# Chapter 1

## Registrar's review

2003 was marked by greater stability

The year under review was somewhat less turbulent for the South African financial system and banking sector than the preceding two years. Whereas the latter part of 2001 was characterised by a significant depreciation of the South African currency, and the main feature of 2002 was consolidation in the country's banking sector, following a liquidity crisis among small and mid-sized banks, 2003 was marked by greater stability. This made possible a number of cuts in interest rates as a result of a decline in the inflation rate in South Africa.

The Bank Supervision Department saw a changing of the guard. Mr Christo Wiese, who had been the Registrar of Banks since November 1994, retired at the end of October 2003, and my appointment as Registrar became effective on 1 November 2003.

issues reviewed

Among the issues reviewed in this chapter are a modification of the Department's supervisory approach and the charter developed by the South African financial sector to advance black economic empowerment. Other issues highlighted include the findings of a review of corporate governance in large South African banks and how the case of the failed Saambou Bank Limited was resolved.

## Overview of the South African banking system

banks remained well capitalised

During the year under review, South African banks remained well capitalised. Although the average risk-weighted capital-adequacy ratio for the sector decreased marginally to 12,2 per cent at the end of December 2003, compared to 12,6 per cent in 2002, it remained above the statutorily required level of 10 per cent.

total balance sheet increased

Growth in the total balance sheet increased during 2003. By the end of December 2003, the total funds of banks – comprising capital, reserves, deposits and loans – had increased by 25,2 per cent (measured over a period of twelve months), to a level of R1 377,6 billion. During 2003, the four biggest banks represented about 81 per cent of the total banking sector, and the five largest banks constituted 87 per cent of the banking sector. The participation of foreign banks in the local banking industry increased from 6,9 per cent in 2002 to 8,7 per cent of total banking-sector assets by the end of December 2003.

participation of foreign banks increased

Total non-bank deposits had increased by 14,1 per cent (measured over a 12-month period) in December 2003, from 12,5 per cent in December 2002. The composition of non-bank deposits remained largely unchanged during the past year.

return on equity and return on assets increased

Both the return on equity and the return on assets of the total banking sector increased during the year under review. By the end of December 2003, the average return on equity was 10,9 per cent, up from 5,6 per cent in December 2002, whereas the return on assets increased from 0,5 per cent in December 2002 to 0,7 per cent in December 2003. The interest margin decreased to 3,3 per cent in December 2003, from 3,8 per cent in 2002. The efficiency of the banking sector saw some improvement, from 67 per cent in 2002 to 65,8 per cent in 2003.

efficiency saw some improvement

South African banks maintained adequate levels of liquidity during 2003. In December 2003, banks' liquid assets amounted to 114,7 per cent of liquid assets required to be held, compared to a level of 118,1 per cent in December 2002.

adequate levels of liquidity

Total gross overdues of the banking sector decreased by R2,4 billion, to a level of R23,8 billion at the end of December 2003. Provisioning by banks against these non-performing loans was adequate, even when benchmarked against international requirements.

total gross overdues decreased

## Modification of supervisory approach

Environmental factors, such as increased financial innovation, increasing competitive pressures and ongoing developments in information and telecommunication technology, may result in rapid and substantial changes in the risk profiles of banks. Since new technologies, product innovation and the size and speed of financial transactions are continually changing the nature of banking, proper management of risks and strong internal controls remain critical to the safety and soundness of banks.

proper management of risks and strong internal controls remain critical

It follows that the supervisory framework has to be tailored to changing banking and financial conditions on an ongoing basis. Changes in the supervisory framework should be aimed at sharpening the focus of the supervisory process on, on the one hand, those business activities that pose the greatest risks to the soundness of individual banks and the banking system as a whole and, on the other hand, the adequacy of banks' management systems to identify, measure, monitor and control their risks. The supervisory process has to be dynamic and forward looking in order to respond to technological advances, product innovation, emerging and new risks, new risk-management systems and techniques, changes in the condition of individual banks and market developments.

supervisory framework has to be tailored on an ongoing basis

The supervisory approach of the Bank Supervision Department has always combined, in some form or another, an offsite and an onsite component. In line with international developments, which require an increasingly risk-focused supervisory approach, the Department recently implemented closer coordination between the offsite and onsite components of its supervisory approach, by housing the offsite and onsite functions in the same division and ensuring that the same team is involved in both facets of supervision. The Department's new supervisory approach comprises risk-focused processes, which will rely on an understanding of a bank or banking group, risk assessments, execution and ongoing refinement of a supervisory plan and targeted reviews, tailored to the risk profile of a particular bank or banking group.

closer coordination between offsite and onsite components

new supervisory approach

Responsibility for each individual bank or banking group has been assigned to a relationship manager, assisted by a team with diverse competencies. Such a relationship team will be the central point of contact for an individual bank or banking group and will also be responsible for developing and implementing the Department's supervisory programme. In order to fulfil the objectives of risk-focused supervision, the relationship team has to remain conversant with a bank's financial condition, management structure, business model, strategic plan and direction and overall operations.

relationship team will be the central point of contact

The Department's supervisory approach includes the following key elements:

key elements

### Quantitative analysis

The Department's quantitative analysis of the monthly and quarterly statutory returns submitted by banking institutions entails analysis by means of time series or graphs and interpretation of the results. The budgets and management accounts of a bank or banking group are considered to be critical, since they enable the supervisory team to form an overall opinion of the financial condition of the particular bank or banking group.

The information that a bank furnishes to the Department in the statutory returns, together with the same information on the total banking sector, is presented in graphic form to enable comparison and discussion of matters arising therefrom.

## Qualitative assessments

The qualitative assessments undertaken by the Department include the following:

- Annual discussions with the chief executive officer of a bank or banking group on the strategic direction of the bank or banking group.
- Meetings with the management of a bank or group to ensure appropriate attention to and action on supervisory concerns.
- Focused discussions with the heads of functional, risk and other areas on the strategies applicable to each area.
- Review of internal management and board reports, as well as internal and external audit reports, to supplement the supervisory process.
- Bilateral meetings with a bank's or banking group's external auditors before the year-end audit to discuss issues of significance and concern.

## Initial assessment

initial assessment of a bank's major risks

Based on the quantitative and qualitative analyses, an initial assessment is made of a bank's major risks. This assessment is used to revise and update the supervisory plan for the particular bank. If areas requiring more detailed review are identified, targeted reviews of those areas are undertaken.

## Targeted reviews

targeted reviews

As part of the Department's functional and risk-focused approach, the supervisory framework endorses the concept of conducting, when appropriate, a series of targeted reviews during a supervisory cycle. Such a review will focus on a single activity, business line, legal entity or identified problem areas of a bank or banking group.

*Ad hoc* reports might be requested in terms of section 7 of the Banks Act, 1990. Such reports would be compiled by identified specialists or external auditors, as deemed necessary in the light of the Department's evaluation of the corporate governance and specific problems within a bank.

## Feedback to the board of directors

trilateral meeting

The Department annually holds a trilateral meeting with a bank's audit committee and external auditors. The purpose of this meeting is to address a particular facet of the bank's business in some depth and to evaluate the bank's risk management in that area.

presentation to a bank's board

A senior member of the Department annually makes a presentation, based on the information submitted to the Department, to a bank's board of directors. This presentation constitutes an opportunity for the Department to share its findings, including those arising from targeted reviews undertaken during the supervisory cycle, with the board. The presentation also affords a bank's directors and management an opportunity to benchmark their bank against its peers and the South African banking sector as a whole.

The Department intends to continue with an effective programme of regular and meaningful contact with the directors and management of each individual bank or banking group. The Department's objective is to maintain a current understanding of a bank's or banking group's business model, risk profile and risk-management processes, without imposing an undue burden, interfering with legitimate management prerogatives, or compromising the objectivity of the supervisory process.

programme of regular and meaningful contact

## Assessment of Financial Sector Black Economic Empowerment Charter

During August 2002, at the National Economic Development and Labour Council's Financial Sector Summit, the financial sector in South Africa committed itself to the development of a charter to enable black economic empowerment. The result of this commitment, the Financial Sector Black Economic Empowerment Charter (referred to below as the Charter), was presented to Government on 17 October 2003.Although the Charter was released amid concerns that it might affect banking profits and dilute shareholdings, the response has largely been positive. This may be attributed mainly to the Charter constituting the outcome of a voluntary initiative by the major institutional players in all material facets of the financial sector, as well as black professionals and black business.

charter to enable black economic empowerment

In general, it is believed that the Charter sets reasonable black economic empowerment (BEE) objectives, albeit ambitious in some quarters, without sacrificing financial soundness or unduly increasing risk in the banking sector. It has to be acknowledged, however, that Government and regulatory authorities have a role to play before industry can effectively pursue the specified targets. Therefore, regulators now have to grapple with some fundamental arrangements that need to underlie implementation of the Charter, as well as consider the role of the Charter in the regulatory framework and assess whether it is capable of satisfying the demands of the relevant stakeholders within the specified time frames.

some fundamental arrangements need to underlie implementation

### Overview

The Charter is the outcome of negotiations between 11 entities, mainly industry associations. These are The Banking Council South Africa, the Life Offices' Association of South Africa, the Association of Black Securities and Investment Professionals (representing black business and the Black Business Council), the South African Insurance Association, the Association of Collective Investments, the Investment Management Association of South Africa, the South African Reinsurance Offices' Association, the Institute of Retirement Funds, the JSE Securities Exchange South Africa, the Foreign Bankers Association of South Africa and the Bond Exchange of South Africa.

outcome of negotiations between 11 entities

The aim of the Charter is to address the following key areas:

aim of the Charter

- Increased financial services for the unbanked.
- Agricultural development.
- Low-income housing.

- Small and medium black businesses.
- Black ownership, control and management.
- Skills development.
- Procurement from black-owned businesses.
- Creation and development of BEE companies.

targets apply from 1 January 2004 to 31 December 2014

The Charter applies to the South African operations of the financial sector, and the targets contained therein apply from 1 January 2004 to 31 December 2014. Specific targets have to be attained by 2008. Financial firms bound by the Charter have to produce annual BEE reports, with an audited scorecard. There are no blanket exclusions, and foreign banks are also affected.

Charter Council to oversee implementation

The Charter Council, a body to be established to oversee implementation of the Charter across the financial sector's various subsectors, will undertake a comprehensive mid-term review in 2009. In addition, the Charter Council will issue guidance notes, undertake annual reviews and issue annual reports.

## Benefits, costs and risks

anticipated benefits

The anticipated benefits of the Charter are the following:

- The Charter obliges the financial-services industry to bring into being not only products – savings and life products and, ultimately, credit – but also actual physical access to the financial system, within a realistic distance of where the poorest South Africans live.

- The Charter represents a commitment by Government and the financial-services industry to finding a means to provide funding for low-income housing in a sustainable manner and based on sound commercial principles.

- Obligations are placed, both directly and indirectly, on the financial-services industry to employ, train, develop and nurture black staff at every level.

- The Charter obliges the financial-services industry to lend money and skills, experience and infrastructure to developing smaller black start-up companies throughout the economy, as well as to finance black buy-in to corporate South Africa.

could also trigger other changes

The Charter's proposed empowerment-based changes could also trigger other changes, such as:

- Banks could share the increased burden by pooling resources. This could lead to further cooperation or outsourcing in the areas of cheque and credit-card processing.

- The need to provide affordable access to finance could trigger innovation and development of new banking products or delivery channels. Smart-card and cellular-telephone technology, for example, are available, but not used to maximum effect.

- Banks could benefit from other financial institutions paying to use their distribution networks.

Pursuit of most of the above benefits is still under discussion, while Government and business resolve how much money should be raised for low-income housing, smallscale agriculture, small-enterprise finance and financing of BEE transactions in general. Although the Charter attempts to manage the risks of BEE, firms will have to contend with certain monetary costs, for example:

certain monetary costs

- *Direct costs:* 0,2 per cent of taxed profits for consumer education, 1,5 per cent of payroll for skills development and 0,5 per cent of taxed profits for corporate social investment.

- *Indirect costs:* Increased costs of employment and training and the cost of compliance and auditing.

The Charter attempts to foster BEE, without introducing significant risk into the financial system, by providing for:

Charter provides for

- Risk sharing with Government and development finance institutions, such as the Postbank, Land Bank, Development Bank, etc.

- The principle of sound business practice, guaranteeing banks the right to underwrite risk.

- Transfer of ownership on the basis of a willing buyer and a willing seller.

## Charting of BEE performance and role of the Charter Council

The Charter contains a scorecard, which provides a basic and objective framework against which transformation and empowerment achievements can be measured. The Charter is based on six pillars, discussed later in this chapter. The scorecard, which will be used to determine a financial institution's final BEE score, is segmented into six similar sections, and a score is allocated to each.

scorecard against which achievements can be measured

A perfect score would be difficult to achieve. Banks, for example, may find their shareholders want them to maintain a favourable overall score, but may be concerned that their existing shareholders should not suffer undue dilution.

Certain companies may not be able to perform in certain aspects of the scorecard, for the following reasons:

- It is not in the nature of their business to do so.

- A regulatory requirement prevents them from doing so.

- A uniformly applicable global group policy demonstrates that similar initiatives have not been undertaken elsewhere in the group. In such a case, the company would have to make a submission to the Charter Council to explain the uniform applicability or non-applicability of the global policy.

The Charter Council will establish adjudication and appeal procedures, oversee the achievement of targets and engage with the BEE Advisory Council, which is to be established in terms of the Broad-based Economic Empowerment Act, 2003 (Act No. 53 of 2003). Each financial institution will report annually to the Charter Council on its progress with implementing the provisions of the Charter. The first BEE report and audited scorecard in respect of the year ending 31 December 2004 are due by 31 March 2005.

role of Charter Council

The Charter Council will have to develop the capacity to fulfil its huge task and will also have to obtain a mandate from all parties. This is likely to be a difficult process, with potential for conflict between different interest groups.

scorecard is to be applied in tendering for Government business

Although the Charter is voluntary, and companies are not obliged to perform in respect of any of its components, the parties to the Charter have agreed that the scorecard is to be applied in tendering for Government business. The reputational implications of poor scorecard performance, both within the industry and in terms of public perception, are likely to be a strong motivator for companies to attain a good score.

### Six pillars of the Charter

empowerment financing and human-resource development are regarded as the most challenging

The six key pillars of the Charter are discussed below. The number of points assigned to each pillar in terms of the scorecard is indicated in parentheses after each heading. Generally, the pillars of empowerment financing and human-resource development are regarded as the most challenging to attain in view of the currently low level of skills in the labour market and the risks that BEE financing poses.

- *Empowerment financing (22 scorecard points)*

BEE financing and targeted investments

The Charter sets a target of R75 billion (3,75 per cent of total designated investments of R2 000 billion) for empowerment financing, to be split between BEE financing and targeted investments. BEE financing may be regarded as funding for black business to acquire equity in other businesses. Targeted investments are widely defined as loan finance or credit extension in markets in which there are backlogs. Such investments would include investment in infrastructure, agricultural development, low-income housing and black small and medium enterprises (SMEs).

Banks will also receive credit for previous empowerment financing. If one assumes that a third of the target of R75 billion is the banking sector's responsibility, the big four banks would need to finance just over R6 billion each.

Separate targets have not been set for BEE financing and targeted investments. The Charter also does not make any reference to the affordability of empowerment financing, that is, how the balance between risk and reward is to be maintained. The parties to the Charter, however, have committed themselves to working in partnership with Government and its development-finance institutions to mobilise resources for empowerment financing.

Guidelines for the evaluation of empowerment transactions, therefore, need to be established.

- *Ownership and control (22 scorecard points)*

minimum shareholding target

The Charter contains a minimum shareholding target of 25 per cent black ownership by 2010. The direct ownership target has been set at 10 per cent, whereas the maximum indirect target has been set at 15 per cent, provided the direct shareholding target has been achieved.

Foreign institutions will have to meet the same targets, but will be permitted to address the targets by activities and investments in other specified areas, as discussed in more detail later in this chapter.

The definition of direct ownership is wide and includes past transactions, such as:

definition of direct ownership is wide and includes past transactions

- Past BEE financing transactions.
- Broad-based ownership, such as pension funds.
- Disposal of assets or parts of a business.
- Direct shareholding at any level within a group.
- Joint ventures or partnerships.

Given a market capitalisation of about R100 billion, R10 billion would be required for the direct ownership target of 10 per cent. Recent BEE transactions and broad-based ownership (defined in the Charter as direct shareholding), such as black-dominated pension funds, however, have significantly reduced the financing burden and the risk of increasing systemic risk in the banking sector. It has been estimated that as much as R5 billion of the banking industry is already in BEE hands, through direct ownership. The Charter sets a target of 30 per cent for BEE representation at the level of director, including a target of 10 per cent black women. These control targets are a prerequisite in any ownership targets.

control targets

As indicated earlier, the Charter mentions that any transfer of ownership should comprise willing buyers and willing sellers. This is an honourable requirement, but not always possible or enforceable. If there are no willing sellers, a company might have to issue new shares to BEE groups in order to meet direct shareholding targets.

- *Human-resource development (20 scorecard points)*

The Charter sets targets for black employment at senior, middle and junior management level. Black senior management currently accounts for only 10 per cent of the total skills available at that level. The Charter obliges financial institutions to spend 1,5 per cent of their payroll cost on skills development for black employees.

targets for black employment

Research has shown that there are wide gaps between the current status and the targeted status at every level of management. At the senior management level, for example, black people were estimated to represent 10 per cent and black women 1,6 per cent in 2002, whereas the 2008 targets are 20 per cent to 25 per cent and 4 per cent, respectively.

there are wide gaps

The currently low levels of black participation in the financial sector will make it extremely challenging to achieve points in the area of human-resource development. It also has to be borne in mind that the financial-services sector is competing with every other sector of the economy for skilled black professionals at all levels.

Almost five years remain until the target date for achievement of the human-resource development objectives, giving institutions the opportunity to design and fund training programmes. It has to be noted, however, that it takes a minimum of four years to develop financial skills academically. Therefore, firms will have to focus proactively on this area, not only to attain the targets set in the timeframes outlined, but also to meet the human-resource skills needed in the medium and longer term.

objective is twofold

- *Access to financial services (18 scorecard points)*

The objective of this pillar of the Charter is twofold:

- To improve the provision of effective access to financial services and products to the lower end of the market, currently classified as living standards measures (LSM) segments 1 to 5 and based largely on the LSMs of the South African Advertising Research Foundation.

- To address the needs of the unbanked market, which currently consists of more than 17 million adults.

accessible finance

A target of 80 per cent of LSMs 1 to 5 has been set for access to transactional and savings products. Targets, however, have not been set for lending or financing, which are addressed in terms of empowerment financing. Accessible finance means that an automated teller machine or branch, providing appropriate and affordable banking services, should be located within 20 kilometres of the target group (LSMs 1 to 5). The Charter recognises that banks incur costs in delivering banking services, but warns banks not to exploit the poor through excessive charges.

An issue to be resolved, either in the implementation phase of the Charter process or by the Charter Council, is whether the LSM ranges prescribed in the Charter agreement are to remain constant over time, or are to be reviewed as the income levels applicable to the LSM ranges are revised upward. The decision in this regard could materially affect the effectiveness of the Charter in broadening access to finance at the lower income levels, which are currently predominantly black in terms of the LSM model.

- *Procurement (15 scorecard points)*

targeted procurement programmes

Financial institutions are expected to provide support to black SMEs to enable them to benefit from targeted procurement programmes. Such support will be in the form of assistance to black SMEs in tendering for financial-sector business and in financial institutions reserving areas of procurement for black SMEs. The Charter requires a minimum of two thirds of total procurement to be spent with BEE-accredited companies as the primary vendors. The remainder may be bought from a non-BEE supplier, which, in turn, has to source its supplies from a BEE company.

Spending on information technology represents approximately one third of the procurement expenses of financial institutions. Achievement of the Charter's procurement targets by the financial-services sector, therefore, depends on the successful implementation of the Information and Communications Technology (ICT) Charter, currently under discussion.

corporate social programmes

- *Corporate social investment (3 scorecard points)*

The Charter requires banks to direct 0,5 per cent of taxed profits to corporate social programmes in the areas of education, training, development programmes, environment, job creation, arts and culture, health and sport. Most banks already invest sizeable sums of money in these areas, but will have to increase their investments to reach the target.

## Treatment of foreign banks

A contentious issue in the development of the Charter was the degree to which foreign banks operating in South Africa would be bound to participate in the Charter, particularly in respect of ownership targets. In summary, instead of foreign banks being obliged to sell part of their business to black shareholders, foreign banks will be permitted to invest a larger amount in the financing of empowerment deals. In other words, foreign banks will be able to attain points usually awarded for black ownership by using their considerable balance sheets to finance empowerment deals.

financing of empowerment deals

The commitment of foreign banks to the rectification of socio-economic imbalances can be demonstrated by, amongst others, them being signatories to the Charter in their own right, and not as part of The Banking Council South Africa, and their initiatives in respect of the Responsible Lending Accord. This Accord was an initiative of ten international banks from seven countries, which adopted guidelines for project finance in emerging markets, in the first industry-wide attempt to encourage socially responsible lending.

Responsible Lending Accord

## Prerequisites for successful implementation and critical issues

Successful implementation of the Charter is dependent on a number of prerequisites. These include:

prerequisites

- Reforms to regulatory frameworks, such as guidelines or legislation creating new asset classes arising from targeted investments.
- Successful implementation of the ICT Charter.
- Sufficient and appropriate auditing skills to assess scorecard criteria.

Within the broader context of the BEE process, policy-makers have to reflect on some critical issues. These include:

critical issues

- What the available options in terms of financing BEE deals are.
- What the banking sector's role in BEE financing should be.
- Whether there is disparity between how the banking sector sees its role in BEE financing and how the Government views that sector's role.
- Whether it is equitable for the burden of financing all (economy-wide) BEE transactions to be placed on the banking sector, which has to justify its own BEE performance and accommodate financing of its own BEE transactions.

The intention is not to debate these issues in this annual report, but to highlight some of the challenging issues surrounding BEE and the Charter.

## Conclusion

The challenge of BEE and broadening access to finance has to be addressed in the context of the overriding regulatory objective of achieving a high degree of economic efficiency and consumer protection in the economy, through securing systemic stability in the financial sector and in the broader economy. Although Government is responsible for establishing the framework within which the banking industry operates, cognisance has to be taken of the implications of the pace of change in the financial sector.

The financial sector has been proactive in responding to the need for change in South Africa. Although one may argue that change at too slow a pace may destabilise the sector, change at too great a pace may pose an even greater threat to financial stability.

optimal balance

It would appear that the Charter has achieved an optimal balance, in that it acknowledges the importance of a stable and growing financial sector and supports principles that will promote and enhance the quality of decision-making.
The Bank Supervision Department is fully committed to the objectives of the Charter. Progress towards and achievement of these objectives could meaningfully contribute to the stability and growth of the financial sector in the long term.

## Review of corporate governance in large South African banks

The importance of sound corporate governance in banks can be attributed to the use of depositors' funds to conduct business. It also has to be borne in mind that the failure of a bank is likely to affect not only its own stakeholders, but also the stability of other banks (known as the contagion effect), as illustrated by the demise of certain South African banks discussed in the previous annual report.

### Corporate-governance review

corporate-governance practices within the five largest banking groups

In August 2002, Adv J F Myburgh SC, assisted by three members of the Bank Supervision Department, was appointed to investigate the status of compliance with sound corporate-governance practices within the five largest banking groups in South Africa, namely, ABSA Group Limited, FirstRand Bank Holdings Limited, Investec Limited, Nedcor Limited and Standard Bank Group Limited. At the end of April 2003, a general report and executive summary were released to the public.

findings

The Bank Supervision Department has accepted the recommendations made by Adv Myburgh and will review the banking sector's commitment to sound corporate governance on an ongoing basis. The Department is currently consolidating the information flowing from the review to determine whether the banking legislation requires further amendment.

Among Adv Myburgh's findings were that, generally:

- The banks investigated were committed to adherence to and application of high standards of corporate governance.
- Acting on the advice of specialists in corporate governance, the banks on their own initiative reviewed their corporate governance from time to time, to ensure compliance with accepted corporate-governance principles.
- Although, in general, corporate governance in the banks was sound, vigilance was required to ensure continued compliance with the standards of governance evolving in South Africa and internationally.

banks were benchmarked

The banks were benchmarked against, amongst other things, local legislation and industry codes (for example, the first and second reports of the King Committee on Corporate Governance, generally referred to as King I and King II), the Listings Standards Report published on 6 June 2002 by the New York Stock Exchange Corporate Accountability and Listing Standards Committee and the report published in the United Kingdom, on 20 January 2003, by Sir Derek Higgs, who had been appointed in April 2002 by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer to lead an independent review of the role and effectiveness of non-executive directors.

The Myburgh working group followed a process of interviewing all directors and selected executive officers of the five large banks. The three issues of most concern to the interviewees were:

- Focus on form, rather than substance.
- Inhibition of the entrepreneurial spirit.
- Overregulation.

The Bank Supervision Department has noted these concerns and will continue to engage the banking sector in discussions to allow for an approach to corporate governance that gives due consideration to the points of view of all stakeholders.

The salient aspects covered in Adv Myburgh's report can be summarised as follows:

salient aspects covered in report

- *Size and composition of a bank's board*

The effectiveness of the board of a bank is dependent on the interaction between its members, whichever form this may take. The board, therefore, should be large enough to ensure that it has sufficient non-executive members with the skills necessary to serve on the required board committees. The board, however, should not become unwieldy and, thus, ineffective.

A large executive presence on the board is regarded as unnecessary. A large presence of executive directors presupposes a large non-executive presence and, consequently, a large board. Furthermore, a board consisting of a large number of executive directors will suffer from the problems of dominant executive action and assumptions, generally incorrect, being made about the non-executive directors' knowledge. When the board is overly large, discussion becomes difficult, and board processes become protracted.

Adv Myburgh, therefore, recommended that:

recommendations

- The board of a bank should consist of no more than about 16 members.
- A bank's board should not have more than about four executive directors.
- The majority of non-executive directors should be independent directors with immediate effect. For example, if a bank has a board of 10 directors and seven of them are non-executive directors, at least four of the seven should be independent directors with immediate effect.
- Banks should aim for the majority of their directors to be independent directors within not more than five years. With reference to the above example, this means that at least six directors should be independent directors within five years.

- *Induction and training*

Training of directors is of critical importance to allow for a greater understanding of the business and to encourage debate at the various meetings. It would be folly to expect a director who has undergone an induction course to be an expert in all aspects of banking. Ongoing education, therefore, is extremely important and should be initiated not only by the director concerned, but by the company secretary.

training of directors is of critical importance

- *Chairperson and chief executive officer*

The chairperson of a bank is prohibited by law from being an employee of the bank. Adv Myburgh emphasised the need for an independent chairperson in order to ensure the necessary checks and balances.

need for an independent chairperson

A notable argument is the case of a chief executive officer (CEO) moving directly into the chair. In his review report, Sir Derek Higgs lists the problems of such a move as follows:

- Having been responsible for the day-to-day running of the company and with the resulting detailed knowledge of the company, such a chairperson may sometimes find it difficult in practice to make room for a new CEO.

- A chairperson of a company who was formerly the CEO of that company may simply take for granted other directors' inside knowledge and, therefore, fail as an information bridge to non-executive directors.

In his report, Adv Myburgh adds that:

- Since the CEO was instrumental in appointing the management team that is left behind when the CEO becomes the chairperson, the management team remains beholden to the former CEO.

- A chairperson who was formerly the CEO might not view the strategy of the company with the necessary detachment, because the former CEO formulated and was in the process of implementing the strategy as a member of management before being appointed chairperson.

three-year colling-off period

Adv Myburgh, therefore, recommended a three-year cooling-off period, in which the CEO should distance himself/herself from the bank in order to mitigate the concerns listed above.

- *Succession planning*

often acknowledged, but seldom applied

Succession planning for the board, including the chairperson and the chief executive officer, is a principle often acknowledged, but seldom applied.

It should be clear that there is a need for a formal process to discuss and debate succession issues, such as what will happen if Ms Y is involved in an accident tomorrow, or how Mr X, who is a board candidate, will acquire the necessary experience in operations. Such a process will force the board members or selected committee members to consider and apply their minds to such issues and, thereby, provide stability in both the short and the long term.

- *Board committees*

It is essential for board members to understand that the establishment of committees to focus on specific areas does not relieve them of their fiduciary duties and responsibilities.

committee structure

In terms of current banking legislation and King II, a bank must have an audit committee, a remuneration committee, a directors' affairs committee and a risk committee. The committee structure, as legislated and set out in the Banks Act, 1990, is a means of ensuring that the important and current areas in a bank are fully considered and that the necessary time is expended on the core issues facing the particular bank.

Although not legislated, the remuneration committee recommended by King II is responsible for, amongst other issues, ensuring that executive remuneration is sound and not excessive, based on the principles of retention and recruitment. According to King II, it is the function of the remuneration committee to recommend, to the board, fees for the non-executive directors and, once such fees have been confirmed by the board, to put them to the shareholders, for approval, prior to implementation.

## Conclusion

Adv Myburgh made specific recommendations to the individual banks in order to enhance their corporate governance. In the main, the banks have implemented these recommendations.

It is important to heed the warning that governance arrangements will not resolve all problems and risks facing a bank. There is a need for constant vigilance to warning signs within a bank. These signs may take the form of, for example, a short-term breakdown in the relationship between two key players, or insignificant time being available at board meetings to discuss strategy, performance, risk and people.

need for constant vigilance

Although implementation of the principles outlined above may be regarded as time consuming or yet another cost centre, the long-term benefits outweigh any short-term inconvenience. It is envisaged that, world-wide, regular review of corporate-governance principles will become the norm, to the ultimate benefit of banks and their stakeholders.

# Resolution of Saambou Bank Limited

The previous annual report contained a comprehensive exposition of the events leading to the demise of Saambou Bank Limited (Saambou). Since Saambou was the seventh largest South African bank at the time, its failure attracted much attention from, amongst others, the media and the general public. A brief report on how the Saambou case was resolved may therefore be of interest.

## Curatorship

Saambou was placed under curatorship on 9 February 2002, following a period of sustained and increasing liquidity pressure. In terms of a decision made in conjunction with the Minister of Finance, depositors were given full access to their deposits with effect from 23 May 2002. It is pleasing to note that no depositor suffered any direct financial loss as a result of the imposition of curatorship.

no depositor suffered any direct financial loss

## Receivership

On 9 May 2002, FirstRand Bank Limited (FRB) proposed a scheme of arrangement in a formal announcement. Upon sanction of the court on 30 August 2002, the scheme had the following two simultaneous effects:

scheme of arrangement

- Saambou became a wholly owned subsidiary of FRB with effect from 31 August 2002. Saambou retained specified assets, in the form of a mortgage book, and specified liabilities, in the form of deposits. As at 31 December 2002, all outstanding deposits had for all practical purposes been repaid.

- The curatorship was withdrawn, and those assets and liabilities not taken over by FRB fell into the receivership and came under control of the court-appointed receiver. The receiver was tasked with the optimal realisation of the receivership assets and the optimal defrayment of the receivership liabilities.

All material assets of Saambou were realised by means of a public bidding process. A deal forum, consisting of the receiver of Saambou and senior representatives of the South African Reserve Bank, was constituted, and senior members of the National

public bidding process

Treasury were also invited to the forum's meetings. The forum considered the bids and made recommendations to the Minister of Finance, for his decision on the preferred bidder. Once the preferred bidder had been identified, a rigorous process ensued and involved the legal teams of all interested parties drafting an acceptable agreement between the preferred bidder and the receiver.

major assets sold

The major assets sold in this way included the following:

- The Saambou personal-loan book, which was sold to African Bank Limited.
- The Planet Finance book and the Saambou commercial property-finance book, which were sold to Imperial Bank Limited.
- The FinEd book, which was sold to the Commercial Bank of Namibia Limited.
- The Saambou housing-finance book, which was sold to FRB.

### Liability of former directors

alleged breaches of the law

The receiver handed information on alleged breaches of the law by certain former directors of Saambou to the Department of Special Operations of the National Prosecuting Authority during the first quarter of 2003. The receiver also completed an investigation into possible delictual claims against certain former directors of Saambou.

## Employment equity

The objective of the Bank Supervision Department's employment plan is to accord with the aim of promoting equity through diversity, in line with the 2005 employment equity (EE) plan of the South African Reserve Bank.

main aims of the 2005 EE plan

The main aims of the 2005 EE plan are to promote employment equity in the Reserve Bank and to ensure a representative, competent and motivated workforce. This is achieved by, amongst others, accelerated development and promotion of employees with potential from the designated groups, that is, black people (including coloured and Asian persons), females and disabled persons.

Department attained its employment-equity objectives

Despite the moratorium on recruitment imposed in August 2002, as part of the Reserve Bank's efforts to contain costs, the Bank Supervision Department successfully attained its employment-equity objectives during the year under review. At the end of 2003, 51 per cent of the Department's workforce was black, as defined above, and 51 per cent of the employees were female. The fast tracking of deserving employees, achieved through accelerated development, salary adjustments and promotion, ensured that EE targets cut across all levels of staff, especially at management level.

## Issues that will receive particular attention during 2004

Besides fulfilling its normal supervisory and regulatory tasks, the Bank Supervision Department will place particular focus on the following issues, amongst others, during 2004:

focus areas

- Continued regular contact and interaction with the directors and management of each individual bank or banking group, in order to maintain a current understanding of the bank's or group's business model, risk profile and risk-management processes.

- Monitoring of banks' implementation of anti-money-laundering measures.

- Development of a supervisory framework for approaches to credit exposures and operational risk in terms of the new Capital Accord, including interaction with other supervisors.

- Continued participation in the initiatives and activities of international and regional bank-supervisory bodies, such as the Basel Committee on Banking Supervision and the East and Southern Africa Banking Supervisors Group.

- Ongoing monitoring of the status of banks' corporate governance.

- Ongoing review and continued amendment of the regulatory framework and the supervisory process and procedures to ensure that they remain in line with international and local standards and developments, including the Financial Sector Black Economic Empowerment Charter.

- Further involvement in the establishment of a regulatory framework for second- and third-tier banking institutions aimed at providing broader access to finance.

- Continued combating and investigation of illegal deposit taking by unregistered institutions and persons.

- Monitoring of developments with a deposit-insurance scheme for South Africa, including continued interaction with National Treasury in that regard.

## Expression of appreciation

I wish to express my appreciation to the Minister and Deputy Minister of Finance for their valued inputs to requests in terms of statutory requirements. Sincere gratitude also go to the Governor and Deputy Governors of the South African Reserve Bank - in particular to Ms Gill Marcus, in her capacity as the Department's Deputy Governor - for their continued invaluable cooperation, guidance and support. My staff and I also wish to thank my predecessor, Mr Christo Wiese, for his unfailing energy and enthusiasm during the past nine years – may he enjoy his well-deserved retirement.

As in the past, the Department received cooperation from countless individuals and organisations, locally and abroad. Among them, to name but a few, are the Chief Executive of the Financial Services Board and his staff, the senior executives of banking institutions and their external auditors, The Banking Council South Africa, the Standing Committee for the Revision of the Banks Act, 1990, the auditing profession, the staff of other departments of the South African Reserve Bank (in particular, the National Payment System, Financial Markets and Exchange Control Departments), the Basel Committee on Banking Supervision, the East and Southern Africa Banking Supervisors Group and the central bankers and bank supervisors worldwide with whom the Department has ongoing contact.

The ongoing challenges that banking supervision poses in a constantly changing financial environment remained as demanding as ever during the year under review. My sincere thanks, therefore, go to my staff, who continued to display dedication, enthusiasm and professionalism in fulfilling their tasks.

**E M Kruger**
*Registrar of Banks, and General Manager: Bank Supervision Department*