indisputable factors that banks will have to assemble and submit for supervisory review.

assessment of compliance with Core Principles

Ongoing assessment of different countries' compliance with the Basel Core Principles by means of the assessment methodology developed by the Core Principles Liaison Group revealed that:

- Many countries had in place the basic legislative framework to grant supervisors the statutory authority needed to implement the principles. The enforcement powers, however, were not always applied in practice.
- Progress with the implementation of prudential requirements had been slow, and significant differences remained between countries. Significant weaknesses had been found in the area of management of credit risk.
- Many countries had to strengthen their supervisory capacity in several areas. In particular, on-site and off-site resources had to be strengthened, and consolidated supervision had to implemented in many countries.

International Conference of Banking Supervisors

As reported in the previous Annual Report, the eleventh International Conference of Banking Supervisors (ICBS) was held in Basel, Switzerland, in September 2000. These biennial international conferences, held since 1979, are designed to promote cooperation among national bank-supervisory authorities on the supervision of international banking. The conferences also enable senior representatives of supervisory authorities from a large number of countries to exchange views on a range of current issues of common concern.

twelfth ICBS will be held in Cape Town

The Bank Supervision Department was honoured to be tasked with planning and co-ordinating the twelfth ICBS, which will be held in Cape Town, South Africa, from 16 to 20 September 2002. Preparations are proceeding well, and South Africa is looking forward to hosting this important occasion.

Cooperation at regional level

objectives of ESAF

At the regional level, the Bank Supervision Department continued to participate in the initiatives of the East and Southern Africa Banking Supervisors Group (ESAF). As mentioned in previous Annual Reports, the objectives of ESAF are to promote the overall standard and quality of banking supervision in ESAF member countries, in line with best international

practice, and to harmonise bank-supervisory philosophies and practices in the region.

The Bank Supervision Department has been fulfilling the role of the ESAF Secretariat since 1999 and will continue to do so until 2004. In order to ensure a focused approach to bank-supervisory training for ESAF member countries and optimal use of available resources, all such training is organised and coordinated by the ESAF Secretariat.

During 2001, members of the Department attended three meetings of the ESAF Executive Committee. As indicated in previous Annual Reports, the ESAF Executive Committee initiated a number of projects, which are at various stages of completion. Among these projects are the following:

- *Compliance with Core Principles for Effective Banking Supervision*

two self-assessments of compliance

ESAF members endorsed the Core Principles for Effective Banking Supervision and declared their intention to implement them within a reasonable time frame. During the year under review, the members undertook two self-assessments of compliance using the Core Principles Methodology, published by the Basel Committee on Banking Supervision in October 1999. The Basel Committee views the formulation of this document as an iterative process, and refinements will be made as experience is gained. A draft document, titled "Conducting a supervisory self-assessment: practical application" and prepared for the Core Principles Liaison Group, was distributed to ESAF members to assist them in benchmarking their own supervisory systems against the Core Principles, with the ultimate goal of enhancing the effectiveness of bank supervision in the region.

In terms of a decision taken at the 2000 Annual General Meeting (AGM), ESAF members are required to submit their completed compliance self-assessments as at the end of March and the end of September of each year. A summary of the responses was drawn up by the ESAF Secretariat and distributed at the 2001 AGM.

- *Bank supervision harmonisation project: Business-process models and supporting information systems*

The objective of the project on the harmonisation of business-process models and supporting information systems is to provide harmonised bank-supervisory legislation, regulations, procedures and systems at a national and regional level, within the ESAF region.

As part of the second phase of this project, the bank supervisors of the Southern African Development Community (SADC) met with the SADC Central Banks Information Technology Forum in February 2001, to discuss information technology (IT) solutions capable of assisting bank supervisors in their harmonisation and other strategic objectives. The ESAF Executive Committee subsequently resolved to support the objectives of IT solutions to be developed by the SADC IT Forum using the business model developed by ESAF. The Executive Committee designated bank supervisors from the Bank of Botswana, Bank of Namibia, Reserve Bank of Zimbabwe and the South African Reserve Bank to form part of an expert group. The role of this expert group is to assist the SADC IT Forum and to:

role of expert group

- Act on behalf of ESAF members.
- Confirm that the harmonised specifications can be used for IT-solution development.
- Ensure quality.
- Engage the non-SADC ESAF members.

- Provide business expertise and knowledge.

- Sign off the IT products that are developed.

Since the ESAF countries are at different stages of developing bank-supervisory models, it is recommended that each individual country should itself decide which products it needs. The financial support of the central bank governors will facilitate the furtherance of this project, and cost sharing of the project will expedite the development of harmonised bank-supervisory standards in the region.

- *On-site supervisory model*

best-practice guideline was developed

ESAF member countries were requested to complete a questionnaire on on-site surveillance, with the objective of determining a minimum standard of on-site supervision. A best-practice guideline for on-site surveillance was developed by the Reserve Bank of Zimbabwe and was distributed to all the ESAF members, for comment. Comments received from members will be incorporated into a guideline document, which will serve as a harmonised standard for on-site surveillance in the ESAF region.

- *Deposit-insurance scheme for the region*

As mentioned in Chapter 1 of this Annual Report, South Africa is in the process of developing a deposit-insurance scheme for deposit-taking institutions in South Africa. The Executive Committee decided in March 2001 that ESAF should keep the development of a harmonised standard on deposit insurance in abeyance until South Africa had implemented its proposed scheme. Member countries should, however, liaise with one another to exchange information on deposit insurance.

- *Standard data-collection standards*

At its meeting in March 2001, the Executive Committee decided to adopt the format of the form DI 900 of the amended South African Regulations relating to Banks to collect data from ESAF members. The Secretariat subsequently circulated the form to all Executive Committee members, for completion.

- *Development of harmonised e-banking supervision standards*

Electronic banking (e-banking) is becoming an issue of growing importance worldwide, including in the ESAF region. In order to ascertain the status of e-banking in the region, ESAF members were requested to furnish the Secretariat with their countries' views on e-banking. A discussion paper will be prepared for submission to members.

- *Role of rating agencies*

The new Basel Capital Accord assigns a specific role to rating agencies. The grades that a rating agency assigns to a particular bank will determine the risk profile of that bank and, thereby, also determine the capital-adequacy ratio of the bank. Rating agencies will therefore play an important role in determining the amount of capital that a bank has to hold.

The ESAF Executive Committee deemed it important for the rating process to be market driven and independent in order for it to be credible. Although rating agencies would be subject to an evolutionary process in the region, it was recommended that they abide by a code of conduct and be self-regulatory in nature. In some countries, rating agencies are subject to rules and have to consult with the bank supervisor before a bank is rated or downgraded.

- *Heads of Supervision Workshop*

The sixth ESAF/IMF/World Bank Heads of Supervision Workshop was held in Maputo, Mozambique, in June 2001. The theme of the workshop was the regulation of microfinance institutions and other topical bank-regulatory issues, such as consolidated supervision, combating of money laundering and the Financial Sector Assessment Programme of the International Monetary and World Bank.

- *Courses in banking supervision*

regionally focused seminars and workshops

As reported previously, attendance of training courses in Basel, Switzerland, has significant cost implications for representatives of countries outside the European Union. The Financial Stability Institute of the Bank for International Settlements, therefore, decided to present regionally focused seminars and workshops in various parts of the world.

The first of two regional seminars for ESAF members during 2001 was held in Cape Town, South Africa. This seminar, which covered credit risk, was attended by 20 participants from nine ESAF countries. The second regional seminar for ESAF members was held in Swakopmund, Namibia. This seminar, which covered the new Capital Accord and problem-bank resolution, was attended by 26 participants from 13 ESAF countries.

The objectives of the seminars were to:

objectives of the seminars

- Update participants on the current best practices in credit-risk management.
- Provide an overview of the latest developments with the new Capital Accord.
- Provide a forum for the exchange of ideas on common problems, such as problem-bank resolution and the implementation of best supervisory practices.
- Provide the Financial Stability Institute with useful information on the most important needs in the ESAF region.

The Bank Supervision Department successfully hosted an intermediate course in banking supervision, attended by 34 participants from 12 of the 16 ESAF member countries, in Pretoria, from 27 August to 7 September 2001. As in previous years, a one-day seminar on updates and trends in bank supervision preceded the ESAF course. The some 270 participants included representatives of the banking sector, external auditing firms, the financial press and the central bank. The speakers from the Federal Deposit Insurance Corporation, the Financial Services Authority, the Financial Stability Institute, an external auditing firm and the South African Reserve Bank covered the following topics:

topics covered

- Risk assessment and evaluation of banks by the Financial Services Authority.
- Latest risk-management techniques for measuring market and credit risk.
- Opportunities, challenges and practicalities of a strong auditor/regulator relationship.
- Global anti-money-laundering efforts of the Financial Action Task Force.
- New Basel Capital Accord.

As part of its ongoing initiative to work with central banks in Southern Africa on technical bank-supervisory training, the South African Reserve Bank has indicated its willingness to host further courses in bank supervision in 2002.

Regulators' Forum

As reported in the previous Annual Report, recent amendments to the Competition Act, 1998 (Act No. 89 of 1998), introduced concurrent jurisdiction between the Competition Commission and specific sector regulators, such as the Registrar of Banks. This development highlighted a need for cooperation and coordination amongst the various regulatory bodies. On 30 May 2001, the Competition Commission hosted a dinner to discuss the possibility of establishing a Regulators' Forum. The delegates present, representing the broad spectrum of statutory regulators in South Africa, unanimously decided in favour of such an initiative. The Forum will initially operate as a voluntary arrangement, without any formal legal status. The nature of the Forum and its governance arrangements may, however, evolve over time.

voluntary arrangement

Forum arose from a need

The formation of the Regulators' Forum arose from a need to:

- Encourage discussion and promote consistency and cohesion in the broad South African regulatory framework.
- Enable regulators to identify common interests, as well as overlap and duplication in functions and activities.
- Facilitate a sharing of resources.
- Promote the coordination of common projects.
- Promote regulatory certainty in the application of regulatory legislation.

The purpose of the Forum includes to:

purpose of Forum

- Promote and facilitate the exchange and flow of information.
- Provide useful information to the public about the role and functions of regulatory bodies.
- Foster an understanding of the activities of various regulators operating in different jurisdictions and industries, as they implement economic reform and engage in the regulation of their respective industries.
- Ensure consistency in regulation.
- Strengthen the relationship among regulators.

The delegates are currently compiling an information document, containing details of the legislation in terms of which they derive their authority and the objectives in regulating the particular industry. The Bank Supervision Department supports the development of effective regulation within South Africa, since the need for coherence and integration in the regulatory framework has become an increasingly important issue, not only in South Africa, but also in other developing and developed economies.

need for coherence and integration

Auditor-regulator College

auditor-regulator relationship regarded as very important

In the South African bank-regulatory environment, the auditor-regulator relationship has always been regarded as very important. This is due largely to the supervisory approach focusing on the need for key players in the supervisory process, including the auditors of

banks, knowing, understanding and fulfilling their respective roles and responsibilities in that process. Furthermore, until the implementation of on-site supervision in 2000, the bank-supervisory approach focused mainly on off-site supervision. Consequently, the Bank Supervision Department used the auditing profession for a large portion of the on-site component of supervision.

From the late 1980s, a number of initiatives were undertaken to strengthen the relationship between the Department and the external auditors of banks. For example, a banking interest group forum was established in order to enable representatives of the Department, banks and their external auditors to discuss and gain an understanding of various supervisory issues, including the expectation gap between auditors and the Department.

The pace of regulatory development during the past number of years is commonly known. During that period, both the auditing profession and the Bank Supervision Department experienced a fairly significant turnover of staff. It, therefore, became necessary to address not only the pressures arising from new developments, but also the loss of competence. During 2001, therefore, the Registrar of Banks, in collaboration with the senior partners of the large auditing firms in South Africa, decided to establish a structure for regular interaction.

structure for regular interaction

objective of the Auditor-regulator College

The objective of the Auditor-regulator College that was established is to enhance the understanding of both auditors and bank regulators, particularly at lower level, of the importance of bank audits and the risk-focused approach that should be taken in such audits. The focus is on the special nature of banks as the custodians of the public's funds. Furthermore, the Registrar, as the bank regulator, had identified a need to sensitise the auditing profession to the needs of the regulator.

The Auditor-regulator College held its first meeting during in November 2001 and will convene on a quarterly basis. The meetings will include formal presentations and discussions on a wide range of issues, agreed in advance by the regulator and the senior partners of the large auditing firms. The establishment of the Auditor-regulator College presents new and exciting opportunities to provide training and share perspectives, amongst others, on the lessons learnt from on-site reviews of banks' risk-management practices. The Department is confident that the College will contribute to strengthening the bank-supervisory process in South Africa.

opportunities to provide training and share perspectives

CONSOLIDATED SUPERVISION

New regulations with regard to consolidated supervision were implemented successfully with effect from 1 January 2001, as part of the amended Regulations relating to Banks. As reported in the 2000 Annual Report, the new regulations provide, amongst others, for a standardised approach to the calculation of a measure of group capital adequacy.

group capital adequacy

The new consolidated-supervision regulations incorporate the latest international developments and are regarded as being at the forefront of worldwide banking supervision standards. Besides having been received favourably by the industry, the regulations have achieved the Bank Supervision Department's objective of complying with the Core Principles for Effective Banking Supervision.

As regulator, the Bank Supervision Department is now in a position to assess the financial condition of individual banking groups. Banking groups will also reap benefits, particularly when they wish to expand their international operations. Consolidated supervision is now applied to all South African banking groups, which have to ensure that they are adequately capitalised in order to sustain both their banking and non-banking operations. At present,

applied to all South African banking groups

the minimum capital-adequacy ratio for a banking group is set at 10 per cent of risk exposures. The entities that are subject to consolidated supervision are the bank controlling company, its subsidiaries, joint ventures and companies in which the bank controlling company or its subsidiaries have a participation.

new quarterly returns

During the year under review, the Department devoted much time to ensuring that the new quarterly statutory returns were being completed correctly. The objective was to verify the integrity of the information, on which the Department bases its analyses, in order to enable the Department to add value to the supervisory process. Much effort was also expended on training the Department's staff members in the review and analysis of the consolidated statutory returns.

training

The Department, because of its progress in the area of consolidated supervision, including group capital adequacy, also participated in an international workshop on the consolidated supervision of financial conglomerates. This workshop, held in Nassau, the Bahamas, in January 2001, was jointly organised by the Financial Stability Institute of the Bank of International Settlements and the Toronto International Leadership Centre for Financial Sector Supervision.

As mentioned in the 2000 Annual Report, the Bank Supervision Department is of the opinion that consolidated supervision will continue to gain in importance and will remain an effective supervisory tool. The supervisory methods used, however, will have to be responsive to changes in the continuously evolving banking industry and financial environment. During 2002, therefore, qualitative consolidated supervision will receive particular attention. The objective will be to obtain a better understanding of the risk environment in which a banking group operates.

ON-SITE SUPERVISION

follow-up reviews

During the year under review, good progress was made with the process of on-site supervision, and more on-site reviews were undertaken. A start was made with follow-up visits to banks previously reviewed in order to assess the progress that these banks had made with addressing the issues that had been identified as requiring attention during a previous visit. More follow-up reviews will be undertaken in the future as resources increase, and the aim will be to decrease the time span between on-site reviews to a period of not more than 18 months.

The on-site reviews undertaken have enabled the Bank Supervision Department to uncover issues that would have remained unknown had the Department relied solely on the outsourcing of the on-site supervisory function to external auditors. Consequently, the Department decided, firstly, to establish a structure (the Auditor-regulator College referred to earlier in this chapter) for regular interaction with the external auditors of banks, in order to share information on the lessons learnt from on-site reviews of banks' risk-management practices, and, secondly, to hold meetings with the external auditors of individual banks after each on-site bank visit.

process is subject to ongoing review

The Department's on-site supervisory process is subject to ongoing review and evaluation, with account being taken of lessons learnt and international best-practice standards. As a result of this ongoing review and evaluation, the Department decided to expand the scope of the on-site reviews beyond a review of credit and counterparty exposures, to embrace banks' entire risk-management process, on a solo and a consolidated basis. Because of the significance of credit and counterparty exposures, the on-site reviews, however, will continue to focus on banks' risk-management practices in these areas.

decided to expand the scope of reviews

As a result of the requirements of the new Basel Capital Accord, the Department will have to develop its internal capacity to enable it to meet the challenges posed by the new Accord. As soon as such capacity is in place, the on-site reviews will be expanded to include risk-management assessments of operational risk and, later, market risk.

APPLICATION OF INCENTIVE SCHEMES

Incentive schemes have received much public attention lately. From a regulatory perspective, there is a growing concern worldwide about the extent and application of incentive schemes by financial institutions. Incentive schemes are not in themselves regarded as an undesirable practice. International trends in the application of such schemes, however, have resulted in regulators becoming increasingly concerned about the implications thereof for the risk profiles of banks.

implications for risk profiles of banks

There is no doubt that incentive schemes have been, and will continue to be, an integral part of the remuneration systems of most financial institutions operating in the free market. It has to be recognised, however, that when such a scheme forms part of the remuneration system of a bank, there is a real danger that the scheme could affect the overall risk profile of the bank. It is this aspect that is of concern to regulators.

Although incentive schemes differ widely in their structuring and application, current research suggests certain basic requirements to which management should attend:

basic requirements to which management should attend

- Financial institutions, banks in particular, critically have to assess the possible effects of incentive schemes on the actions of employees and the possible risks that could emanate from such schemes.
- Each institution has to ensure that new employees understand the institution's appetite for risk, as well as the overall goals that the institution is trying to achieve through an incentive scheme.
- Banks should also determine whether their incentive schemes generate a community of interest between employees and shareholders in that the reward for success is available to the group as a whole and is not restricted to certain individuals or certain sections of the group.
- Controls on risk taking and proper measures to ensure the honesty of employees are essential and should regularly be reviewed.
- Clear policies on the structuring and implementation of incentive schemes are essential, and such policies should preferably promote relatively long assessment periods for purposes of calculating performance bonuses.
- The international literature calls for disclosure of the details of incentive schemes to the shareholders of institutions before such schemes are approved, as well as an extensive range of details on the remuneration received by executives and employees.

finalising guidelines

The Bank Supervision Department and the Financial Services Board are currently finalising guidelines on incentive schemes applicable to financial institutions. These guidelines should become available during 2002, and the application thereof will be assessed during on-site visits.

ACCESS TO FINANCE

Broader access to finance and banking services for all remains an important issue in South Africa. In its endeavour to enhance such access to finance and to formalise the micro-

several initiatives

finance industry further, the Bank Supervision Department embarked on several initiatives during the year under review.

International experience

Frankfurt Seminar

During September 2001, a member of the Department attended the Frankfurt Seminar in Frankfurt, Germany, a joint project between the Goethe University of Frankfurt and the Ohio State University of the United States of America. It was the fourth seminar that focused on new development finance.

four major challenges face MFIs

A number of conclusions drawn from the seminar might be relevant to South Africa and its microfinance institutions (MFIs). Four major challenges face MFIs, namely, loan repayment, cost recovery, accessing commercial funding and attracting private-equity investment. It also became clear that similar problems were being experienced worldwide:

similar problems worldwide

- The financing of social development has increasingly been effected through a commercial approach and has become a function of the private sector.
- The promotion of savings has become a focus area in most countries.
- There is a shortage of collateral and security for most MFIs.
- The concentration of the microfinance industry is exacerbated by an oversupply of participants.
- The legal framework is inadequate or, in some countries, non-existent.

Some speakers at the seminar also emphasised that in order for MFIs to succeed under increasingly competitive conditions, it is not sufficient for MFIs to know their products and offer their products efficiently. MFIs should also know their clients and understand how their clients use and benefit from the MFIs' products. Based on a better understanding of their clients' financial practices and needs, MFIs could develop better products and services, whilst improving the financial sustainability of the organisation. In other words, the creation of value for clients and the financial sustainability of an MFI are compatible objectives.

creation of value for clients

several problems

The microfinance industry has successfully demonstrated that some institutions are capable of serving many of the poor with a great measure of success. Several problems have, however, emerged in recent years. These problems include inflexible products, faulty policies, a failure to understand client demands and preferences fully, high levels of client non-performance, multiple memberships, rising delinquency and default rates, cross-financing between MFIs and informal sources, and a failure to reach the very poor.

causes of and solutions to poverty are complex

It is also becoming clear, worldwide and in South Africa, that the causes of and solutions to poverty are more complex than often assumed. The poor often seem to regard the function of financial-services industry as being not only to help them with their investment projects, but also to smooth consumption, bear risk and reduce their vulnerability. An understanding of the behaviour and complex financial-management strategies of the poor is essential to providing them with better financial services.

Local developments

During 2001, members of the Bank Supervision Department participated in the activities of the Small, Medium and Micro Enterprises (SMME) Finance Reference Group of the Department of Trade and Industry (DTI). Other stakeholders that participated included

important economic and social challenge

Khula Enterprise Finance, the National Treasury, The Banking Council South Africa, the Microfinance Regulatory Council (MFRC), commercial banks, business associations and non-governmental organisations. The Reference Group's work has been focused on access to finance. It remains one of the important economic and social challenges in South Africa to integrate businesses owned by historically disadvantaged individuals into the formal sector. Since these businesses come in a variety of forms and sizes, with different locations and needs, they may need assistance with both business development and access to finance.

During its meetings, the first of which was held in November 2000, the Reference Group identified factors inhibiting SMME access to finance and recommended actions to remedy the current situation. In late November 2001, the DTI hosted a workshop to discuss the recommendations of the Reference Group. The recommendations arising from the workshop will be submitted to the Minister of Finance.

The Bank Supervision Department also participated in a number of other forums. For example, members of the Department attended the board meetings of the MFRC and participated in the MFRC's lender workshops, held in Johannesburg, Durban and Cape Town, as well as in a discussion forum with the Micro Lenders Association. Furthermore, the Department initiated discussions with various stakeholders on possible changes to the legislation governing the microfinance industry. This initiative will be strengthened during 2002.

Status of formal and informal banking services in South Africa

banks serve only a portion of the population

Banks and branches of foreign banking institutions, registered as such in terms of the Banks Act, 1990 (Act No. 94 of 1990), represent the pinnacle of the broad banking industry. Although banks provide a wide variety of financial services to their customers and although the industry as a whole is regarded as being highly sophisticated and well regulated, banks serve only a portion of the population in South Africa.

mutual banking has not proved to be successful

Mutual banks, registered as such in terms of the Mutual Banks Act, 1993 (Act No. 124 of 1993), were intended to provide financial services to a greater portion of the population, especially after the disappearance of the erstwhile mutual building societies. The structure of a mutual bank was designed to be less formal and simpler than that of a bank, the principle of mutuality being paramount. Unfortunately, however, mutual banking has not proved to be successful in South Africa, and only two registered mutual banks have remained.

exempted institutions provide limited financial services

The lower end of the market is served to some extent by institutions that have been exempted, subject to certain conditions, from the provisions of the Banks Act. These institutions, which are largely self-regulated and which were described in several previous Annual Reports, are stokvels or savings clubs, credit unions and financial service co-operatives. Although growing in number, these institutions provide limited financial services at a micro or community level only.

mcrolenders regarded as an important player

Microlenders, in general, engage in consumption lending and are not authorised to take deposits from the general public. Microlenders, however, may be regarded as an important player within the broader financial-services industry in South Africa. Microlenders are regulated by the MFRC in terms of an exemption notice issued under the Usury Act, 1968 (Act No. 73 of 1968).

Factors affecting microfinance development

Formal research has not yet been conducted to determine the reasons for or the factors

that have influenced the lack of growth and development of mutual banking in South Africa. The Bank Supervision Department believes, however, that the following factors have to be considered in deciding on the future direction to be taken in this regard:

factors to be considered

- The economic and social history of the country in general and communities in particular.
- The depth of current financial services being offered, and whether or not such financial services are retreating from rural areas.
- The development of a second-tier banking system based on sound business principles.
- The presence and effectiveness of a middle financial-services market or second-tier banking system.
- The ability of the population in general to take up and deal with debt, its savings patterns and its inclination to compare prices.
- Less onerous entry criteria and regulatory and supervisory standards in a framework in which risks and exposures are effectively capped.

Research

thorough research is required

wide consultation is required

The initial discussions and meetings on microfinance development have led to a realisation that the solution to the problem is not merely the establishment of a legislative framework for a second-tier banking system. The problems and concerns are as varied as they are deep rooted. It is clear, therefore, that thorough research is required in order fully to understand the problem of access to finance at grass-roots level. Also, wide consultation with persons and institutions currently involved in the microfinance industry is required in order to gain an understanding of the problems and challenges facing the industry.

need for market deepening

In the light of the above-mentioned problems, the Bank Supervision Department launched a research project to study the issues relevant to access to finance, as well as the possibility of addressing some of the problems in South Africa by means of a so-called second-tier banking system. Policy research in South Africa long ago identified the need for market deepening beyond banks at the top end and microlenders at the bottom end. In view of the focus on the expansion of services to small businesses and for housing purposes, a more fully developed financial landscape has become necessary. The development of a significant second tier of deposit-taking institution to serve the lower end of the market has been under discussion for some time, but has proved difficult to implement. As indicated above, the Mutual Banks Act has also been unable to support this objective fully.

Further meetings and consultations with various role players are planned for 2002. The Bank Supervision Department is also considering the hosting of a consultative conference in this regard.

ILLEGAL DEPOSIT-TAKING

In accordance with one of its auxiliary functions, the Bank Supervision Department is responsible for the regulation and control of illegal deposit-taking. During the year under review, the Department continued to inspect and close down persons and institutions acting in contravention of the provisions of the Banks Act, 1990.

As explained in previous Annual Reports, the taking of deposits without being registered as a bank or falling within and complying with one of the exemptions to the Banks Act amounts to an offence in terms of the Act. Registered banking institutions have to comply with certain prescribed prudential requirements in terms of the Banks Act, whereas illegal deposit-taking schemes obviously do not comply with such requirements. Such schemes not only operate illegally, but also pose a risk to investors in such schemes on the one hand and financial stability on the other hand. The funds invested in such illegal schemes may be used for purposes not known to an investor and may result in the investor losing all invested funds in a very short period of time.

risk to investors

During the year under review, 18 new inspections, together with some inspections carried over from the previous year, were undertaken. The Bank Supervision Department hopes that the steps taken have served to quell, at least to some extent, the enthusiasm of unscrupulous individuals to operate schemes designed to deprive others, often the poor, of their funds. The public is also continually encouraged to inform the Department of possible contraventions of the Banks Act. The Department believes that the queries about various schemes received from the public during 2001 were largely attributable to the awareness campaigns previously conducted.

successful prosecution Miracle 2000 pyramid scheme

Of particular importance was the successful prosecution of Mr S M Radebe, an integral figure in the operation of the Miracle 2000 pyramid scheme. The firm PricewaterhouseCoopers was appointed to inspect the activities of Miracle 2000, and the inspectors concluded that the scheme had operated illegally, in contravention of the Banks Act. Mr Radebe was charged and pleaded guilty to contravening the Banks Act, as well as the Harmful Business Practice Act, 1988 (Act No. 71 of 1988). The court subsequently found Mr Radebe guilty of contravening, firstly, the Banks Act, for which he was fined R50 000, or one year in prison, and, secondly, the Harmful Business Practice Act, for which he was fined R150 000, or three years in prison. It is hoped that this successful prosecution is a further deterrent for prospective pyramid-scheme founders and a stopping mechanism for those already operating such schemes.

In a recent court decision handed down in the High Court of South Africa, Natal Provincial Division, in the matter between Barnard and Lynn v Schoeman and Rogers (as yet, unreported), the court found that payment to certain investors in a pyramid scheme was an undue preference and ordered them to repay the funds to the entity under liquidation. Investors should be aware that action might be taken against them, in line with insolvency legislation, for payment received from an illegal deposit-taking institution.

increase in more complex scheme

Of note, during the year under review, was the increase in more complex schemes, involving high net worth individuals. Most of these schemes used the guise of selling shares in the scheme/institution. This method, *prima facie*, appears to be legal. On closer inspection, however, it will become apparent that a prospectus has not been issued, that the so-called products traded or services rendered by such an institution are more often than not non-existent and that the investors are guaranteed their capital plus a fixed return. Moreover, the investors' intention is to deposit money with such an institution without any risk and with their capital and predetermined interest guaranteed. Upon application of the principle of substance over form, it becomes apparent that such an institution is accepting deposits illegally, in contravention of the provisions of the Banks Act.

MONEY LAUNDERING

Financial Intelligence Centre (FIC)

repository of data

The long awaited Financial Intelligence Centre Bill was promulgated as an Act of Parliament on 1 January 2002. The Act will bring into existence the Financial Intelligence Centre (FIC) to coordinate policy and efforts to counter money-laundering activities. The FIC will not be an investigative body, but a repository of data to produce financial intelligence regarding listed

institutions' financial transactions. The FIC Act will also bring into existence the Money-laundering Advisory Council, which will oversee the national strategy pertaining to anti-money-laundering initiatives.

functions of the FIC

The functions of the FIC will broadly encompass collection, processing and analysis of information, informing of and cooperation with investigating authorities, supervision and regulation of compliance by accountable institutions and appointment of persons to specialise in measures to detect and counter money-laundering activities.

accountable institutions

The FIC Act will apply to a list of accountable institutions issued by the Minister of Finance, who has the power to add or remove institutions, or to exempt accountable institutions of certain types of transaction. These accountable institutions will be required to implement certain internal administrative systems in order to keep detailed records of their customers. The accountable institutions will also have to report certain transactions above a specified amount, as well as transactions that are suspicious. Furthermore, the accountable institutions will be required to train their employees to recognise and deal with suspicious transactions.

In order to expedite the orderly implementation of the FIC, the Minister of Finance has appointed an official to oversee the process. The intention is for the FIC to be operational by the end of 2002.

CONCENTRATION IN THE SOUTH AFRICAN BANKING SYSTEM

most widely used index is the H-index

Several indices may be used to measure concentration in a banking system. The most widely used index in the literature to measure the extent of competition and concentration in a banking system is the Herfindahl-Hirschman Index (H-index). It is calculated by adding the square of the market shares of the banks in the industry, and ranges between 1 (for a monopoly) and 1/n, where n is the number of banks in the system. Alternatively, the H-index can be calculated as the square of the deviation of market segments of single banks from the average bank, plus 1 divided by the number of banks in the industry. The H-index accounts for both the number and relative size of banks in the system and is therefore preferred to other measures of concentration.

tool to suggest the degree of monopoly power

Another way of expressing the H-index is to sum the squares of the percentage-point shares of the banks in the system. The index will vary between 0 (many banks in a system) and 10 000 points (for a monopoly) when expressed in this way. The H-index can also be seen as a statistical tool used to suggest the degree of monopoly power. The smaller the H-index is, the greater is the competition in, and the lower is the concentration, of the banking system. A higher H-index will mean weaker competition and higher concentration of a banking system.

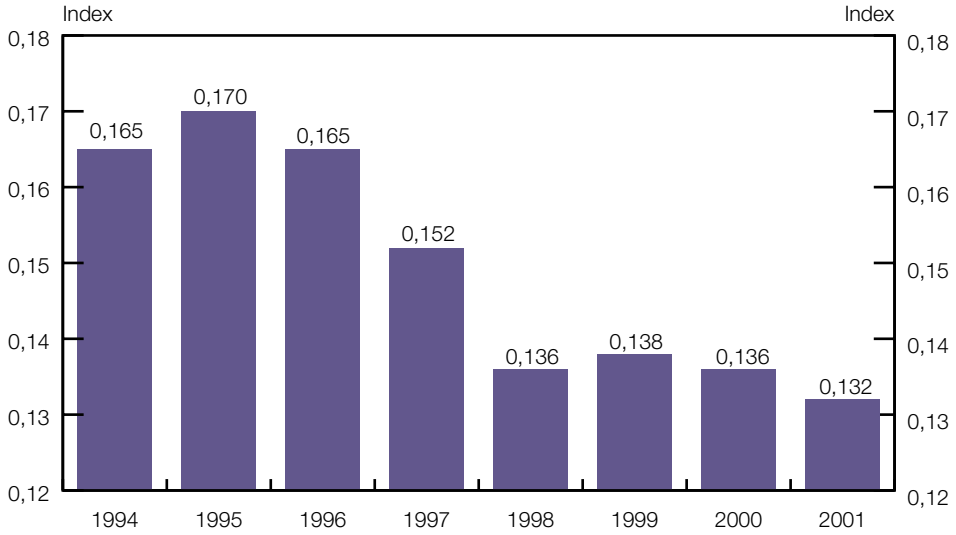
screening device and planning tool

Banking regulators widely use the H-index as an efficient screening device for horizontal mergers (those between banks operating in the same product and geographical markets) and as a planning tool for industry participants. In practice, use of the H-index has been focused mainly on the lower H-index values of 0,10 to 0,25 in order to determine the existence of any oligopolistic patterns within a given industry. Oligopoly concerns are normally raised when the index reaches a level of 0,18.

H-index improved gradually

For South Africa, which currently has some 58 banking institutions, the H-index improved gradually from 0,170 in 1995 to 0,132 in 2001 (see Figure 1). As indicated in Chapter 1 of this Annual Report, foreign participation in the local banking industry has grown during the past five years, and foreign banks held about 7,7 per cent of the total assets of all banks doing business in South Africa at the end of December 2001 (up from 3,1 per cent in December 1996). This increase in foreign participation has contributed to the marginal decline of the South African banking system's H-index.

FIGURE 1: H-INDEX FOR THE SOUTH AFRICAN BANKING SYSTEM (1994 - 2001)



average level of concentration

A comparison of H-indices (shown in Figure 2) for different countries shows that South Africa belongs to a group of countries, such as Spain (0,134), Canada (0,158) and Australia (0,166), with an average level of concentration. Concentration is high in Greece (0,29), New Zealand (0,25) and Sweden (0,24). By contrast, concentration is very low (between 0,039 and 0,089) in the United States of America, Germany, Italy, the United Kingdom and France, the average being 0,123 for the Group-of-ten countries.

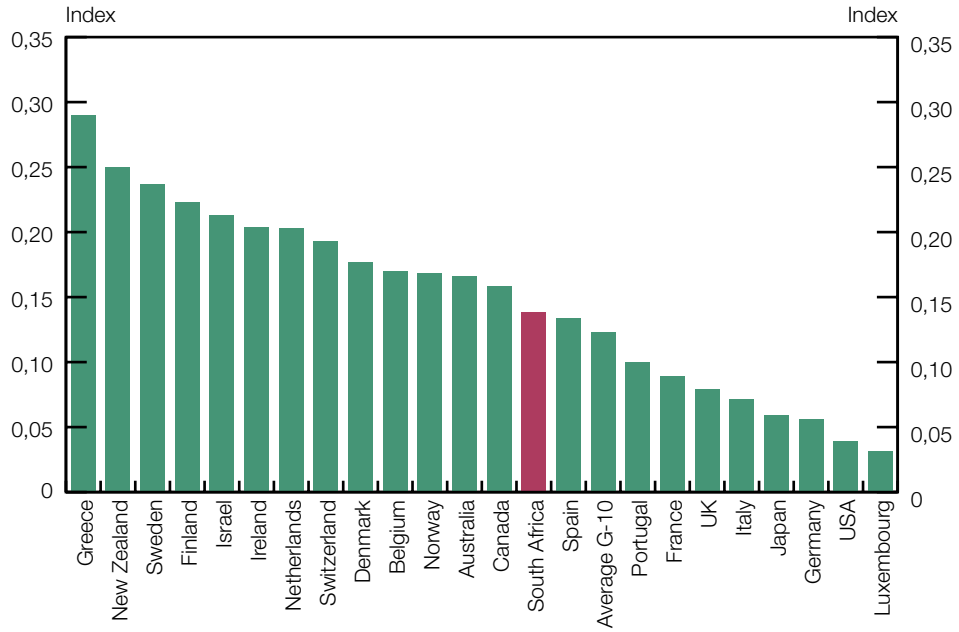
indication of the intensity of competition

To some extent, the H-index is also an indication of the intensity of competition in a banking system. It can be used as a tool to assess the impact of possible bank mergers on competition. At the Federal Reserve in the United States of America, it is common practice to assume that a merger would generally not be seriously anti-competitive if the post-merger H-index falls below the numerical guidelines prescribed by the Department of Justice, that is, a change of 0,02 in the H-index. A post-merger H-index higher than the prescribed numerical guideline calls for the conduct of a detailed economic analysis of competition to determine whether other factors, such as potential competition, indicate that the market would be more (or less) competitive than the H-index alone suggests.

regulators have to decide which institutions to include

When analysing market concentration, regulators have to decide which institutions to include as competitors. In the past, regulators viewed commercial banks as distinct from other financial institutions. This is changing, however, since brokerage and insurance companies offer similar products, in competition to commercial banks. When these other financial institutions are included in the commercial banking market, concentration, as measured by the H-index, is usually reduced. When, for instance, a cross-sector financial merger needs approval, regulators may have to include a wider range of financial institutions than included in most evaluations of market concentration.

FIGURE 2: H-INDEX: AN INTERNATIONAL COMPARISON, 1999



Source: Israel's Banking System Annual Survey 2000

According to banking theory, a rise in the concentration of the banking system, subject to certain assumptions about the interaction between banks in the system, leads to an increase in the market power of banks in that country or region. The more concentrated a market is, the more likely it is that market participants will conspire to raise prices for people who purchase their services. Thus, in the banking environment, one may expect that the higher the margins between lending and deposit rates are, and the higher the levels of profits earned by banks are, the more concentrated the market will be. Most data for European banking systems indicate a positive and significant relationship between concentration and financial margins.

relationship between concentration and financial margins

There is an alternative argument in the literature, setting out a different relationship between market share and profitability. The argument is that banks will be more profitable because they are more efficient, and that because they are more efficient, they will achieve a larger market share. If this is a valid explanation, there may not be a specific relationship between market concentration and profitability. Another argument, however, might apply in this regard. Regulation might restrict the entry of new banks to a market, enhancing the opportunity available to existing banks to take excessive profits. Other things being equal, therefore, if a market is contestable, there will be less opportunity for banks to generate excessive profits, or to have unduly wide margins.

MARKET RISK

During the year under review, the activities of the Bank Supervision Department relating to market risk focused mainly on ongoing surveillance of the daily trading activities of banking institutions.

Surveillance

implementation of a surveillance procedure

The focus with regard to banks' trading activities during 2001 was the implementation of a surveillance procedure. This procedure includes, amongst others, the monitoring of banks' trading positions and analyses of their daily capital-adequacy requirements (CAR).

Since 1 May 1999, trading banks have been required to submit their CAR values, irrespective of the calculation method used by a particular bank, to the Bank Supervision Department, on a daily basis, via electronic mail or telefacsimile transmission. The Department's surveillance capabilities in this regard have been enhanced through the introduction of a new statutory return, form DI 425. The Department will continue its surveillance of banks' trading positions during 2002 as part of its supervisory programme.

Approval of banks' internal models

In terms of regulation 24 of the Regulations relating to Capital-adequacy Requirements ("CAR") for Banks' Trading Activities in Financial Instruments, the Department may grant approval to a bank to use an internal model in order to calculate its capital-adequacy requirements (CAR) for market risk.

Any approval granted to a bank for the use of such an internal model is valid only for a period of one year, normally coinciding with the bank's financial year. Before the expiry date of the approval, the particular bank has to submit a written request for renewal of the approval to the Bank Supervision Department, for consideration During 2001, the Department renewed the approval granted to the two banks using an internal model, but did not receive new applications for such approval.

ELECTRONIC COMMERCE

During the past number of years, electronic commerce (e-commerce) has shown impressive growth. E-commerce touches all aspects of the economy and involves the integration of elements of technology, legislation, infrastructure, business operation and public policy. All elements need to interface as smoothly as possible in order to yield maximum benefit. In South Africa, as in the rest of the world, the Internet is increasingly being used to advertise and sell goods and services. This has given rise to a growing interest in the development of more reliable and secure methods of electronic payment.

only banks will be permitted to issue e-money

During April 1999, the South African Reserve Bank (SARB) issued a position paper on electronic money, as well as submission guidelines for electronic money products and schemes for persons wishing to issue electronic money (e-money) in South Africa. In terms of the position paper, only banks will be permitted to issue e-money. Primary and intermediary issuers of electronic value will therefore be subject to regulation and supervision by the SARB.

Several concerns have been raised about the introduction of e-money, especially prepaid smart-card schemes. These concerns relate to, amongst others, possible contravention of the Banks Act, 1990, as regards deposit-taking, and of the National Payment System Act, 1998, as regards offering payment and clearing services as a regular part of an issuer's business.

New developments and initiatives in the e-commerce field include:

developments and initiatives

- *EMV (Europay Mastercard Visa) Forum* - The EMV Forum is an initiative by South African banks, the leading card associations and retailers of South Africa to implement the global EMV chip-card standard in the South African payments system. This will ensure interoperability between chip cards and terminals on a global basis, regardless of the manufacturer, the financial institution, or where a card is used.

- *CEPS (Common Electronic Purse Specification) Forum* - The CEPS Forum is an initiative by South African banks and the leading card associations to explore and facilitate the implementation of a national and international interoperable e-purse solution for

South Africa, based on a CEPS standard and, preferably, based on a single architecture.

- *Mobile banking* - One of the latest additions to electronic banking in South Africa is banking by mobile telephone. Mobile banking offers numerous services, including, amongst others, a facility that allows clients to use their mobile telephones to make electronic payments to third parties.

- *Wireless payments* - Banks, card associations and mobile-telephone operators have developed a common interoperable technical architecture framework for the implementation of wireless payment solutions in South Africa.

All these developments and initiatives will create new opportunities for financial innovation. The Bank Supervision Department will therefore be monitoring these new developments carefully in order to ensure that the integrity of the South African financial system is maintained.