Chapter 2

Current issues in banking supervision

This chapter reports on the most important supervisory and regulatory developments during 2006. The most significant international development was the publication of the revised Core Principles for Effective Banking Supervision. Locally, The Bank Supervision Department intensified its efforts aimed at the implementation of the new Capital Accord, while continuing to focus on the development of bank directors. Other issues discussed in this chapter include concentration risk in the South African market, banks' compliance with anti-money laundering legislation, internal models for market risk, liquidity risk simulation, consolidated supervision, the Independent Regulatory Board of Auditors and training of the Department's staff.

important supervisory and regulatory developments

Core Principles for Effective Banking Supervision

During the year under review the Basel Committee on Banking Supervision continued its efforts to publish high-quality standards on banking supervision. Banking supervisors across the world would certainly concur that the highlight of 2006 was the Basel Committee's publication of a revised version of the document titled "Core Principles for Effective Banking Supervision", commonly referred to as the Core Principles. The Basel Committee is constituted of senior representatives of banking supervisory authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States of America.

high-quality standards on banking supervision

The twenty-five principles

The Core Principles comprises twenty-five fundamental requirements, covering various components and aspects of a bank supervisory system, that need to be complied with for a banking supervisor to operate effectively and for banks to operate in a safe and sound manner. The revised principles, globally accepted as the building blocks of sound banking supervision, are as follows:

various components and aspects of a bank supervisory system

Principle 1 – Objectives, independence, powers, transparency and cooperation
An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2 – Permissible activities
The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

Principle 3 – Licensing criteria
The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance

of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4 – Transfer of significant ownership
The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5 – Major acquisitions
The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6 – Capital adequacy

reflect risks that bank undertakes

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 7 – Risk management process

identify, evaluate, monitor and control or mitigate all material risks

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8 – Credit risk
Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9 – Problem assets, provisions and reserves
Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10 – Large exposure limits
Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11 – Exposures to related parties
In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must

have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12 – Country and transfer risks
Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13 – Market risks
Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14 – Liquidity risk
Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15 – Operational risk
Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16 – Interest rate risk in the banking book
Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 17 – Internal control and audit
Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 18 – Abuse of financial services
Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 19 – Supervisory approach
An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and

also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Principle 20 – Supervisory techniques
An effective banking supervisory system should consist of on-site and off-site supervision and regular contact with bank management.

Principle 21 – Supervisory reporting
Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Principle 22 – Accounting and disclosure
Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Principle 23 – Corrective and remedial powers of supervisors
Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

Principle 24 – Consolidated supervision
An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 25 – Home-host relationships
Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

Development of the Core Principles

heads of government of G7 countries

The heads of government of the G7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States of America) held their 1995 annual summit in Halifax, Canada, after which they issued a communiqué which included the following statement:

"Closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent an erosion of prudential standards. We urge:

– *a deepening of cooperation among regulators and supervisory agencies to ensure an effective and integrated approach, on a global basis, to developing and enhancing the safeguards, standards, transparency and systems necessary to monitor and contain risks."*

This message was reiterated in the G7 countries' communiqué following its summit held in Lyon, France, the following year. Support was also expressed for the adoption of strong prudential standards and the promotion of effective supervisory structures in emerging markets.

The Basel Committee, in response, explored ways in which it could increase its efforts aimed at strengthening prudential supervision worldwide. These efforts culminated in the Basel Committee publishing the original Core Principles in September 1997. The Core Principles document was drafted in association with supervisors from non-Basel Committee countries and is viewed as the first *bona fide* consensus document of the global banking supervisory community.

efforts aimed at strengthening prudential supervision worldwide

Banking supervisors use the Core Principles to assess the quality of their supervisory system and identify any weakness that may exist. The IMF and the World Bank use these principles to conduct Financial Sector Assessment Programs (FSAPs). FSAPs are programmes undertaken by the IMF and the World Bank to enhance the effectiveness and soundness of financial systems in countries. The key objectives of FSAPs are to identify the strengths and vulnerabilities of a country's financial system and to determine the way in which the major sources of risk to such systems are being managed. Following from this, the aim is to determine technical assistance requirements and prioritise policy responses.

Financial Sector Assessment Programs

The Core Principles, although widely viewed as a sound standard for the regulation and supervision of banks, posed a few difficulties to those tasked with assessing compliance with them. This was mainly a result of assessors interpreting the principles in diverging ways and therefore resulting in inconsistent assessments. In late 1998 the Basel Committee, in association with non-Basel Committee supervisors, the IMF and the World Bank, undertook a project to establish guidelines that would promote consistent assessment. This project resulted in the Basel Committee publishing the "Core Principles Methodology" (the Methodology) in October 1999.

Core Principles Methodology

The Methodology sets out assessment criteria and accompanying gradings which are to be applied when assessing compliance with each principle. The assessment criteria comprise essential and additional criteria. In determining compliance only the essential criteria are considered, while additional criteria are accepted as "best practice" which should be considered by countries with advanced banking systems.

assessment criteria and accompanying gradings

The assessment criteria have the following revised grading scale:

revised grading scale

- Compliant – a country will be considered compliant with a principle when all essential criteria applicable for this country are met without any significant deficiency. Of course, there may be instances where a country can demonstrate that the principle has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the principle, and therefore other measures may also be needed for the aspect of banking supervision addressed by the principle to be considered effective.

- Largely compliant – a country will be considered largely compliant with a principle if only minor shortcomings are observed which do not raise any concern about the authority's ability and clear intent to achieve full compliance with the principle within a prescribed period. The assessment "largely compliant" can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficient and no material risks are left unaddressed.

- Materially non-compliant – a country will be considered materially non-compliant with a principle whenever there are severe shortcomings, despite the existence of formal rules, regulations and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are of such a nature to raise doubts about the authority's ability to achieve compliance. It is acknowledged that the "gap" between "largely compliant" and "materially non-compliant" is wide, and that the choice may be difficult. However, the intention is to force the assessors to make a clear statement.

- Non-compliant – a country will be considered non-compliant with a principle whenever there has been no substantive implementation of the principle, several essential criteria are not complied with or supervision is manifestly ineffective.

Revision of the Core Principles

significant developments have taken place

Following the publication of the original Core Principles, significant developments have taken place in both banking regulation and in the manner in which banks conduct their business. Issues that in particular have come to the fore are risk-management, corporate-governance and anti-money laundering concerns. Furthermore, the numerous compliance assessments that have been performed have identified some shortcomings in the Core Principles. In this light, the Basel Committee initiated the process of revising the Core Principles and its Methodology at the end of 2004.

Basel Core Principles Reference Group

The revision of the Core Principles was mainly executed by a Basel Committee working group, namely the Basel Core Principles Reference Group (BCP Reference Group). This working group consisted of representatives of the Basel Committee and the Core Principles Liaison Group (CPLG). The CPLG consists of senior representatives from eight Basel Committee member countries (France, Germany, Italy, Japan, the Netherlands, Spain, the United Kingdom, and the United States of America), 16 non-G10 supervisory authorities (Argentina, Australia, Brazil, Chile, China, the Czech Republic, Hong Kong, India, Korea, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, and the West African Monetary Union), the European Commission, IMF, World Bank, and the Financial Stability Institute.

mandate to the BCP Reference Group

The Basel Committee's mandate to the BCP Reference Group was to maintain continuity and comparability with the 1997 Core Principles framework and only focus on areas where modifications were required. The objective, therefore, was to update rather than rewrite the principles.

intensive discussions

The drafting process did not only involve intensive discussions within the BCP Reference Group, but also incorporated the views of banking supervisors not directly involved in the revision of the Core Principles. In addition, the comments from the International Association of Insurance Supervisors, the International Organization of Securities Commissions, the Financial Action Task Force and the Committee on Payment and Settlement Systems were considered. This culminated in an eleven-week global public consultation process which commenced in April 2006.

endorsed the revised Core Principles

Comments received during the public consultation process were processed whereafter the final versions were provided to the Basel Committee and the CPLG for their approval. Subsequently, at the biennial International Conference of Banking Supervisors which was held in Mérida, Mexico from 4 – 5 October 2006, senior bank supervisors from 120 countries endorsed the revised Core Principles and its Methodology, whereafter it was published by the Basel Committee.

Compliance with the revised Core Principles

benefits of the Core Principles

Banking supervisors around the world concur that the adoption of the Core Principles enhances not only a banking supervisory system, but also the banking and financial sector in general. Some of the benefits that it offers to the supervisor are as follows:

- Comprehensiveness – notwithstanding the fact that the principles cover numerous components of a supervisory system, a detailed assessment of each principle is possible as a result of the essential and additional criteria in the Methodology.

- Flexibility – the principles are flexible in that, for a number of criteria, compliance can be achieved in more than one way.

- Comparability – the principles focus on the key requirements for an effective supervisory system and compliance is possible for all supervisors globally. It therefore enables peer group comparisons.

Department performed a self-assessment

During the first half of 2006 the Department performed a self-assessment of compliance with the revised Core Principles. The Core Principles had, at that stage, not yet been endorsed for publication and, therefore, the Department monitored all further amendments throughout the assessment process. This exercise was facilitated by the Department having served as a member of the BCP Reference Group.

project team was established

A project team was established in the Department comprising a chairperson, five senior staff members appointed as team leaders and two project co-ordinators. The team leaders who, in turn, each had six staff members reporting to them, were tasked with the responsibility of co-ordinating and steering the assessments that were being conducted. The two project co-ordinators were responsible for ensuring that the assessments were conducted in an objective and consistent manner.

key objectives

The key objectives of the self-assessment were to:
- benchmark the South African banking supervisory system against the Core Principles;
- conduct a comprehensive gap analysis; and
- develop an action plan for eliminating the shortcomings that were identified.

self-assessment was very conservative

The self-assessment conducted by the Department was very conservative in that gradings were not assigned to the principles, but rather to each essential and additional criterion of all the principles. Every graded criterion had to be supported by one or more of the following: The Banks Act; the Regulations relating to Banks; and the Department's supervisory process. Criteria not rated as compliant had to be explained clearly in terms of the shortcomings in the aforementioned categories, as applicable. This approach, although very time-consuming, allowed for the precise identification of shortcomings and the determination of rectification plans.

process culminated in a three-day workshop

The self-assessment process culminated in a three-day workshop attended by all of the Department's staff during the second quarter of 2006. The workshop was very successful in that it allowed different views to be expressed and also resulted in lively debates on certain issues. Following the incorporation of comments received at the workshop, the five team leaders were directed to implement the proposed rectification plans that would steer the Department to full compliance with the Core Principles.

project team continues to meet

A project team continues to meet on a monthly basis to assess the progress made in implementing the action plans. The ultimate objective for the Department is to obtain a favourable rating when it is next assessed by the IMF and World Bank FSAP.

The new Capital Accord (Basel II)

The 2004 and 2005 *Annual Reports* provide an extensive overview of the implementation of Basel II in South Africa.

intensify efforts to prepare for Basel II

During the past year all parties involved in and affected by the activities of the Accord Implementation Forum (AIF) became acutely aware of the full implication of the Basel II implementation date of 1 January 2008 and the required effort to meet associated deadlines. This prompted all involved to intensify their efforts to prepare for Basel II implementation during 2006.

Accord Implementation Forum activities

highlighted areas for improvement

A second draft of the proposed amendments to the Regulations relating to Banks (proposed Regulations) was made available by the Department to the AIF forums from the end of January 2006. The proposed regulatory returns were subjected to a variety of tests, which highlighted areas for improvement and further refinement. The AIF forums were given opportunity until 30 June 2006 to comment on this second draft.

comprehensive third draft of the proposed Regulations

As a result of continued work in the AIF forums, international developments and further information becoming available in certain areas, the commentary period for the AIF forums was extended to encapsulate further valuable input. A comprehensive third draft of the proposed Regulations was made available on 31 October 2006, whereafter further updated modules were released until the end of November 2006.

basis for banks' systems-development processes

Following the issuing of draft three of the proposed Regulations, the Department engaged actively with the chairpersons and delegates of the respective AIF task groups and subcommittees through structured meetings which were held until 8 December 2006, with a view to concluding high-priority issues that needed to be clarified and incorporated into a fourth draft of the proposed Regulations. This was a critical step to ensure that a stable draft of the proposed Regulations was produced to serve as a basis for banks' systems-development processes and preparation for the parallel runs that are scheduled to take place during the second half of 2007.

Minister of Finance will consider for approval

It is anticipated that the Minister of Finance will consider for approval the proposed Regulations during the latter part of 2007, which will enable the implementation of Basel II on 1 January 2008.

Overview of approaches

a variety of approaches

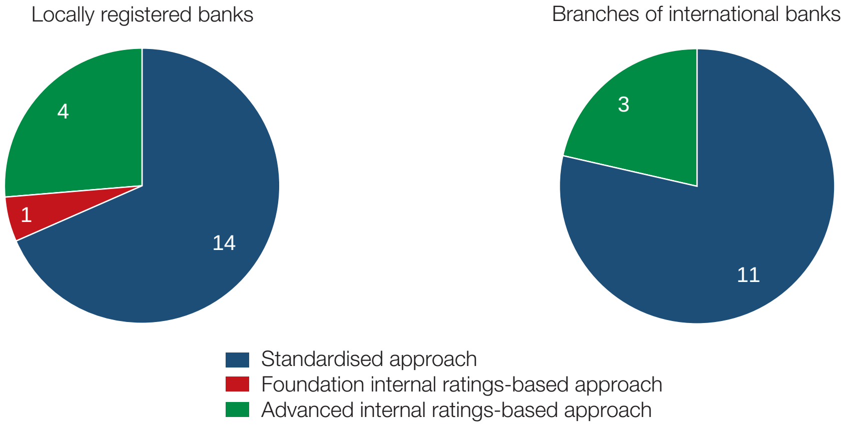
Basel I did not make provision for different approaches and all banks followed the same methodology for the calculation of the minimum required capital (MRC). By contrast, Basel II offers a variety of approaches, in particular for credit risk and operational risk. The use of the more advanced approaches would be subject to the approval of the supervisory authority. The Department will be processing the approval applications during 2007.

Credit risk

The targeted approaches in respect of credit risk are as follows:
- Standardised approach (STA)
- Foundation internal ratings-based (FIRB) approach
- Advanced internal ratings-based (AIRB) approach

The number of banks that have indicated they would be targeting the respective approaches for credit risk are as follows:

Figure A Credit risk

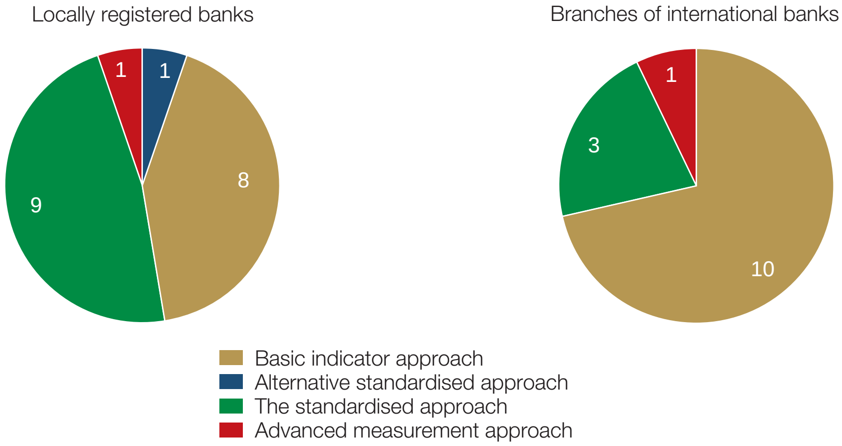


Operational risk

Targeted approaches in respect of operational risk are as follows:
- Basic indicator approach (BIA)
- Alternative standardised approach (ASA)
- The standardised approach (TSA)
- Advanced measurement approach (AMA)

The number of banks that have indicated they would be targeting the respective approaches for operational risk are as follows:

Figure B Operational risk



Quantitative Impact Study 5

During 2006 the Department requested locally-incorporated banks targeting the advanced approaches for credit and/or operational risk, as well as other specially selected smaller banks to take part in Quantitative Impact Study 5 (QIS 5). The banks were requested to complete and submit the QIS 5 worksheets by 31 July 2006.

purpose of QIS 5

The purpose of QIS 5 was manifold and included the following:
- Obtaining relevant information pertaining to the impact of implementing Basel II.
- Assessing the state of preparedness for Basel II implementation.
- Developing guidance on relevant issues pertaining to Basel II.

From a quantitative perspective, the QIS 5 results indicated that the MRC, in terms of Basel II and when compared to the MRC in terms of Basel I, would increase by:
- 12,70 per cent for Group 1 banks (banks implementing the advanced approaches for credit and/or operational risk); and
- 4,75 per cent for Group 2 banks (specifically selected smaller banks).

It should be noted that the above-mentioned increases in MRC, refers to a monetary value and not the capital-adequacy ratio. Currently, the banking sector is well-capitalised, and it is anticipated that the banking sector will remain well-capitalised upon implementation of Basel II. The banking sector, on a weighted basis, has made good progress in its capital management, *inter alia*, by managing capital on a proactive basis.

Formal field tests

resources, systems, processes and procedures

Banks are required to demonstrate that they have the necessary resources, systems, processes and procedures in place to duly populate and complete the proposed statutory returns with the implementation of Basel II. Accordingly, the Department conducted formal field tests during the year under review.

purpose of the field tests

The purpose of the field tests was to assist the Department in assessing the level of preparedness for the implementation of the new regulatory framework and to ensure that the objectives set for the proposed Regulations could be met and that they would facilitate the implementation of Basel II.

returns for credit risk and financial information

Banks that did not participate in the QIS 5 conducted formal field tests of the proposed returns for credit risk and financial information during the period September 2006 to November 2006. This was a valuable exercise to identify areas where refinement was needed in respect of regulatory reporting.

Conclusion

skills requirements in respect of Basel II

The ever-increasing demand for appropriately skilled resources is a worldwide phenomenon and skills requirements in respect of Basel II is a constant challenge. Notwithstanding, significant progress was made with the Basel II project in South Africa through the combined efforts of many interested parties within the National Treasury, the banks, the South African Institute of Chartered Accountants and, in particular, assistance from The Banking Association South Africa.

Apart from the quality of resources, supervisors worldwide continue to face many other challenges in ensuring that the implementation of Basel II can be effected in a manner that is appropriate in their respective countries, while at the same time ensuring that the objectives of the Basel II framework are achieved. As highlighted by the Chairman of the Basel Committee recently, supervisors have utilised supervisory tools in the past which fortunately will still be relevant for Basel II implementation, such as sound judgement.

many other challenges

Review of compliance with the Financial Intelligence Centre Act, 2001

As indicated in the 2005 *Annual Report*, two firms of auditors were commissioned to verify compliance with the requirements of the Financial Intelligence Centre Act, 2001 (FICA) by the five largest banks and in particular to verify the client-verification data that the banks had submitted to the Department during the year.

verify FICA compliance

As from January 2006, the review team of the Department performed a similar review of the remaining banks and selected branches of foreign banks. The review comprised an analysis of the policies and procedures of the banks concerned, coupled with the testing of sample files to assess whether or not each bank's policies and procedures complied with the implementation of best practice.

On completion of each review, each bank was informed of the Department's recommendations regarding improvements that could be made to the adopted policies and procedures.

The Department is of the opinion that banks and branches of foreign banks have made good progress in the implementation of anti-money laundering (AML) and combating the finance-of-terrorism (CFT) measures, and it will continue to monitor and supervise their progress in this regard.

banks have made good progress

Enforcement of deadline for client identification and verification

In terms of the exemption granted by the Minister of Finance in Government Notice No. 749 published in *Government Gazette* No. 26487 of 21 June 2004 (the exemption), banks were given until 30 September 2006 to establish and verify the identity of all the clients they had categorised as a low money-laundering risk. After this date, banks were to comply with the law by stopping transactions on the accounts of clients in the low risk category who had not co-operated with their bank in its efforts to comply with the provisions of the exemption.

verify the identity of all clients

The Department duly monitored the banks' compliance with the exemption and requested banks to provide it with the figures verifying their compliance and non-compliance with the know-your-customer (KYC) requirements in terms of FICA.

At the end of the process some banks were found to have been unable to identify and verify some of their customers across all categories of risk, and this was accordingly communicated to the FIC. The aforementioned banks were requested to submit detailed plans of action to address the non-compliance.

Cellular telephone banking

challenges with AML/CFT compliance

The banking industry continued to extend banking services to a wider range of prospective clients. One of these initiatives was cellular telephone (cell phone) banking. The introduction of cell phone banking, however, brought about unique challenges with regard to compliance with AML/CFT measures. The Department released Banks Act Circular 6/2006 in July 2006 to provide guidance to banks to ensure that they had adequate and appropriate policies and procedures in place to detect, investigate and prevent money laundering and the financing of terrorism.

The cell phone banking product is covered by exemption 17 of the exemptions in terms of FICA and is therefore subject to reduced requirements to establish and verify a client's identity. The circular highlighted further parameters and conditions that banks had to put in place if they wished to provide cell phone banking products.

Banks' operations in Africa and the impact of FICA

uniform compliance with Financial Action Task Force standards

South African banks have expanded their operations into the African region. It is therefore important, in terms of cross-border supervisory standards, that all regulatory authorities in Africa ensure industry alignment and uniform compliance with Financial Action Task Force (FATF) standards. South Africa contributes to this objective through its participation in the East and Southern African Anti-Money Laundering Group (ESAAMLG) and the Committee of Central Bank Governors (CCBG).

Supervisory process

role of internal audit function

The Department proposed that the role of the internal audit function of banks be extended to include FICA requirements. During 2007, the internal audit function of each bank will be required to report to the Department on the following:

- A high-level overview of internal audit functions in respect of the implementation of AML/CFT.
- Key internal audit findings in respect of the 2006 financial year as well as the 2007 financial year to date.
- An overview of reports issued, actions taken and the timing thereof, in order to address the key findings.
- Interaction with the bank's audit committee and anti-money laundering control officer responsible for AML/CFT.
- An overview of the internal audit plan for the forthcoming twelve months, including the adequacy of resources.
- An overview of the current compliance status with AML/CFT requirements.

staff to be fully trained in AML/CFT

Banks were requested to have their staff fully trained in AML/CFT and to furnish the Department with copies of their training programmes and manuals. Banks were also encouraged to expose their directors to enhanced training in AML/CFT.

Combating illegal deposit-taking

business of a bank

The Department is primarily responsible for the regulation and supervision of registered banks in the Republic of South Africa. It neither registers nor supervises investment schemes. The Banks Act, however, provides that no person may conduct the "business of a bank" unless such a person is a public company and is registered as a bank. The "business of a bank" is defined in the Banks Act and can be described as the soliciting or advertising for or the acceptance of “deposits” from the general public as a regular feature of a business. There are a number of exclusions and exemptions to the above-mentioned prohibition.

A “deposit” is comprehensively defined in the Banks Act, but can be described as an amount of money paid by one person to another subject to an agreement in terms of which an equal amount or any part thereof will be repaid on demand, on a specified or unspecified date, or in agreed upon circumstances. There are a number of specified exemptions to the aforementioned general definition.

“deposit” comprehensively defined

Deposit-taking, i.e. conducting the business of a bank, requires a high degree of confidence and trust and it is for these reasons that banks need to be stringently regulated. When deposits are illegally taken from the general public by unregulated and unsupervised persons and entities, such deposits are not afforded any level of trust and confidence as enjoyed by the banking system.

high degree of confidence and trust

Sections 81 to 84 of the Banks Act afford the Department certain powers to control the activities of unregistered persons. These activities are, however, confined to illegal deposit-taking. The above-mentioned provisions provide, *inter alia*, that the Registrar of Banks may do the following in respect of unregistered persons suspected of taking deposits from the general public in contravention of the Banks Act:

powers to control activities of unregistered persons

- Apply to court for an order prohibiting anticipated or actual schemes involving illegal deposit-taking;
- exact information from unregistered persons;
- inspect the affairs of an unregistered person (inspectors are appointed by the Governor or deputy governors of the South African Reserve Bank in terms of the provisions of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989);
- direct such a person to repay such money if the Registrar is satisfied that the person has illegally taken deposits from the general public; and
- appoint a manager to manage and control the repayment of the money unlawfully obtained.

The Department understands the rationale for the above-mentioned powers to be the following:

- As banks are subjected to stringent regulation and meticulous supervision in exchange for the right to accept deposits from the general public, it is unfair and untenable to allow unregistered persons not subjected to the same regulation and meticulous supervision to compete with banks in an unfettered manner. The Department is therefore empowered to take action against unregistered persons in order to prevent unfair competition with registered banks. The regulation of banks described above is a costly but necessary exercise in the interest of the public. The unregulated person, however, has the advantage of freedom brought about by non-regulation and therefore competes with the regulated person unfairly.

- Notwithstanding the fact that deposit-taking from the general public by an unregistered person is a criminal offence, deposit-taking schemes are often characterised by an element of fraud and are harmful not only to the established and regulated banking system but also to the economy as a whole. To prevent the development of a secondary illegal, harmful and/or fraudulent “banking” system, it is necessary for the Department to enforce the above-mentioned powers.

- Another purpose of the above-mentioned powers is to contribute to depositor or investor protection.

Department only reacts to complaints

Since the Department neither registers nor supervises unregistered persons, it is generally not aware of such deposit-taking schemes unless it is informed thereof by members of the public. The Department only reacts to complaints received from the general public that contain sufficient details and documentary evidence to justify the Department invoking its powers in terms of the Banks Act.

exorbitant returns on investments

One of the hallmarks of these investment schemes is that they offer exorbitant returns on investments, thereby luring depositors on a large scale. In recent cases, it has been found that the managers of such schemes often fraudulently justify the exorbitant returns by stating that funds taken from the public will be invested in lucrative property developments, or by providing so-called “bridging finance” at a higher rate than the promised return or by means of a foreign-exchange transaction yielding income in excess of the promised return. Schemes of this nature that have been investigated by the Department have all failed and have been found to be well-disguised pyramid schemes where investors have lost all or large portions of their investments.

investors fully aware of risks involved

Although the Department is concerned about the number of uninformed persons losing their hard-earned money or life savings through such schemes, it seems the continued existence and frequent establishment of these schemes are the result of greedy investors who are fully aware of the risks involved, but are making a healthy profit by withdrawing from the scheme at an early stage and at the cost of investors who join the scheme at a later stage.

During the year under review, the Department investigated approximately forty such businesses or investment schemes.

Market risk

internal model approach

There are twelve banks in South Africa that conduct proprietary trading and report on the resulting market risk. To calculate the capital requirement for market risk, three of these banks report to the Department according to the internal model approach (IMA). Another three banks are in the process of applying to the Department for approval to use this approach. Seven banks report according to the building-block method and the remaining two employ the simplified method.

increased frequency of on-site reviews

The imminent introduction of Basel II and its greater sensitivity to bank-wide risk is an additional motivating factor encouraging banks with significant market-risk exposures to pursue the IMA. Accompanying the task of annual and new approvals for this approach is a strategy for the increased frequency of on-site reviews that the Department has begun to deploy. The short-term reviews aim to assess operational risks associated with applying the IMA, and to review the validity of the multiplication factor more regularly, enabling a more rapid response to adjusting capital requirements via the multiplication factor under both adverse and favourable circumstances.

documentary investigation, on-site inspection and interviews

The Department conducted in-depth reviews on banks following the IMA, as part of the process of annual IMA approval and re-assessment of the value-at-risk (VaR) multiplication factor. In addition, a new application for the use of the IMA by a bank was reviewed. The Department’s assessments are thorough, measuring the compliance of the banks’ treasuries, market-risk departments and back-offices with standards set out in the Core Principles, as well as qualitative standards for banks with IMA approval documented in the integrated version of the Basel II framework, as published in June 2006. The reviews address economic, regulatory, prudential, technical, mathematical, organisational and governance-related aspects of the banks' treasury operations, taking the form of documentary investigation and on-site inspection and interviews. Following the Department's satisfactory findings, approval was granted to a bank applying for first-time use of the IMA and all the banks applying for renewals of approval.

market volatility

Upward movements in the local interest rate environment, as well as escalated activity in equities markets marked by continual record-breaking levels in the JSE all-share index, coupled with a weakening in the rand-dollar exchange rate resulted in dramatic increases in volatility and in the position risk of trading banks in the latter half of the year. This market volatility triggered noticeable increases in the trading profitability of many banks during August and September 2006. Most banks did not adjust their trading limits or increase their appetite for market risk during this period.

Liquidity risk

general increase in liquidity risk

Due to the growth in long-dated assets, i.e. mortgage loans which were mainly being funded by short-term funding, the Department continued to focus on liquidity risk management during the year under review. This asset growth had resulted in a general increase in liquidity risk especially in the short-term maturity mismatch of banks. The Department, at the annual meetings held with the respective boards of directors of banks, engaged on this issue.

ongoing monitoring of action plans

As indicated in the 2005 *Annual Report*, all issues that the Department identified during the reviews were communicated to the banks concerned. As part of its ongoing monitoring of action plans, the Department continued to monitor the progress of the reviewed banks' action plans.

simulated liquidity crisis

As a result of these action plans one bank, in conjunction with consultants, conducted an exercise to test the effectiveness of its contingency strategy in a simulated liquidity crisis. Central to the simulation exercise was stress testing the dependency of wholesale funding by way of bank-specific events and external events that had an impact on the bank occurring over a short time frame, and the ability of the bank to handle the liquidity crisis independent of any assistance from the South African Reserve Bank. The exercise required responses from all functional areas of the bank and management. The Department primarily participated in the exercise in an observer role and, to a limited extent, interactively.

banks should communicate with the Department

Various tools and procedures utilised by the bank proved effective in identifying a crisis and monitoring key liquidity risk indicators. The management of the bank found the exercise to be invaluable since it highlighted those areas where further enhancements to the existing contingency policies and procedures were required. The exercise also made it evident that banks should communicate with the Department more promptly when a crisis is identified.

In 2007 liquidity risk supervision will focus on developing liquidity risk-monitoring practices during the field testing of the draft regulatory returns in preparation for implementing the proposed Regulations in line with Basel II. In particular, the proposed Regulations will include behavioural aspects of deposit volatility, while supervisory reviews will examine the utility of stress testing conducted by banks.

Supervision of financial conglomerates: Joint Forum

banking, securities and insurance sectors

The standard-setting body with respect to the supervision of financial conglomerates is the Joint Forum, a body of financial-sector supervisors with equal representation from the banking, securities and insurance sectors. It was established in 1996 under the auspices of the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) – often referred to as the Joint Forum parent committees.

The work of the Joint Forum encompasses issues relating to financial conglomerates as well as issues that are of common interest to the three parent committees. It has published a number of papers setting out principles to be applied in the supervision of financial conglomerates. These publications, which were originally issued in 1999, were reissued as a compendium in 2001.

Brazil, India and South Africa were invited to participate

In addition to the two working groups already in existence, dealing with (i) how firms identify and manage concentrations, and (ii) how they manage the risks related to customer suitability, the Joint Forum recently created a third working group which held its first meeting on 2 and 3 November 2006 in Basel, Switzerland. Although they are not Joint Forum member countries, Brazil, India and South Africa were invited to participate in this new working group, called the Joint Forum Working Group on Conglomerate Principles (JFCP). The JFCP's mandate comprises taking stock of the implementation by supervisors worldwide of the principles contained in the Joint Forum's *Supervision of Financial Conglomerates* (the Joint Forum principles) issued in 1999.

incorporated into South African banking legislation

The Joint Forum principles were incorporated into the South African banking legislation in November 2000, when the Regulations were promulgated with respect to banking groups. Furthermore, the Department has for some time been engaged in the process of formalising its working arrangements through Memoranda of Agreements for sharing information with supervisory agencies internationally in the various jurisdictions where South African banks' operations are located. In addition, a Memorandum of Agreement has been locally entered into with the FSB, the regulator of non-bank financial institutions in order to foster the supervision of financial conglomerates with bank and non-bank regulated entities and to facilitate the sharing of information pertaining to such conglomerates. Furthermore, formal meetings are held, on a quarterly basis, with the FSB to discuss, among other matters, those relating to conglomerate groups.

The Joint Forum principles require that the fitness and properness of individuals in financial conglomerates are assessed. The vetting by the Department of individuals regarding fitness and properness for the appointment of directors as executive officers has always been applied at the levels of both the bank and the bank controlling company and in consultation with the FSB. Furthermore, an amendment to the banking legislation, promulgated in 2003, further enhanced the Department's powers by vesting in it the power to object to any such appointment. With respect to shareholding, South African banking legislation requires the Registrar of Banks' approval when the shareholding in a bank or banking group breaches the thresholds of 15 and 24 per cent. The Minister of Finance's approval, in addition to that of the Registrar of Banks, is required when shareholding breaches the 49 and 74-per-cent thresholds.

continued compliance with the Joint Forum principles

Finally, the imperative of ensuring continued compliance with the Joint Forum principles has been fully taken into account in the Basel II implementation process which is intended to culminate with full implementation on 1 January 2008.

Independent Regulatory Board of Auditors

Auditing Profession Act, 2005 promulgated

Following recommendations made by the Review Panel on the Accountancy Profession, set up by the Minister of Finance in December 2002 in the aftermath of high-profile corporate failures that had taken place both locally and internationally during the preceding three years, the Auditing Profession Act, 2005 (the Act) was promulgated and assented to by the President of the Republic of South Africa in January 2006. This Department served on the aforementioned Review Panel. The Act came into effect on 1 April 2006, thereby heralding the beginning of a new era of regulation of the auditing profession in South Africa through the creation of the Independent Regulatory Board of Auditors (IRBA), a statutory regulatory body that superseded the Public Accountants and Auditors Board which ceased to exist from that date.

objectives of the Act

The objectives of the Act include:
- the establishment of IRBA;
- the protection of members of the public through the regulation of audits performed by auditors;
- the development and maintenance of international standards of auditing and ethics;
- advancing the implementation of appropriate standards of competence and ethics; and
- the development and implementation of appropriate disciplinary procedures in respect of improper conduct.

The Board of Directors (Board) of IRBA, which is funded jointly by government and the auditing profession, comprises representatives who are not registered auditors as well as registered auditors. The Act, however, prescribes that the majority of IRBA Board representatives be persons who are not registered auditors, with the maximum of registered auditor representatives being limited to 40 per cent of the Board.

functions of IRBA

The functions of IRBA are:
- promoting professional integrity;
- protecting the public in dealings with registered auditors;
- prescribing standards of professional competence, ethics and conduct;
- encouraging continued education and research;
- prescribing auditing standards;
- governing the accreditation of professional bodies;
- governing the registration of auditors; and
- determining registration fees and charges.

IRBA committees

In terms of section 20(2) of the Act IRBA must, at least, establish the following permanent committees:
- Committee for Auditor Ethics;
- Committee for Auditing Standards;
- Education, Training and Professional Development Committee;
- Inspection Committee;
- Investigating Committee; and
- Disciplinary Committee.

Section 22(1)(h) of the Act stipulates that one of the members of the Committee for Auditing Standards must be an incumbent of the Department or a person nominated by that incumbent.

Furthermore, IRBA, through its disciplinary committee, is responsible for the development and maintenance of appropriate discipline and procedures in respect of improper conduct by registered auditors. The disciplinary code is applicable to both individual members and audit firms.

duty on registered auditors to report

The Act has also placed the duty on registered auditors to report to IRBA whenever they are satisfied or have reason to believe that a reportable irregularity has taken place or is taking place in an entity in respect of which they are the registered auditors, in terms of section 45 of the Act. The Act places a duty on IRBA to further report such continuing irregularities pertaining to banking institutions to the Department. This replaces the requirements pertaining to material irregularities which were applicable under the now repealed Public Accountants and Auditors Act, 1991.

Training of staff

ensure that the skills base is constantly improved

To ensure that the skills base of the Department is constantly improved, considerable resources are allocated for training purposes. During the year under review the Department allocated approximately R1 million of its funds to the training of approximately 90 employees. This training enables staff to:

- implement sound global supervisory standards and practices;
- share supervisory practices and experiences; and
- promote cross-border supervisory contacts and co-operation.

International courses attended

During the year under review, staff members attended the following courses:

- IMF Regional Meeting on Financial Soundness Indicators Co-ordinated Compilation Exercise, in Brazil.
- Basel II and Financial Stability: Preconditions and Implementation Challenges, in Indonesia.
- International Banking Supervision Seminar: Core Supervisory Issues and the Core Principles, in Switzerland.
- The Financial Services Authority International Seminar, in the United Kingdom.
- The Federal Reserve Bank's Bank Supervision Specialised Course, in the United States of America.

Basel II training

Regarding the validation and monitoring of the advanced approaches for Basel II, risk specialists and quantitative experts will need to sufficiently understand a bank's internal ratings systems and models to conduct an initial validation and to monitor compliance. This will require a high level of expertise in areas such as statistics, modelling techniques and evaluation, simulation and stress testing.

commenced training on a number of fronts

The Department has recognised these challenges and has commenced training on a number of fronts as outlined below:

Firstly, the continued subscription to FSI Connect, a web-based training programme developed by the Financial Stability Institute of the Bank for International Settlements (FSI). The programme consists of more than 130 modules, each module covering a specific topic which includes a self-test that must be passed by the participant before graduating to the next module.

Secondly, vetting sessions on the draft Basel II returns were attended by all staff.

Thirdly, specialised training courses were presented in Pretoria.

- A reputable London-based consultancy presented Basel II training courses which had been adapted to ensure that they complied with South African legislation. The courses covered the following modules:
  - Fundamentals of credit risk and operational risk.
  - Basel II frameworks and risk mitigation.
  - Modelling and rating regimes.
  - Loss given default and exposure at default.

- The Federal Deposit Insurance Corporation of the United States of America presented a four-day training programme on operational risk in relation to Basel II, in Pretoria. The course content was comprehensive and well structured, enabling the participants to develop a thorough understanding of operational risk from a bank supervisor's perspective.

Intermediate Course in Risk-based Supervision

Department provided SADC training

During the year under review the Department hosted and presented the fourteenth Intermediate Course in Risk-based Supervision. The course was attended by fifteen participants from Angola, Mauritius, Malawi, Mozambique, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

The objectives of the course were to:

- update participants on current best practice in risk management as set out in the revised Basel Core Principles;
- provide a platform to discuss problem-bank resolution;
- provide an overview of the latest developments with Basel II; and
- provide a forum for the exchange of ideas on common problems such as combating money-laundering and the implementation of best supervisory practice, such as improving corporate governance in banks.

Regional training initiatives

The FSI presented a regionally-focused seminar in Pretoria during May 2006. The seminar, titled "Basel II and its implementation", covered the implementation and practical application issues relating to the Basel II framework. The various approaches for measuring credit risk, Pillar 2 and Pillar 3 issues, and cross-border issues were covered. The seminar was attended by twenty-four participants from twelve Southern African Development Community (SADC) countries.