Chapter 2

Current issues in banking supervision

important supervisory and regulatory developments

This chapter reports on the most important supervisory and regulatory developments during 2007. The key focus is the implementation of Basel II in South Africa and a comprehensive review is provided in this regard. The application for the acquisition of shares in a major South African bank is discussed, while other issues covered in this chapter include illegal deposit-taking, maintenance of a board directorship continuity programme, consumer education and bank on-site visits.

Implementing Basel II in South Africa

Introduction

Basel Committee's revised capital framework

The Department's effort to implement Basel II – the Basel Committee's revised capital framework – on 1 January 2008 was a major exercise undertaken over several years. Accordingly, the discussion below takes a holistic view of Basel II implementation from the start of the process, shortly after the millennium change, up to the date of implementation.

The discussion covers the process of incorporating Basel II into the regulatory framework, along with the development, implementation and embedding of the following elements of Basel II:

- Pillar 1, relating to the determination of the minimum required regulatory capital in respect of credit, market and operational risk, including the application and approval processes that were followed in respect of credit and operational risk, where banks targeted approaches other than the base approaches, the quantitative impact studies, field tests and parallel runs, and the recognition of eligible external credit assessment institutions.
- Pillar 2, relating to capital management, including the initial internal capital adequacy assessment process (ICAAP) assessments and the updating of the supervisory review and evaluation process (SREP).
- Pillar 3, relating to market discipline, which included industry training.

Background

culmination of more than five years' work

On 26 June 2004, the Basel Committee issued the publication titled *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, commonly referred to as 'Basel II'. It represents the culmination of more than five years' work by the Basel Committee.

Basel II seeks to set significantly more risk-sensitive capital requirements (in respect of operational risk as well) and is aimed at greater international convergence through capital requirements and better disclosure, thus enhancing the role of market discipline; and to ensure improved supervisory processes and procedures.

Initial considerations and decisions

Should South Africa adopt Basel II?

The mission of the Department is to promote the soundness of the banking system through the effective and efficient application of international regulatory and supervisory standards.

Nonetheless, before proceeding with the implementation of Basel II, the Department considered a range of preconditions that would facilitate the successful implementation of Basel II and was satisfied that South Africa met these preconditions. These included the following:

range of preconditions

- Macroeconomic policies and environment.
- Fiscal discipline and environment.
- Accounting (compliant with international standards, namely IFRS).
- Auditing (compliant with international standards, namely International Standards on Auditing (ISA).
- Legal environment
  - Corporate law
  - Insolvency law
  - Banking law (compliant national standards, namely with the Basel Core Principles and Basel I)
  - Financial Advisory and Intermediary Services Act
  - FICA (compliant with international standards, namely FATF recommendations)
  - National Credit Act (NCA).
- Bank supervision (compliant with international standards, namely with the Core Principles and Basel I).
- Corporate governance (compliant with international standards, namely relevant Basel Committee prescriptions contained in the publication titled *Enhancing Corporate Governance for Banking Organisations*, as well as the local best practice standards, that is, with the King I and II reports on corporate governance).
- Risk management (compliant with international standards, namely with Core Principles, Basel I and various other relevant Basel Committee guidelines contained in various publications. Furthermore, the Department strives towards best practice on an ongoing basis.).
- Payment system (compliant with international standards, namely Core Principles for Systemically Important Payment Systems)
- Disclosure (compliant with international standards, namely IFRS).

The implementation date that was decided upon was 1 January 2008, to all banks.

South Africa's approach to the scope of its implementation of Basel II

A fundamental decision that underpinned the Department's preparation for the implementation of Basel II was that Basel II would be adopted in its letter and spirit as an absolute minimum standard, and no sub-Basel II deviations would be permitted, although enhancements to Basel II that set a higher standard were, and in future may be, incorporated into the regulatory and supervisory framework.

no sub-Basel II deviations

The Department has a responsibility to ensure the promotion and adoption of sound, robust and universally applicable standards relating to such aspects as are material to all dimensions of banking and the banking system. This approach enables the Department to promote a sound and robust banking system that is best positioned to deliver optimal value to South Africa. The Department remains committed to ensuring that its approach remains relevant in the face of market and international regulatory developments. As such, the Department sees Basel II not as a single destination, but rather as an important milestone on the journey towards best practice.

robust and universally applicable standards

Basel II contains a menu of approaches

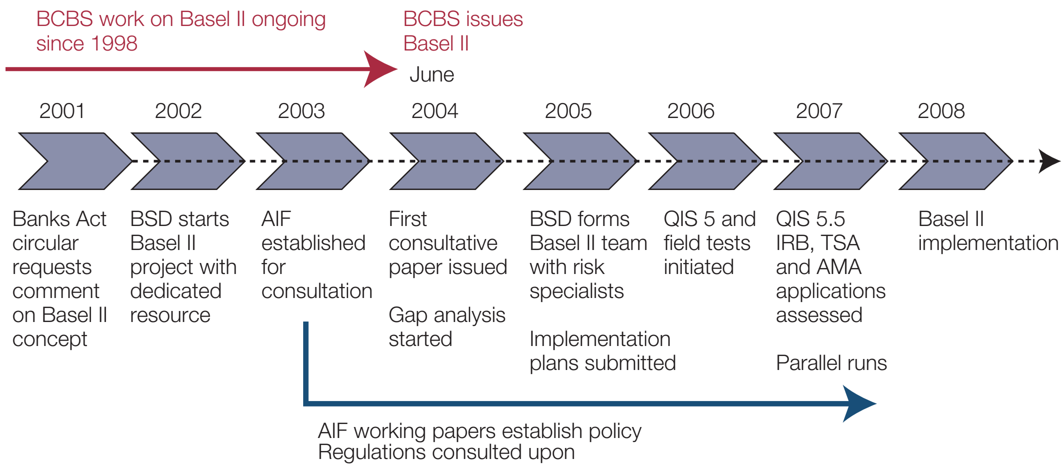
It is in this regard that the Department welcomes the fact that Basel II contains a menu of approaches that cater for a spectrum of banks, banking groups, or bank regulators and bank supervisors, from the basic to the highly sophisticated. All approaches contained in Basel II are available to banks in South Africa, subject to relevant conditions being met.

does not discriminate

As Basel II caters for the full spectrum of banks, banking groups and banking systems, it does not discriminate against any particular bank, banking group, bank regulator or supervisor. Furthermore, whether or not the bank, banking group, banking system or bank regulator and supervisor are sophisticated; or located within a developing country or within a developed country, the same standard and minimum requirements apply to all parties in relation to a particular approach. Accordingly, Basel II has the flexibility to enable a bank or banking group to make choices relating to the scope of the adoption of Basel II that are relevant and appropriate to its individual circumstances. At the same time, should a bank regulator or supervisor in a developing country make available an advanced approach to banks within its jurisdiction, it would be expected to attain and maintain the minimum Basel II standards in relation to its regulatory and supervisory frameworks and policies, practices and procedures.

The time line for Basel II implementation is outlined in Figure 2.

Figure 2 Time line for Basel II implementation



AIF	–	Accord Implementation Forum
AMA	–	advanced measurement approach (operational risk)
BCBS	–	Basel Committee on Banking Supervision
BSD	–	Bank Supervision Department
IRB	–	internal ratings-based approach (credit risk)
QIS	–	quantitative impact study
TSA	–	the standardised approach (operational risk)

Familiarisation

understanding of Basel II

The first step in the implementation process was to gain an understanding of Basel II. This entailed, *inter alia*, presentations and workshops with the industry. In view of the nature, extent and complexity of Basel II, a process of updating and informing will be sustained into the future.

Project management

The Department applied a project management approach to the implementation of Basel II. To this end, a master plan titled "Key Milestones" was compiled, consisting of key deliverables, deadlines and the allocation of responsibilities. A separate document titled "Road to Parliament" captured the planning around the required proposed amendments to the regulatory framework.

project management approach applied

The plans were updated as and when required by changed circumstances and/or as unanticipated bottlenecks developed.

The Department was cognisant throughout the implementation phase of factors such as a shared sense of the importance of the project; commitment from the top in respect of all stakeholders; a participative approach; effective planning; sound communication; clear fixing of duties and responsibilities; holding responsible parties accountable; regular monitoring; and sound meeting procedures, all of which contributed to the success of the project.

Human resources allocated by the Bank Supervision Department to Basel II implementation

During 2002 the Department appointed a person to head the Department's Basel II implementation initiative and in 2005 a dedicated team was established to drive the implementation. The team included risk specialists and quantitative analysts. The Basel II team mostly consisted of staff transferred from within the Department.

appointed person to head Basel II implementation

Each risk specialist had a dedicated responsibility for a specific risk area or aspect of a particular risk area. These responsibilities included, *inter alia,* the development of minimum criteria for applications to use more advanced approaches; development of agendas for on-site visits; the conducting of on-site visits; and the provision of technical guidance for model evaluation.

responsibility for specific risk areas

In addition, the Department allocated a lead analyst to each of the larger banks – those intending to apply to use an advanced approach for regulatory minimum capital adequacy purposes. The lead analyst, assisted by other analysts, had the overall responsibility for the supervision of a bank or banking group, but was also assigned the dedicated responsibility for Basel II implementation, including monitoring the implementation and state of readiness of the allocated bank or banking group. Lead analysts liaised with risk specialists concerned to assist in gaining an understanding of, and assessing, the quality of risk management in the relevant risk area within an allocated bank or banking group. In the case of banks or banking groups intending to adopt an advanced approach, the risk specialist and quantitative specialist concerned were engaged to assist with the assessment of relevant models, methodologies, data requirements, input, output and related controls.

allocated a lead analyst to each of the larger banks

The Department's Analysis Division and the risk specialists will henceforth continue to work together in a similar way on a matrix basis.

Consultative and participative approach

The implementation process constituted a participative consultative process which involved the immediate stakeholders, namely the banks, the National Treasury, the Bank, external auditors of banks, The Banking Association South Africa and the Department.

involved the immediate stakeholders

extensive consultation

From the outset there was extensive consultation with all stakeholders to gain insight into their views on Basel II and to develop a consensus on the objectives of, and processes for, the implementation of Basel II.

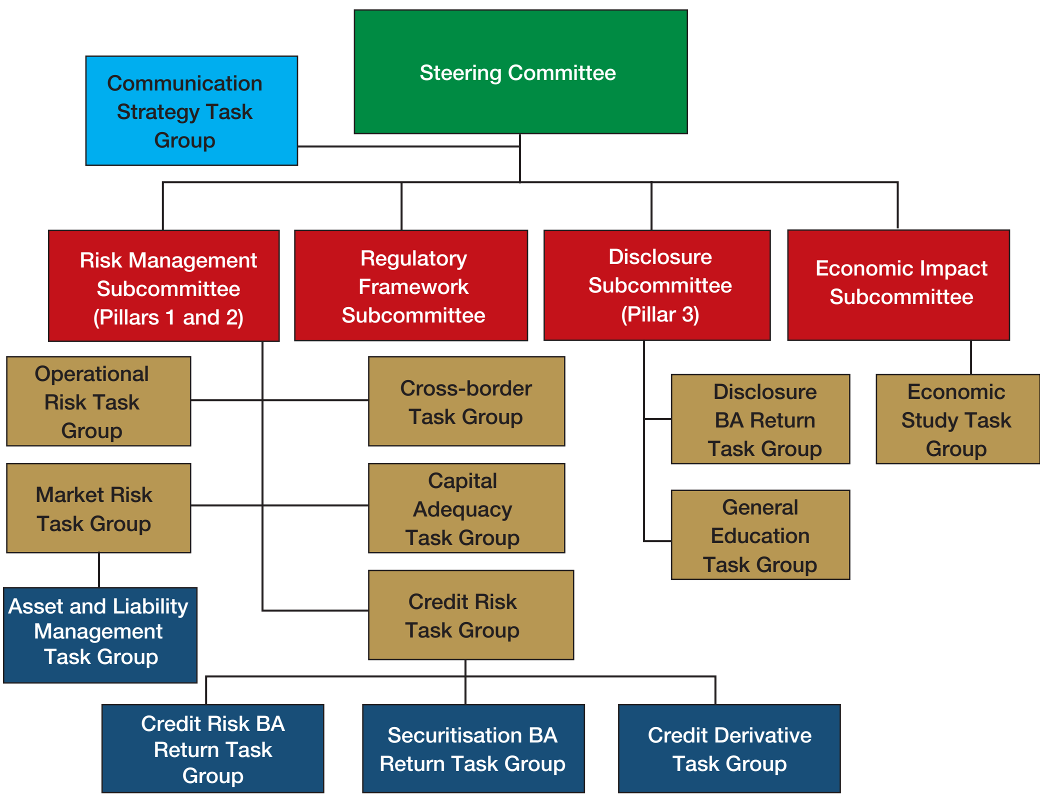
The Department's official communiqués relating to Basel II were by way of Banks Act circulars and included the following:

- Banks Act Circular 4/2001 in which banks were requested to comment on the initial pronouncements of the Basel Committee relating to the Basel II Framework.
- Banks Act Circular 14/2003 communicated the Department's initial thoughts on the implementation of Basel II to banks. Feedback was also requested on banks' and banking groups' intended approaches in order for the Department to formulate its strategy around Basel II.
- The first consultative paper was communicated to banks in Banks Act Circular 1/2004.
- The implementation date in South Africa for all approaches under Basel II was confirmed as 1 January 2008, in Banks Act Circular 20/2004, dated 14 December 2004.

established the Accord Implementation Forum

During 2003 the Department established the Accord Implementation Forum (AIF) – a joint public- and private-sector forum – to assist in driving the Basel II implementation process. The AIF's mandate was to promote, co-ordinate and drive initiatives for the implementation of Basel II in South Africa. The AIF, through its Steering Committee, was chaired by the Registrar of Banks and the Secretariat was provided by The Banking Association South Africa.

Figure 3 Accord Implementation Forum Steering Committee



AIF subcommittees

As outlined in Figure 3, the AIF consisted of the following subcommittees:

- Steering Committee – responsible for the overall implementation of Basel II
- Risk Management Subcommittee – responsible for the Pillar 1 and Pillar 2 dimensions of Basel II
- Regulatory Framework Subcommittee – responsible for converting Basel II into the appropriate South African compatible regulatory framework
- Disclosure Subcommittee – responsible for the Pillar 3 dimension of Basel II, including the education requirements around Basel II
- Economic Impact Subcommittee – responsible for addressing the economic implications for South Africa of implementing Basel II.

AIF Steering Committee

The Registrar of Banks was the Chairperson of the AIF Steering Committee, which met quarterly. As Chairperson, he had veto rights over any final decision. The deputy heads of the Department, as well as the Basel II project leader also attended Steering Committee meetings. South Africa's largest banks were represented by their chief financial officers or chief risk officers and heads of the Basel II project. The Chairperson of the Banking Project Group of the South African Institute of Chartered Accountants also attended these meetings, as did the National Treasury. As and when required, task groups were established to address relevant aspects of Basel II.

The AIF forums held more than 250 meetings of the different subcommittees and task groups, and generated over 250 working documents, which constituted important input into the drafting of the amendments to the regulatory framework.

international regulatory bodies and standard setters

The Department also worked with, or followed closely the work done by, international regulatory bodies and standard setters, such as the Basel Committee and the Committee of European Banking Supervisors (CEBS). Furthermore, the Department was represented on various subcommittees of the Accord Implementation Group (AIG), a subcommittee of the Basel Committee, which focuses on Basel II implementation.

Gap analysis and readiness assessment, and implementation plans

gap analysis and readiness assessment

As regards the goal of each bank implementing Basel II, banks were requested to perform a high-level gap analysis and readiness assessment to facilitate planning, identification of key deliverables, deadlines and the responsible person(s). The gap analysis and readiness assessment were based on a high-level top-down perspective and were initiated through Banks Act Circular 15/2004.

To ensure comparability between, and to draw conclusions from, the outcomes of the self-assessments by banks and banking groups, a standardised set of templates was issued for use in performing the gap analysis and readiness assessment. The Department reviewed the gap analysis and readiness assessments submitted by banks, following which the Department compiled a report on the process that was shared with the banking sector.

Subsequently, during the latter half of 2005, all banks were requested to submit their implementation plans to the Department for scrutiny.

Economic impact study

National Treasury commissioned independent economic impact study

To assess the potential economic impact of the implementation of Basel II, South Africa's National Treasury commissioned an independent economic impact study focusing on the expected changes in capital levels in the South African banking system and any resulting change in bank behaviour that could have a knock-on effect on the macroeconomy.

Basel II would have a largely neutral impact

The study suggested that, in aggregate, the introduction of Basel II would have a largely neutral impact on the minimum regulatory capital that South African banks would be required to hold once active capital management is taken into account, although results may vary between banks. Consequently, while pricing was not driven only by capital requirements, the study found that pricing was unlikely to be affected by the change in the capital regime and thus the National Treasury expected the direct short-term macroeconomic impact of Basel II to be limited, while the indirect longer-term impact in terms of improved capital allocation, risk management and international competitiveness should be positive for the economy.

no adverse impact on access to finance and black economic empowerment

In addition, the National Treasury did not expect Basel II to impact adversely on access to finance and black economic empowerment (BEE) objectives, as banks are subject to clear commitments in terms of the Financial Sector Charter (the Charter). As part of the qualitative assessment, banks indicated that they entered into commitments in terms of the Charter and BEE financing with full knowledge of the imminent introduction of Basel II. Furthermore, it is expected that the introduction of Basel II would have a positive impact on access to finance by small and medium enterprises (SMEs), as regulatory capital requirements for lending to SMEs are expected to decrease under Basel II.

Lastly, the National Treasury anticipated that the risk of any short-term disruptive impact on bank behaviour or macroeconomic impact is mitigated by specific transition arrangements that allow for the smooth adjustment of regulatory capital over time.

Quantitative impact studies, field tests and parallel runs

purposes of quantitative impact studies

The Basel Committee designed, developed and distributed quantitative impact studies, *inter alia*, for the following purposes:

- The Basel Committee considered it imperative that the provisions of the proposed new capital framework be assessed and analysed prior to its finalisation and implementation, to ensure a proper understanding of its impact on both a bank's capital position and the drivers of a bank's capital calculation
- The Basel Committee also wished to avoid a situation where the implementation of Basel II caused a bank to raise capital at short notice.

The Department and certain banks combined to take part in three of the Basel Committee's initiated quantitative impact studies, namely QIS 3, QIS 4 and QIS 5. QIS 5 was the most recent impact study and, subsequently, was the only one based on the latest version of the Basel II framework, which captured trading book amendments and double-default effects.

Moreover, following QIS 5 during 2007, the Department requested locally incorporated banking groups targeting the advanced approaches for credit and/or operational risk to participate in QIS 5.5 (a follow-up to QIS 5, discussed in the Department's 2006 *Annual Report*). The Department also requested banks to complete a data quality questionnaire.

QIS 5.5 objectives

The objectives of QIS 5.5 included

- obtaining relevant information pertaining to the impact of implementing Basel II, in particular the impact on a banking group rather than the narrower bank legal entity reported in QIS 5.
- assessing the state of preparedness for Basel II implementation.
- testing and further developing guidance on relevant issues pertaining to Basel II. During QIS 5.5 key policy decisions and national discretion items, such as the

treatment of minority interests, excess capital from insurance entities and sovereign risk weightings, were tested.

- discussing the identification and implications of the status of an ‘equivalent regulator’ with the various banking groups.

Results

increase in miminum required capital

Based on the QIS 5.5 information received for the banking groups, the Department determined that the
- minimum required capital (MRC) in terms of Basel II, when compared with the MRC in terms of Basel I, would increase
  - by approximately 12 per cent for bank legal entities targeting the advanced approaches for credit and/or operational risk (around 1 per cent less than for QIS 5)
  - by approximately 13 per cent for banking groups targeting the advanced approaches for credit and/or operational risk; and
- updated QIS 5 and QIS 5.5 information reflected a marked improvement in the quality of the data, as reflected in the narrowing of dispersions and reduction of variances.

The above-mentioned increases in MRC refer to a monetary value and not the capital-adequacy ratio. The Department remains confident that the banking system is well capitalised.

Field tests

banks requested to perform field tests

Banks that targeted the advanced approaches and participated in QIS 5 were requested to conduct informal field tests in respect of the proposed statutory returns and directives relating to credit risk (BA 200 series) as contained in draft 3 of the proposed amended Regulations, and financial information (BA 100 series), based on working documents of the Disclosure BA Returns Task Group.

In addition, the remaining banks that targeted the base approaches for credit and operational risk were required to perform two formal field tests of selected proposed statutory returns. The purpose of the field test was to
- assist the Department in assessing the level of preparedness of banks and banking groups for the implementation of Basel II;
- ensure that the objectives in terms of the proposed amended Regulations could be met; and
- ensure that the proposed amended statutory returns would facilitate, and be effective and efficient for the implementation of Basel II.

The first formal field test was conducted from 15 September 2006 to 15 November 2006. Banks’ submissions for the second formal field test were required to reach the Department by 30 April 2007.

Parallel runs

parallel-run process during the fourth quarter of 2007

In terms of Banks Act Circular 5/2007, all banks were required to participate in the parallel-run process during the fourth quarter of 2007, by submitting, in accordance with the prescribed schedules, both the existing (Basel I-based) statutory returns and the proposed (Basel II-based) statutory returns. The submitted returns were assessed and analysed, and discrepancies and substantial variances in the capital calculations were followed up with banks.

Consolidated supervision

Basel II requires consolidated supervision

Basel II requires that supervisors undertake consolidated supervision. In South Africa, the supervision of a banking group on a consolidated basis

- aims to capture all material risks to which the banking group may be exposed, and to preserve the integrity of the banking group's capital and reserve funds, *inter alia*, by eliminating any double or multiple gearing of capital and reserve funds;
- includes the accounting consolidation or sub-consolidation of financial information by a bank or controlling company;
- is an overall evaluation, both quantitative and qualitative, of the risks incurred by, and the strength of, a group to which a bank belongs, primarily to assess the potential impact of other group financial entities on the bank;
- means the supervision of a bank as part of a group of entities to which the bank belongs and therefore, as a minimum, includes all financial entities and all financial activities within the banking group (without the Department being responsible for the supervision of any non-bank entity), which entities or activities include
  – all banks in the banking group concerned
  – all related regulated or unregulated financial entities or financial activities conducted by such banks or any relevant subsidiary
  – all joint ventures or associates
  – the controlling company of such banks
  – all related regulated or unregulated financial entities or financial activities conducted by such controlling company or any relevant subsidiary
  – any other entity that may be specified; and
- serves as a complement to, instead of a substitute for, the solo supervision of a bank.

Home and host supervisor co-ordination and co-operation

co-operation with other regulators

Effective implementation of Basel II also requires co-operation with other regulators to ensure effective supervision of banking groups operating across borders. The Department's powers to share information with other supervisors are prescribed by section 89 of the Banks Act, 1990. The Department is fully committed to sharing information with other supervisors to facilitate the optimal effectiveness and efficiency of the supervisory process for all concerned.

In respect of home-host supervisory co-ordination and co-operation, the Department

MoUs

- is party to a number of memorandums of understanding (MoUs) with counterpart bank supervisory authorities in other relevant jurisdictions (see Appendix 10);
- facilitates access by home-country supervisors to local offices and subsidiaries of banks or banking groups domiciled in foreign countries, for appropriate supervisory purposes;
- subscribes to the Basel Committee's standards on home- and host-country co-operation, including standard procedures for cross-border inspections outlined in Annex A of the October 1996 report by a working group comprising members of the Basel Committee and the OGBS;
- is committed to adhering to the provisions contained in the Basel Committee's publication titled *Home-host Information Sharing for Effective Basel II Implementation*, issued in June 2006; and
- compiled a Home-Host Relationship and Communication Procedure Draft Policy that complies with the provisions of Core Principles 24 and 25.

The Department strongly believes that close co-operation and information sharing are prerequisites for effective consolidated supervision, and welcomes any contact with host or home-country supervisors. Accordingly, the Department has participated in supervisory colleges related to Basel II implementation that were organised by other supervisory authorities, such as the Financial Services Authority of the UK, The Netherlands Bank and the Bundesanstalt für Finanzdienstleistungsaufsicht of Germany, and, in turn, the Department organised a supervisory college that was attended by representatives of a number of African supervisory authorities.

prerequisites for effective consolidated supervision

The aims of a supervisory college include increasing the efficiency of supervision, reducing regulatory effort and reducing the associated regulatory burden on banks and banking groups.

aims of a supervisory college

Legislative framework

While the focus of the Department's efforts has been the incorporation of the Basel II regime into South African legislation, several other internationally agreed principles, standards, codes or practices directly impacting on regulatory and supervisory frameworks were developed or updated by various standard-setting bodies in recent years. The aforesaid principles, standards, codes or practices include

- the Core Principles
- internationally agreed standards, codes or practices relating to corporate governance and internal controls
- IFRS
- International Accounting Standards (IAS)
- ISA.

incorporation of the Basel II regime

In order to incorporate appropriately all the relevant internationally agreed principles, standards, codes or practices directly impacting on a bank or banking group, the South African regulatory framework was divided into three tiers.

regulatory framework divided into three tiers

1. The top tier is the Banks Act, 1990, which contains the enduring principles and overarching enabling framework. It is anticipated that amendments to this tier would be few and far between. Only Parliament is empowered to amend the Banks Act.
2. The middle tier is the Regulations relating to Banks, which contain the essence and bulk of the internationally agreed stipulations, requirements and standards. The Minister of Finance is empowered in terms of section 90 of the Banks Act, 1990, to promulgate these regulations.
3. The bottom tier will comprise directives, Banks Act circulars and guidance notes, and will be used in future to deal with operational matters that may change quite frequently or require immediate attention. The Registrar of Banks is empowered in terms of the Banks Act, 1990, to issue directives, Banks Act circulars and guidance notes.

The technical Basel II prescriptions were effected to the Regulations relating to Banks, however, amendments to the Banks Act, 1990 were required to enable amendments to these regulations. Following the submission of the finalised draft Banks Amendment Bill to the Minister of Finance for parliamentary approval, the Bill was considered and approved by the Portfolio Committee on Finance in June 2007. The National Assembly approved the Bill in August 2007, and approval was obtained from the National Council of Provinces in September 2007. The Bill was promulgated into law by the President of the Republic of South Africa in November 2007, enabling the Minister of Finance to promulgate the proposed amended Regulations. The proposed amended Banks Act, 1990 will become effective on 1 January 2008.

technical Basel II prescriptions

Regulations would be revised *in toto*

The Department took the in-principle decision that the Regulations relating to Banks would be revised *in toto*, in other words, even those regulations on which Basel II did not impact would be revised and updated where necessary. This enabled the recent amendments to the Core Principles, IFRS and IAS to be incorporated into the proposed amended Regulations.

draft one released during May 2005

Draft one of the proposed amended Regulations and of the proposed amended Exemption Notice was released during May 2005, with a request for comments by 31 August 2005. During the comment period, the respective committees, subcommittees, task groups and working groups of the AIF finalised their comments in respect of the draft and developed comprehensive financial returns and risk returns, and directives for its completion, based on, *inter alia*, the requirements of Basel II, the latest IFRS and best risk management practices.

second draft released January 2006

Owing to the extent and nature of the comments and proposed returns received by the Department in response to the drafts, a second draft was issued in a modular fashion as from the end of November 2005 up to the end of January 2006, with a request for comments by 30 June 2006. In the interim, the Basel Committee released further and updated information directly impacting on matters already dealt with in the first two drafts of the proposed amended Regulations and the proposed amended Exemption Notice. Accordingly, the Department updated and reissued all relevant modules by March 2006, with a request for comments by the beginning of July 2006.

third draft released October 2006

A substantial volume of comments was received on the second draft of the proposed amended Regulations and of the proposed amended Exemption Notice. The magnitude of further comments, proposals and amendments to these regulations, financial returns and risk returns received by the Department resulted in the release of a third draft of the proposed amended Regulations and of the proposed amended Exemption Notice by way of 25 modules, the first of which was released at the beginning of September 2006 and the last at the end of October 2006, with a request for comments by the end of November 2006.

Following the release of the third draft of the proposed amended Regulations and of the proposed amended Exemption Notice, banks, banking groups, the audit profession and the various committees, subcommittees, working groups and task groups of the AIF continued their respective processes, which included

- field testing the proposed amended returns and directives;
- further researching and debating international best practices in the various fields affecting the proposed amended Regulations and the proposed amended Exemption Notice; and
- engaging with other supervisory authorities and standard-setting bodies regarding their decisions and processes for the successful implementation of Basel II in their respective jurisdictions or regions.

Based on the further comments received during November 2006, the Department hosted separate meetings with the chairpersons of the respective committees, subcommittees, working groups and task groups of the AIF at the end of November 2006, and during the beginning of December 2006 to clarify and resolve outstanding matters.

fourth draft released January 2007

On 15 January 2007, the Department released the fourth draft of the proposed amended Regulations and of the proposed amended Exemption Notice for final consideration, with a request for comments thereon by the respective committees, subcommittees, working groups and task groups of the AIF by 15 March 2007.

On 9 March 2007, the Department hosted an integration workshop to clarify certain reporting requirements and to ensure a general alignment in, and between, all relevant components of the proposed amended legislation. During March and April 2007 the Department received and processed the further substantial comments received from the AIF structures subsequent to the integration workshop and the release of the fourth draft of the proposed amended Regulations and the proposed amended Exemption Notice for final consideration and comment by the respective committees, subcommittees, working groups and task groups of the AIF. Thereafter an updated version of the fourth draft of the proposed amended Regulations and the proposed amended Exemption Notice was released for public comment at the end of April 2007. Comments were requested by 25 June 2007.

integration workshop

Following the release of the fourth draft of the proposed amended Regulations and the proposed amended Exemption Notice for public comment at the end of April 2007 and the industry training sessions held during May, June and August 2007, further matters that required clarification or directives in respect of certain items or returns were brought to the attention of the Department. The Department subsequently considered these matters and further effected final amendments to the proposed amended Regulations and the proposed amended Exemption Notice where it was deemed necessary or appropriate to do so.

On 22 August 2007, a fifth draft of the proposed amended Regulations and the proposed amended Exemption Notice was presented to the Standing Committee for its consideration and approval. The Standing Committee unanimously approved this draft of the proposed amended Regulations and the proposed amended Exemption Notice, subject only to the finalisation of a number of minor administrative issues.

fifth draft released August 2007

On 19 September 2007, the Department presented a sixth draft of the proposed amended Regulations and the proposed amended Exemption Notice to the Minister of Finance for his consideration and approval.

sixth draft released September 2007

On 13 December 2007, following clarification of certain matters, the Minister of Finance granted his approval for the publication and the subsequent implementation on 1 January 2008 of the amended Regulations relating to Banks and the amended Exemption Notice.

Minister granted approval December 2007

The transparent, participative and consultative process conducted through the AIF for purposes of incorporating Basel II into, and updating, the regulatory framework entailed holding numerous meetings of the respective committees, subcommittees, working groups and task groups of the AIF during the three-year period preceding the finalisation of the amended legislation. The contents of all the AIF working documents developed during the period were taken into account in drafting the amended Regulations and amended Exemption Notice. This process enhanced the comprehensiveness and robustness of the amendments to the regulatory framework.

Supervisory framework

As part of the Basel II implementation process, the Department revisited its supervisory framework, now formally known as the 'SREP', and modifications were effected to the Department's supervisory process (which was previously outlined in the 2004 *Annual Report*), resulting in an updated SREP.

revisited supervisory framework

Modifying the SREP

As a starting point, it was recognised that Basel II is more risk-sensitive than Basel I and that risk management practices in banks have evolved considerably over recent years.

four principals contained in Pillar 2

Furthermore, it was incumbent upon the Department to adopt the four principles contained in Pillar 2 of Basel II in the SREP, which are outlined below in relation to the Department's SREP.

Bank's responsibilities

ICAAP

- A bank should have in place a process for assessing its overall capital adequacy in relation to its risk profile and a strategy for maintaining its capital levels (Principle 1).
- A bank should operate above the minimum regulatory capital ratios (Principle 3); referred to as the 'buffer' requirement.

The above is generally known as the 'ICAAP'.

Supervisor's responsibilities

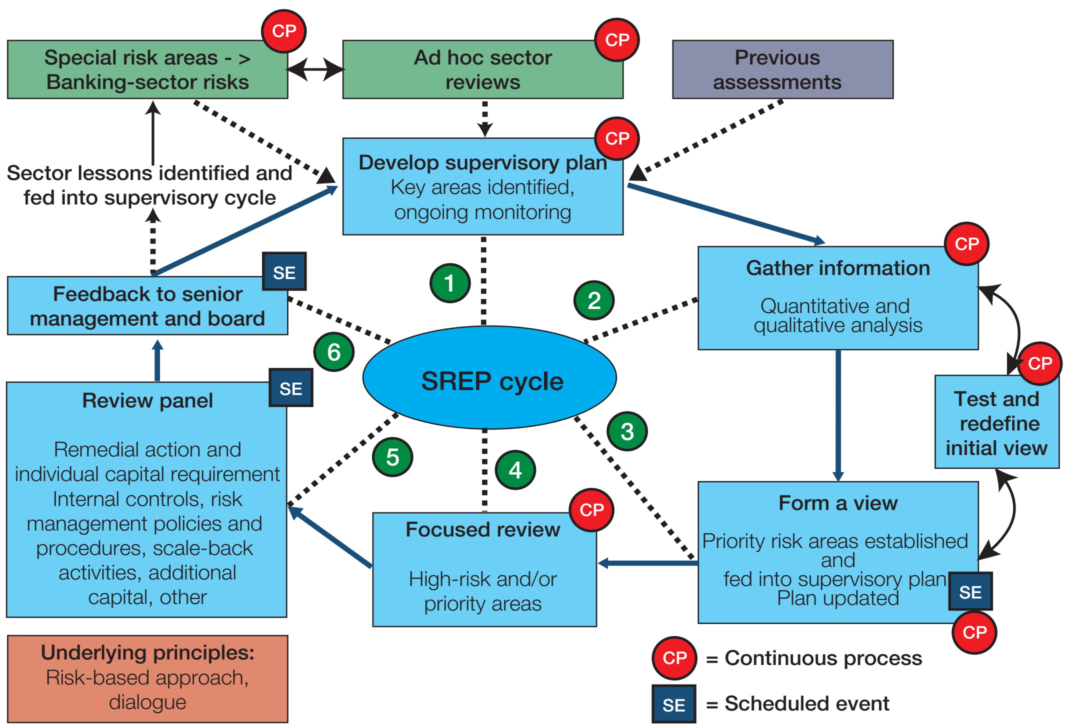
evaluate bank's ICAAP

- A supervisor should review and evaluate a bank's ICAAP (Principle 2).
- A supervisor should take appropriate action if not satisfied with the results of this process (Principle 2).
- A supervisor should review and evaluate a bank's compliance with the regulatory capital ratios (Principle 2).
- A supervisor should have the ability to require banks to hold capital in excess of the minimum (Principle 3).
- A supervisor should seek to intervene at an early stage to prevent capital from falling below the minimum prescribed levels (Principle 4).
- A supervisor should require rapid remedial action if capital is not maintained or restored (Principle 4).

The modified SREP process

The modified SREP process, which is to be implemented at the beginning of 2008, incorporating the above elements, is reflected in Figure 4.

Figure 4 Modified supervisory review process



The SREP cycle (the complete process that makes up the SREP) consists of various stages (Stages 1 to 6) that take place as an ongoing process with some specified scheduled events. The SREP cycle supports and enhances the Department's approach to risk-based supervision.

SREP cycle

Stage 1 – Develop supervisory plan

The process begins with the formulation by the analyst of a supervisory plan, which is captured in writing. A sound, robust and well-considered supervisory plan is a necessary prerequisite for an effective SREP.

well-considered supervisory plan

In line with the Department's approach to risk-based supervision, the supervisory plan takes into account the systemic relevance and key risk areas identified in respect of the particular bank. In determining the systemic relevance and identification of the key risk areas, previous years' assessments are relied on. Banks are classified as high, medium or low risk and allocated to a 12-month, 18-month or 24-month supervisory cycle respectively. The supervisory plan is communicated to the bank at the start of the SREP cycle.

systemic relevance and key risk areas identified

The main purpose of the supervisory plan is to ensure a disciplined, comprehensive and professional planning process that forms the foundation for supervisory actions, interactions and interventions.

Stage 1 is a continuous process (i.e., the supervisory plan will be updated as and when new information becomes available, and a change of the supervisory plan becomes warranted).

Stage 2 – Gather information

Throughout the SREP cycle, information is gathered by analysts and risk specialists. Information sources include the bank's annual report, financial statements, statutory supervisory returns, ongoing supervisory information collection, including, meetings between the Department and the bank's senior management and staff, and other stakeholders and market intelligence.

Stage 2 is also a continuous process.

Stage 3 – Form a view

Stage 3 entails the process in terms of which the information gathered by analysts and risk specialists in Stage 2 is assembled, analysed and synthesised in order to form a view of the bank. The focus is on materiality and risk.

information assembled, analysed and synthesised

During this stage there are two distinct scheduled events that take place once during each SREP cycle:

1. The submission by a bank of its ICAAP report (the ICAAP report is submitted in a non-prescriptive free-format form by the bank to the Department).
2. The development of a supervisory perspective, which entails the gathering of information, the assembling of relevant information and the population of risk score sheets, and analysis of the risk review as prepared by the analyst. The score sheets, *inter alia*, cover Pillars 1 and 2 risks (e.g. risks not fully covered, risks not covered in Pillar 1 and external factors). Pillar 3 aspects are also considered.

It is envisaged that these two processes will enable a bank and the supervisory teams to compare findings, and constructively challenge one another's conclusions and recommendations. At this stage a pre-review panel meeting will take place to seek guidance on priorities, clarification of issues and further work to be done.

Stage 3 consists of both continuous processes and scheduled events.

Stage 4 – Focused review

detailed or specialist review

Depending on the outcome of Stage 3, the analysis team and the risk specialists could identify areas of a bank that may require a detailed or specialist review. This review may be carried out by the analyst, risk specialists, on-site review team, internal auditors, external auditors, external risk consultants, or other advisors (e.g. lawyers or actuaries). The resulting information gathered is incorporated into the SREP cycle and necessary consequential adjustments are effected.

Stage 4 is a continuous process.

Stage 5 – Review panel

panel review process

Stage 5 consists of the panel review process, which entails a review by the review panel (consisting of the Department's Executive Committee and risk specialists) of the procedural and substantive correctness of the SREP, as well as the conclusions reached and recommendations made during Stages 3 and 4, which form the basis for the panel review.

The review panel's recommendations may include remedial actions to be taken and adjustments to the individual capital requirement (ICR). It is important to note that the ICR should not be seen as the only tool, but that other recommendations, such as strengthening of internal controls or risk management policies and procedures, may in certain circumstances be more appropriate.

Stage 6 – Feedback to senior management and board

conclusions and recommendations

Stage 6 consists of the process in terms of which the conclusions and recommendations reached in Stage 5 are communicated to the bank's board of directors, risk committee, audit committee and senior management. Industry lessons identified are incorporated into the macro-surveillance cycle and report, and may warrant ad hoc sector reviews to be conducted.

Approval of banks' approaches to credit and operational risk

Background

In terms of Banks Act Circular 14/2003, banks were requested to indicate to the Department their anticipated intentions regarding the approaches to credit and operational risk available in terms of Basel II.

Since enabling legislation to approve these approaches was only to be effective as from 1 January 2008, banks were invited to apply for in-principle approval during 2007. These applications and any final decisions were to be converted into formal applications and responses when the legislation was enacted.

To ensure consistency in judgements on the applications received, the Department established decision-making panels consisting of members of the Department's Executive Committee and other members of senior management.

consistency in judgements

Credit risk

Following the receipt of updated information from banks on their intended Basel II approaches for purposes of determining their regulatory required minimum capital for credit risk during the course of 2006, the Department undertook on-site visits to banks intending to use the internal ratings-based (IRB) approach, which started in October 2006. The on-site verification and review work ended in May 2007.

The objective of the on-site visits was to perform verification work in establishing the nature and extent of compliance with the minimum IRB requirements and to review the model validation process in relation to certain credit models for significant portfolios.

perform verification work

In tandem with the above process, the Department developed a set of minimum requirements, issued as a working paper by the AIF, relating to an application by a bank intending to use the Basel II IRB approach for purposes of determining its required regulatory minimum capital in respect of its credit risk exposure. In terms of the working paper, banks that intended seeking approval for the use of the IRB approach as from 1 January 2008 were required to lodge their in-principle applications with the Department by the end of 2006.

All formal applications were considered individually and assessed against a clearly laid-out comprehensive set of criteria, which included the ability and capacity of the particular bank to adopt and implement the targeted approach(es) soundly, effectively and efficiently.

During the process of considering and reviewing IRB applications, technical reviews of the model build and validation process were undertaken, and the Department assessed the extent to which the bank had in place capable and independent validation teams, robust internal audits of the model validation process, and effective challenge by independent committees through the governance process, right up to the board-designated committee.

technical reviews of the model build and validation process

In addition to in-depth technical reviews of the banks' models, senior management understanding and use of the models in the banks' business were also viewed as paramount to IRB approval. To this end, the Department tested senior management and board understanding through a series of interviews with key personnel. This included business unit and risk management heads, up to the most senior executive management in banks. While different levels of understanding are required, depending on the degree of seniority, interviewees were expected to articulate their level of understanding and demonstrate it appropriately. Discussions were also held with the boards of all the banks intending to adopt the IRB approach. These discussions focused on directors' understanding of the IRB models and their perceived roles in the process. Interaction with senior management to assess their understanding will continue post implementation.

senior management and board understanding

Stress testing of the IRB output components under Pillar 1 is mandatory. Banks that adopted IRB with effect from 1 January 2008 were required to demonstrate their stress-testing methodologies ahead of IRB approval.

stress testing

IRB applications and the Department's views on them were assessed during June 2007 by the Department's internal review panel. Following these reviews, the applicant banks concerned were informed of the in-principle decision of the review panel, which could range from approvals without conditions, conditional approval, minded to approve, to rejection.

Thereafter, over a period of four months, follow-up on-site work was undertaken to establish whether those banks that had received 'conditional approvals' or a 'minded to approve' had met the conditions to qualify for in-principle approval. The review panel reviewed the final recommendations on the applications during November 2007.

The following in-principle approvals were granted:

- One bank to use the foundation IRB approach
- Three banks to use the advanced IRB approach.

continues to monitor and assess the use of IRB models

The Department continues to monitor and assess the use of IRB models, and enhance outputs in specific areas, for example, encouraging banks to further their research on the procyclicality of IRB estimates. As regards appropriate stress testing for South African conditions, the Department organised an economic symposium in late 2007 that brought together economists and credit and risk specialists from the banks adopting the IRB approach. The objective was to promote discussion on the types of economic issues relevant to the South African environment and challenge the thinking on incorporating them into IRB model estimates and stress testing.

Focus areas for review during 2008 include ratings migration, credit risk mitigation, expected losses and provisions, database reviews and securitisation.

A separate, ongoing model monitoring programme has also been put in place that will complement an ongoing rolling self-assessment process that has been implemented.

Home-host involvement and reliance

Domestic banks

extensive information sharing

Extensive information sharing took place between the Department and sub-consolidating or other host supervisors in relation to applications to use the IRB approach before and during the review process. The Department thereafter formally informed the sub-consolidating supervisor of the decision taken on the application.

Extensive discussions were held and will continue to be held as part of the SREP cycle with the sub-consolidating supervisor or other host supervisors for domestic banks or banking groups with significant interests in entities registered, domiciled or operating in other jurisdictions. These supervisors had been, and will continue to be, invited to perform joint reviews of bank or banking groups concerned.

Specific examples in 2006/07 included joint reviews of one of South Africa's largest banks' IRB application in conjunction with the UK Financial Services Authority and the Hong Kong Monetary Authority.

College of African Banking Supervisors

In addition, in February 2007 the Department hosted the first-ever College of African Banking Supervisors to discuss ways of managing Basel II implementation in a South African bank. Even though not all the invited supervisors were intending to adopt Basel II at that stage, supervisors usefully discussed their various supervisory approaches and how home-host co-operation could be enhanced in line with the revised Core Principles. Information exchange and avoiding duplicative activities were high on the agenda and the college set the scene for ongoing co-operation between the Department and fellow supervisors on the continent.

Foreign banks

A similar approach applies to a South African branch of a foreign bank operating in South Africa, subject to considerations of proportionality. Subject to an assessment of the nature and extent of compliance with the substance of Basel II, as well as considerations relating to reducing the regulatory burden, information may be shared among the home and host supervisors, and reliance may be placed on the home supervisor by the Department. The applicability of model assumptions, data and data history to the South African context is also taken into account.

similar approach applies

Operational risk

The Department developed the following documentation relating to the Basel II approaches available to a bank for purposes of computing its regulatory required minimum capital in respect of operational risk:

computing regulatory required minimum capital

- A self-assessment template, issued as a working paper by the AIF, to be completed by the following entities under the following circumstances:
  - a bank intending to seek formal approval to use the standardised approach (TSA) for purposes of determining its regulatory minimum capital requirement
  - a bank intending to seek formal approval to use the alternative standardised approach (ASA) for purposes of determining its regulatory minimum capital requirement
  - a foreign-controlled bank subsidiary or branch intending to seek approval to use the hybrid advanced measurement approach (hAMA) for purposes of determining its regulatory minimum capital requirement.
- A set of minimum requirements, issued by the AIF, relating to an application by a bank intending to use the Basel II advanced measurement approach (AMA) for purposes of determining its regulatory minimum capital in respect of its operational risk.

All formal applications were considered individually and assessed against a clearly laid-out comprehensive set of criteria, which included the ability and capacity of the particular bank to adopt and implement the targeted approach(es) effectively and efficiently.

Selective on-site visits were conducted at banks targeting TSA and ASA approaches. The main topics discussed were as follows:

TSA and ASA approaches

- Operational risk governance
- Gross income mapping
- Loss data collection
- Risk and control self-assessment
- Outsourcing, disaster recovery and business continuity planning
- The role of, and operational risk reviews performed by, internal audit
- Home-host issues and information sharing, where applicable.

The AMA application process was split into two stages. The first stage was the completion of the application pack by the bank. This required the bank to provide

AMA application process

- summary information on its plans for AMA implementation;
- its approach in a number of key areas such as governance;
- details on how the institution has met the AMA qualitative and quantitative requirements as contained in proposed legislation; and
- detailed information covering the specifics of the AMA model.

During Stage 2, the Department requested and analysed further detailed information on particular topics, based on Stage 1 reviews, which included on-site visits to the applicant bank.

senior management and board understanding

During the standardised and advanced approach on-site visits, the Department tested senior management and board understanding and involvement through a series of interviews with key personnel. This included business unit and risk management heads, and senior executive management in banks. Similar to the approach for credit risk, depending on the degree of seniority, banks were expected to articulate their level of understanding and to demonstrate it appropriately. Interaction with the board of directors and senior management, as appropriate, to assess their active involvement in the oversight of the operational risk management framework, will continue post implementation.

recommendations made

The applications made to, and recommendations made by, the Department were reviewed during July 2007 by a panel comprising the Department's senior management. Following the review panels, the respective applicant banks were informed of the in-principle decision made by the review panel, which could range from approvals without conditions, conditional approval, minded to approve, to rejection. At that stage one bank's application was rejected and one bank was informed that it needed to address various specific requirements before any form of approval could be considered. In-principle conditional approvals were granted to all other applicant banks.

Thereafter, over a period of three months, follow-up off-site and/or on-site work was undertaken to establish whether those banks that had received conditional approvals had met the conditions to qualify for in-principle approval. A similar process was followed for the one bank that was requested to meet specific requirements before any form of approval could be considered. Final recommendations were reviewed by the review panel during November 2007.

The following in-principle approvals were granted:

- One bank approved to use the AMA approach
- One bank approved to use the ASA
- Eleven banks approved to use TSA.

The remaining twenty banks did not lodge applications and, consequently, are by default opting to use the basic indicator approach.

Rating agencies

The amended Banks Act, 1990 will allow banks to choose between the IRB approach and the standardised approach for calculating regulatory capital requirements for credit risk.

extensive use of ratings

The standardised approach for credit risk and the treatment of securitisation exposures make extensive use of the ratings issued by external credit assessment institutions (ECAIs) (i.e., credit rating agencies) for determining the risk weights of exposures and ultimately the calculation of regulatory capital.

recognition as eligible ECAIs

In terms of section 85A of the Banks Act, 1990, credit rating agencies requiring recognition as eligible ECAIs would be required to obtain prior written approval from the Registrar of Banks. The Department will publish the criteria for recognition as eligible ECAIs on the website of the Bank, following which, ECAIs would be able to apply to the Department for such recognition.

During November 2007, after an extensive assessment process, the following ECAIs were recognised for regulatory capital purposes under the standardised approach for credit risk and the treatment of securitisation exposures:

- Fitch Ratings
- Moody's Investors Services
- Standard & Poor's Rating Services.

This list is subject to ongoing review by the Department and will be updated accordingly.

Pillar 3 – Market discipline

minimum capital requirements

The purpose of Pillar 3, market discipline, is to complement the minimum capital requirements (Pillar 1), and the supervisory review and evaluation process (Pillar 2). Pillar 3 is a recognition that the market can play an important role in monitoring banks to ensure a sound and healthy banking system.

From 1 January 2008 all banks operating in South Africa will be required to disclose to the public, on a regular basis, but not less frequently than once a year, specified qualitative information in respect of banks' risk management objectives and policies, reporting systems and general definitions.

Banks are also required to disclose to the public specified quantitative information on a quarterly basis in respect of: their primary capital, including their primary capital-adequacy ratio; the bank's total capital, including its total capital-adequacy ratio; the components of capital; the total required amount of capital and reserve funds; and any risk exposure or other item that is subject to rapid or material change.

Bank management is responsible for determining appropriate additional mediums by means of, and locations at, which to disclose the required information to the public.

Therefore, in order for banks to comply with the substance of the law, each bank should ensure that the required disclosures reach its particular client base and that the said disclosures enable the bank's clients to be informed about the bank's exposure to risks, and provides clients with a consistent and understandable disclosure framework that enhances comparability.

Policy process and forum

Policy Committee has a formal mandate

The process of producing policy in the form of directives and guidance notes has been facilitated by the implementation of a framework for policy processes and the establishment of a policy committee. The Department's Policy Committee consists of the members of the Department's Executive Committee as well as a number of other staff members. The Policy Committee has a formal mandate and is tasked with addressing and dealing with all policy issues relevant to the mandate of the Department.

The policy process is captured in a formal document and a flow chart. This framework prescribes a formal process that includes the registration of all issues; the planning of research and development of policy recommendations; and robust debating of the motivating memoranda and related evidence, public comment.

The final policy is disseminated in one of the following formats:

- Banks Act, 1990
- Regulations relating to Banks

- Banks Act circular, directive or guidance note
- Letter to the bank(s) or banking group(s)
- Training, where appropriate, for the market.

At present, the primary focus of the Policy Committee is on Basel II and, more specifically, on the development of guidance notes and directives related thereto.

Policy decision on minimum required regulatory capital requirement

Several years ago the South African minimum regulatory-required capital ratio, in relation to risk-weighted assets, was increased from the 8 per cent level, as specified in Basel I, to a level of 10 per cent, to ensure robust capital levels appropriate for banks operating in the South African environment.

An intense process was undertaken to consider whether a similar approach of increasing the minimum required capital would be appropriate under Basel II and, if so, what the quantum or ratio of the increase should be.

Pillar 2 requirements split

The ultimate outcome of the deliberations and interactions, which included the professional input from an international rating agency, was that the Basel II Pillar 2 requirement would be split into two distinct and separate components, namely a

1. Pillar 2a requirement, which seeks to cater for systemic risk; and
2. Pillar 2b requirement, which seeks to cater for idiosyncratic risk.

Pillar 2a

systemic risk

The identification, assessment, control and mitigation of, and reporting on, systemic risk are central to effective and efficient bank supervision. It is the responsibility of the Department to identify issues of a systemic risk nature and to act upon such systemic risks in a prudent and responsible manner.

After significant debate, the Department decided that Pillar 2a should be set at 1,5 per cent for systemic risk. That is, in addition to the 8 per cent under Pillar 1, an additional 1,5 per cent capital requirement would be imposed on all banks. In reaching this decision, cognisance was taken, *inter alia*, of the following:

- Basel II is highly formula-driven, so the relevance of the assumptions underlying the formulae should be carefully considered in relation to the South African economy.

South African banking system's specific economic and industry risk

- The South African banking system's specific economic and industry risk may not be captured in its entirety by the Basel II Pillar 1 requirements.
- The Basel II formula was calibrated in the context of large mature economies, and the correlation and volatility assumptions embedded in that formula may not capture sufficiently the specificities of the South African operating environment in a crisis scenario. (The Basel Committee, in its publication titled *An Explanatory Note on the Basel II IRB Risk Weight Functions*, dated July 2005, states that the degree of the obligor's exposure to a single systemic risk factor, which may be interpreted as reflecting the state of the global economy, is expressed by the asset correlation R).
- Operational risk is generally considered to be higher in South Africa (even though it might be argued that high credit spreads compensate for the increased risk in the regulatory capital requirement calculation).
- Structural issues in South Africa (such as low savings ratios and concentration on short-term (less than 32 days) deposits) exacerbate liquidity risk concerns relating to banks.

- Single-name and sector concentration is higher in South Africa than in mature economies.
- The 1,06 scaling factor for credit risk-weighted assets has been maintained by the Basel Committee as communicated in its press release dated 24 May 2006.

The above should not be regarded as an all-inclusive list of the systemic risk factors present in the South African economy, but rather as a demonstration of the types of issues considered in setting the Pillar 2a requirement.

The Department believes that the Pillar 2a systemic risk requirement of 1,5 per cent is appropriate in the South African context in terms of ensuring the soundness of the banking system.

Pillar 2b

idiosyncratic risk

Broadly speaking, the Pillar 2b idiosyncratic risk requirement will be based on the outcome of the Department's SREP in relation to each bank or banking group, which will include an assessment of that bank's or banking group's ICAAP. The SREP will include extensive and ample dialogue between the bank or banking group and the Department, and between host and home supervisors.

The aim of the Pillar 2b idiosyncratic risk requirement is to cater for bank- or banking group-specific exposures and factors, thereby contributing to the overarching aim of ensuring that a bank or banking group is adequately capitalised.

Capital should not be regarded as the ultimate, only or final outcome of the SREP. The SREP will, and should, include extensive dialogue between the bank or banking group and the Department, as well as between the home and host supervisors. Furthermore, supervisors have access to an assortment of supervisory tools, such as the power to require the strengthening of internal controls, risk management policies, and governance processes and procedures, to achieve their supervisory goals.

The setting of the Pillar 2b requirement will be a culmination of the aforementioned process. The Department will endeavour to avoid the duplication of capital requirements in respect of particular risk exposures.

Human resources and training

Context

effective challenge

The Department regards the concept of effective challenge as fundamental and indispensable to its approach to supervision. The Department would only be in a position to add value to the banking system if it is able to challenge effectively a bank or banking group on all material dimensions of its corporate governance, including risk management, capital management, internal controls, and such other checks and balances as may be required to lead, manage and conduct the business of a bank or banking group in a prudent and sound manner. Effective challenge is exercised both while conducting on-site visits and as part of the analysis and assessment of the statutory returns and other information received from banks. The SREP constitutes the formalised framework within which this effective challenge takes place.

ability and capacity

For the Department to challenge banks, and thus duly to discharge its duties and responsibilities effectively, it is essential that it has the necessary ability and capacity, in terms of resources and knowledge, skills and experience.

Training of departmental personnel

higher demands on human resources

The main implication for the Department arising from Basel II implementation was the higher demands on human resources and the demand for human resources with different skills, especially quantitative skills.

To date, much attention has been given to up-skilling and right-skilling the Department's professional staff, in anticipation of the implementation of Basel II; a process that will continue going forward.

significant training undertaken

Significant training was undertaken at both a theoretical and practical level. The former was provided by the Department's staff, external trainers and web-based training programmes, covering both the theory of Basel II and training on the new statutory returns and processes that the Department is implementing.

On the practical side, there was significant focus on case studies and on-the-job training as more experienced staff members devoted time to mentoring colleagues through processes such as assessing applications. The training made available included the following:

- presentations on the theory underlying Basel II
- working through examples and case studies
- involvement in assessing a bank's
  - gap analysis and readiness assessment
  - implementation plan
  - QIS submissions
  - parallel-run submissions.

The theoretical and practical training covered all risk areas – credit risk, market risk, operational risk and capital management – with all staff having to attend several days' training on supervisory returns related to these risk areas, while more intensive training was made available on a selective basis. In addition, significant efforts were made in 2007 to ensure that all staff concerned had appropriate skills to undertake Pillar 2 SREPs in line with the Department's revised supervisory cycle.

Industry training

With the finalisation of the fourth draft of the proposed amended Regulations and the proposed amended Exemption Notice during the first quarter of 2007, it became apparent that all material matters affecting the proposed amended legislation had either been resolved or were at an advanced stage of being resolved.

On 2 April 2007 the Department issued Banks Act Circular 2 of 2007, informing all key stakeholders that the Department recognised the need for training, particularly within the banking industry, given the significant amendments to the legal framework, and their scope and complexity.

three industry training sessions of three days each

In conjunction with the AIF, the Department hosted three industry training sessions of three days each; during May, June and August 2007 respectively. Sessions were led by members of the Department and a wide variety of industry specialists.

The purpose of the training was to

- provide attendees with a comprehensive overview of the proposed amendments to the Banks Act, 1990 and the proposed amended Regulations;
- bring to the attention of the attendees the most important principles or approaches followed by the respective structures of the AIF during the process of formulating the

proposed amendments to the Banks Act, 1990 and the proposed amended Regulations;

- highlight some of the major issues that were debated by the respective structures of the AIF during the process of formulating the proposed amendments to the Banks Act, 1990 and the proposed amended Regulations;
- highlight the scope of the proposed amendments to the Banks Act, 1990 and the proposed amended Regulations, and their impact on specific entities within banking groups or on key role players, such as the board of directors, senior management, independent risk control functions, compliance functions, internal audit and external audit; and
- highlight some of the most important reporting requirements or directives for the completion of the financial, risk or related statutory returns.

The three industry training sessions of three days each were attended by more than 850 attendees from the banking sector, the audit profession and other spheres of business, and the majority of the Department's staff.

more than 850 attendees

Information technology

During 2007 the Department upgraded its information technology (IT) database to accommodate the submission of the proposed Basel II regulatory returns. The implementation of the database caters for the additional requirements of the Basel II risk management returns, particularly the storage and processing of greater volumes of data.

upgraded its information technology database

The database was implemented in the first half of 2007 and the new BA risk returns, together with the validation and editing rules, were developed and implemented in the third quarter of 2007.

During the quarter ended 31 December 2007 a parallel-run exercise was undertaken, which entailed banks submitting the new BA returns (based on Basel II) and the existing DI returns (based on Basel I). In general, the parallel-run exercise served its purpose.

Business continuity and disaster recovery

During 2006, a disaster recovery site (DRS) was commissioned for the Bank. In 2007 the Department's IT systems were set up at the site. All the Department's systems are mirrored on the site, that is, in the event of a disaster it would be possible to continue with the Department's operations at the DRS with minimal loss of capacity or functionality.

minimal loss of capacity or functionality

Four tests were performed to assess the adequacy of the site during 2007, which consisted of three scheduled tests and one unscheduled or surprise test. All the tests were generally successful. However, the Bank has identified areas for improvement relating mainly to additional software that is required to be installed and tested during 2008.

Role of board of directors – meetings with boards

The implementation of Basel II within a bank or banking group is the responsibility of the board of directors of that bank or banking controlling company. At the meetings with the boards of directors of banks during the year under review, the Department discussed each board's involvement in the implementation of Basel II.

responsibility of board of directors

To facilitate the discussions, each board chairperson was required to make a presentation on the involvement of the board and its subcommittees in the following areas:

- Processes and programmes followed by the board to familiarise itself with Basel II and its implications and impact, and to apprise itself of the broader issues pertaining to Basel II
- Critical interventions and decisions by the board on the Basel II implementation process
- Progress made with the implementation of Basel II, including, but not limited to, critical areas identified that require further action.

Conclusion

An article written by the Chairperson of the Basel Committee and President of the Netherlands Bank, Dr Nout Wellink, first published in the *Financial Times* on 9 April 2008, appropriately encapsulates Basel II and its appropriateness for modern financial markets:

> The current financial market turmoil underscores the importance of strongly capitalised banking systems. It also highlights the shortcomings of the Basel I capital regime, which has been in place since 1988 and has contributed in the past few years to the concentration of risk in the banking sector.
>
> There is a strong consensus that the implementation of Basel II will put capital regulation on a sounder footing. Among other things, Basel II will enhance capital regulation, supervision, risk management and market transparency. All exposures, whether on or off the balance sheet, will be subject to regulatory capital charges. There will be greater differentiation in the capital requirements for high- and low-risk exposures. Basel II will create more neutral incentives between retaining exposures on the balance sheet and distributing them to investors through securitisations. It will introduce more robust capital requirements for banks' rapidly growing trading and derivatives activities. Supervisors will be given the tools to help strengthen banks' risk management and governance. Better disclosure of banks' risk profiles, including structured credit and securitisation activities, will be required.
>
> These enhancements are achieved by reinforcing the basic building blocks of sound credit risk management practices, subject to rigorous internal controls and supervisory standards. The framework is therefore more adaptable to rapid innovation in financial markets and products. Moreover, the three pillars of Basel II (minimum capital, risk management and supervisory scrutiny, and market transparency) provide multiple perspectives on banks' risk profiles and capital cushions.
>
> Recently this page has featured the arguments of a number of Basel II critics, primarily from the academic community. First, it has been argued that Basel II adopts the models that failed to perform in the recent turmoil. As a result, it is argued, the framework does not place constraints on bank risk-taking. This claim is based on a misunderstanding of what constitutes a model. Basel II does not allow banks to use the credit pricing models that failed to perform. Nor does it permit the modelling of correlations, which broke down under stress. Instead, the framework requires banks to develop robust data series on defaults, losses and recoveries that include an economic downturn. These data inputs are filtered through a prudential capital framework specified by supervisors. This will induce an important upgrade in banks' risk management systems that, had these enhancements been achieved before the crisis, would have helped put banks on to a sounder footing.
>
> Second, it has been argued that Basel II is too procyclical, amplifying financial crises. However, it is not possible to have greater risk differentiation – a main objective of strengthening capital regulation – without some fluctuation in minimum capital requirements

as credit quality deteriorates. The Basel Committee has worked hard to introduce many safeguards across the three pillars of the framework to achieve a reasonable balance between risk sensitivity at banks and the stability of industry capital over the cycle. This includes the requirement that banks perform stress tests and demonstrate that they hold adequate cushions above the minimum during good economic conditions, in order to weather such stress.

The Basel II framework will change bank incentives and require them to develop more forward-looking approaches to assessing, managing and holding adequate capital for risks. Supervisors will have stronger tools to intervene early before capital minimums have been breached.

The Basel Committee has put into place a rigorous data collection framework to track the impact of Basel II across member countries. Where the framework proves to be too cyclical, the committee will take the necessary steps to achieve a better balance. But, whatever is done, we need to retain the benefits of risk differentiation across banks and over time to highlight supervisory attention on those banks that take on excessive risk for a given unit of capital.

There are no quick-fix, simple measures or ratios that will achieve our objective of a robust capital regime. Basel II is being implemented only now in most countries, but the market turmoil has already provided some important lessons that will help guide the Basel Committee in further strengthening the framework. Overall, it is the best practical approach we have that balances a range of objectives and trade-offs. I believe Basel II provides regulators with a better tool to ensure that capital cushions reflect banks' changing risk profiles in an environment of rapid financial market innovation.

While strong capital is a necessary condition for a stable banking and financial system, it is not sufficient. Sound, company-wide risk management, including prudent underwriting, strong supervision and robust liquidity cushions, is also a critical element. The committee's work agenda seeks to strengthen practice in these areas. It has been devoting particular attention to strengthening global standards for the management and supervision of liquidity risk, which it will issue for public comment in the coming months.

Application in terms of section 37 of the Banks Act, 1990 for the acquisition of shares in Standard Bank Group Limited (SBG), a bank controlling company

In 2005, South African regulatory approval was granted in terms of section 37 of the Banks Act, 1990 for the acquisition of a majority shareholding in Absa Group Limited (Absa), a bank controlling company, by Barclays Bank plc (UK) (Barclays). Barclays acquired 50,1 per cent of Absa shares for a total consideration of R33 billion.

Over the years, the international participation in the local banking industry has continued to increase, from 3,0 per cent at the end of December 1994 to 8,2 per cent by the end of December 2004 to 29,47 per cent at the end of December 2007. The increase since 2004 is the result of the Absa/Barclays transaction and the acquisition of a stake in the SBG by Industrial and Commercial Bank of China (ICBC) in 2007.

acquisition of a stake in the SBG

On 24 October 2007, South African regulatory approval was granted to ICBC, in terms of which ICBC could acquire up to 20,5 per cent equity in the SBG, a bank controlling company. The acquisition of the minority interest by ICBC resulted in R36,7 billion (approximately US$5,5 billion) equity investment into the SBG. The transaction is the second international material investment in one of the largest banks in South Africa.

Background

The SBG is one of the largest banking groups in South Africa, with total assets of over R1,191 billion (approximately US$175 billion) of which R659,1 billion was in South Africa as at 31 December 2007. The SBG has operations in 18 African countries and 20 countries outside Africa, has more than 950 branches, and employs more than 46 000 people.

ICBC is the People's Republic of China's largest bank, with 17,1 per cent market share in Chinese banking assets and one of the world's largest banks in terms of market capitalisation of approximately US$319 billion at 22 October 2007. ICBC was listed in the largest initial public offering in history in October 2006, raising US$21,9 billion in new equity. It is listed on the Hong Kong and Shanghai stock exchanges, has over 16 000 branches in China, nearly 100 branches elsewhere in the world, and 2,5 million corporate and 180 million personal bank customers. ICBC has branches in Hong Kong, Singapore, Tokyo, Kuala Lumpur, Seoul, Frankfurt, Luxembourg and London, and representative offices in New York, Moscow and Sydney. The US$5,5 billion transaction with the SBG represents ICBC's largest investment outside China.

ICBC applied to the Department for approval in terms of section 37(2)(a)(i) of the Banks Act, 1990, to acquire more than 15 per cent, but not exceeding 24 per cent, of the issued shares of the SBG.

Approval in terms of section 37 of the Banks Act, 1990 requires the consent of the Registrar of Banks. Such consent shall not be granted unless the Registrar is satisfied that the proposed acquisition will not be contrary to the public interest, and the interest of the depositors of the bank and bank controlling company concerned.

Ownership

shareholder of reference

Prior to this transaction, the shareholder base of the SBG had been relatively widely dispersed. This transaction provided the SBG with a shareholder of reference. The foreign ownership in the SBG has increased from approximately 25 per cent to 40 per cent and the SBG will therefore still be majority-owned by South Africans. ICBC has committed itself to the broad-based economic empowerment targets set for the SBG in terms of the Financial Sector Charter.

Implications for the South African economy

ICBC's investment will result in an inflow of approximately US$5,5 billion of foreign direct investment into South Africa, the largest inflow of direct investment capital since the second quarter of 2001.

This transaction confirms that South Africa is viewed as an attractive market for investment, and signals a vote of confidence in the soundness of South Africa's macroeconomic policy and its financial markets. Furthermore, this transaction will raise the profile of South Africa's capital markets as an investment location, particularly for the Asian market.

Benefits for Africa

strategic partnership

China and South Africa established a strategic partnership in 2004 and further cemented relationships at the African–Asian summit in Beijing in 2006. As trade and investment flows continue to develop between China, South Africa and other areas of

Africa, so too has the bilateral nature of such trade dramatically increased. ICBC's strategic alliance with the SBG will place both institutions in a position to capture the growth opportunities on the African continent.

strategic partnership

Implications for the South African banking industry

The magnitude of the investment is a strong endorsement of strength and profitability of the South African banks and of the quality of regulation of the South African banking industry. The inflow of capital will increase the tier one capital base of the SBG, which will further improve the banking sector's quality of capital. Banks that are adequately capitalised and well managed are essential for a healthy financial system.

inflow of capital

Conditions of approval

The transaction was subject to the approval of the Registrar of Banks, the China Banking Regulatory Commission, the JSE Limited (JSE), the Competition Commission, and the SBG and ICBC shareholders. All regulatory approvals were obtained, and the shareholders of the SBG and ICBC gave their support for the transaction.

The Registrar consented to the transaction subject to a number of conditions, among which is that the shareholding shall not exceed 20,5 per cent of the total nominal value of all issued shares of the SBG without the prior approval of the SBG Board of Directors and thereafter, consultation with the Registrar. The purpose of these conditions was to ensure ongoing maintenance of the soundness of the South African financial system and the prevailing policy objectives. ICBC accepted these conditions unequivocally.

Accordingly, after due consideration, regulatory approval for the acquisition by ICBC of more than 15 per cent, but not exceeding 24 per cent, of the shares in the SBG was granted by the Registrar in terms of section 37(2)(a)(i) of the Banks Act, 1990.

The future

The approval of this transaction and the conditions imposed on the SBG–ICBC transaction by the Registrar of Banks are specific to this transaction. Any future application by an international institution to acquire a majority shareholding in a major domestic bank would be considered on its own merits, taking into account the circumstances prevailing at that time.

Illegal deposit-taking

The Department is responsible for the administration of the Banks Act, 1990, in terms of which the Registrar of Banks is tasked with, *inter alia*, controlling certain activities of unregistered persons. During the year under review the Department received a number of complaints, with supporting documentary evidence, pertaining to certain business activities conducted by a number of institutions, which indicated that these institutions were accepting deposits from the general public as a regular feature of their business. The acceptance of deposits from members of the public as a regular feature of business is tantamount to conducting "the business of the bank", as defined in section 1 of the Banks Act, 1990. In terms of this Act, it is an offence for any person to conduct the business of a bank unless such person is a public company and is registered as a bank in terms of the Act.

activities of unregistered persons

As the institutions in question were not registered as banks or mutual banks in terms of the Banks Act, 1990 or Mutual Banks Act, 1993 (Act No. 124 of 1993), they were found to be taking deposits from the general public in contravention of section 11 of the Banks Act, 1990. Forensic auditors from a number of auditing firms were appointed as temporary inspectors to investigate such institutions and to provide the Department with reports on the activities of these institutions.

In general, when inspectors conclude that the activities of a certain institution are in contravention of the Banks Act, 1990, the inspectors are appointed as managers in terms of this Act. The purpose of the appointment is to take control of the funds that were illegally taken and liquidate any assets acquired by such institution in order to repay the depositors or investors all or part of their investments.

In cases where the institutions are liquidated prior to such an appointment and liquidators have been appointed to deal with the estate of the institution in respect of the Insolvency Act, 1936 (Act No. 24 of 1936), managers are not appointed. In such cases, the Insolvency Act takes precedence over the Banks Act and, hence, the managers are unable to conclude their mandate legally and the involvement of the Department in the repayment process is thereby ended.

Department reacts to complaints

The Department reacts to complaints from members of the public regarding the existence of suspected illegal deposit-taking schemes. However, by the time the Department receives a complaint and inspectors are appointed, the suspected illegal deposit-taking scheme has been in operation for some time and the perpetrators of such schemes have taken a sizeable amount of money from the public and have usually misappropriated such funds. It would appear that the investing public complains about such schemes only at the stage where the scheme is not able to pay them the exorbitant returns on their investments. When managers are appointed in such cases, the scheme usually has limited funds available for repayment. According to the Department's records, investors were refunded their entire capital investment in only one case. Usually, investors receive less than 50 per cent of their investment.

The activities of these unregistered persons are in direct competition with the legitimate business of registered banks. The proliferation of illegal deposit-taking schemes is not only detrimental to the banking system but also to the financial system and the South African economy in general. In some instances the funds are illegally transferred offshore in contravention of Exchange Control Regulations, 1961 (promulgated by Government Notice R1111 of 1 December 1961 and amended up to Government Notice No. R.885 in *Government Gazette* No. 20299 of 23 July 1999). Tax evasion by the operators of illegal deposit-taking schemes is also common.

inspection of 42 schemes

During the year under review, 18 new inspections, together with 24 inspections carried over from previous years, were undertaken. The inspection of these 42 schemes was delegated to 16 forensic auditing firms. Upon finalising an investigation into illegal deposit-taking schemes, the Department refers the matter to the South African Police Service (SAPS) and prosecuting authorities for further investigation into, and prosecution for, contraventions that may have been committed by the operators of these schemes, if and where appropriate.

The Department finalised five investigations during 2007. Two were reported to the SAPS Commercial Branch; two others were already under SAPS investigation; while the fifth scheme was found not to be conducting the business of a bank.

In addition to the above, the Department has enhanced its co-operation with the SAPS Commercial Branch by making staff available for training and guidance on matters pertaining to illegal deposit-taking.

Maintenance of a board directorship continuity programme

A topic selected as one of the flavour-of-the-year topics for discussion with banks at meetings with their boards of directors in 2007 dealt with the maintenance of a board of directors continuity programme. The selection of the topic was intended to enable the Department to gain insight into, and assess the following:

discussion with banks

- The robustness of the process followed by the directors' affairs committees of banks in assessing the skills, experience and other qualities of members of the board of directors to enable the effective functioning of the entire board of directors.
- The adequacy of the process followed in the selection and ongoing assessment of directors including
  - assessing whether directors possess the knowledge and skills that may reasonably be expected of directors
  - assessing whether non-executive directors have sufficient time available to carry out their duties and responsibilities to the banks properly and exercise the utmost good faith, honesty and integrity in all their dealings with, or on behalf, of the bank.

selection and ongoing assessment

- The adequacy of the process followed in the induction of directors including
  - updating directors on the relevant laws and regulations
  - induction on their fiduciary duties and responsibilities
  - formal orientation to familiarise incoming directors with the bank's operations.
- The reasonableness of the process followed in the evaluation of directors performance covering various aspects.
- The adequacy of the process put in place to assess the following:
  - Each director's level of skill and efficiency
  - the comprehensiveness of the actions implemented to address identified shortfalls of skill and knowledge
  - monitoring and follow up on corrective actions implemented to address identified shortfalls of skills and knowledge.
- The process followed to ensure periodic replacement of non-executive directors and the adequacy of the formal succession plan for the boards and the executive.

During the meetings held with the board of directors of the various banks, each chairperson gave a presentation covering the aspects listed above, leading to a discussion between the Department and the board.

The exercise proved invaluable to both the banks' board of directors and the Department. In a few instances, it became clear that an assessment of whether individual members of a board had sufficient time to prepare for meetings in order to enable them to contribute meaningfully to the deliberations at such meetings had never been made. In addition, instances where an analysis of the available information indicated that a board member did not have sufficient time to attend to the matters of the bank on account of board commitments to other institutions were referred, through the board chairperson, for review by the directors' affairs committee and subsequent report-back to the Department.

exercise proved invaluable

There have also been instances where, following the discussions that took place at the meeting with the board of directors, some directors had reconsidered their ability to discharge meaningfully their duties as directors of a bank or banking group and decided on either relinquishing some of their other board commitments or resigning from the board of the bank or banking group.

persons with a broad mix of skills

In the light of the onerous responsibilities resting on bank directors, as trustees who need to ensure that public deposits and savings are properly safeguarded, it is imperative that boards of directors of banks comprise persons with a broad mix of skills, competence, experience and available time to discharge the duty of trust imposed on them properly.

Consumer education

In 2001, the FSB – the non-bank financial services regulator – appointed the Consumer Education Review Committee (the Review Committee), to review and monitor the progress being made by the FSB to promote appropriate programmes and initiatives by the financial services industry to inform and educate users and potential users of financial services and products. The Department is represented on this committee, while other members of the committee are as follows:

- Association of Unit Trusts
- Black Brokers Forum
- Consumer Affairs Committee
- Department of Trade and Industry
- Financial Intermediaries Federation of South Africa
- Financial Services Board
- Fund Managers Association of South Africa
- Institute of Retirement Funds
- JSE
- Labour movements
- Life Offices Association
- National Consumer Forum
- South African Council of Churches
- South African Institute of Financial Markets
- South African Insurance Association
- The Banking Association South Africa.

development of a strategy document

The Review Committee was involved in the development of a strategy document that outlines the Consumer Education Initiative, the consumer education materials and the preparation for the implementation of broader sub-strategies contained in the Consumer Education Initiative.

The main objective of the initiative was to give consumers the ability and tools to make informed choices and help them minimise their exposure to costly mistakes. An informed consumer will be less exposed to fraudulent activities and the benefit of this will be a win-win situation for consumers, providers of different financial services and financial-sector regulators.

As the Department received reports of get-rich-quick and other illegal schemes, it continued to warn the public not to become involved in such schemes. The Department also contributed to a warning campaign launched in the print media and on radio by the Review Committee.

The Review Committee had previously recommended that other service providers be encouraged to participate in consumer education initiatives. The committee took a resolution to verify the type of consumer education the banks provided with a view to identifying collaborative measures that could be embarked on with the committee.

In the year under review banks, particularly in the Gauteng Province, conducted financial education drives. Some of these initiatives included information about the following:

initiatives

- *Identity theft* occurs when someone wrongfully acquires or uses another person's personal and financial data, typically for his or her own financial gain.
- *Phishing* is an impersonation of a corporation or trusted institution that aims to steal valuable information such as credit card details, user identity documents and passwords.
- *Card fraud and skimming* is the practice of extracting the information from the magnetic strip on a credit card with the intention of making a copy of the card.
- *Pharming* aims to redirect a website's traffic to another bogus website through domain spoofing to obtain confidential information such as passwords.
- *Security information management (SIM) swap fraud* occurs when fraudsters obtain and utilise the customer's replacement SIM card to acquire security messages and one-time passwords sent to the customer by the bank.
- *Cheque fraud* is the act of fraudulently obtaining and using cheques for financial gain.
- *Deposit slip scams* occur when deposit slips are used to trick people into transferring money into fraudsters' accounts.
- *Money laundering* is a process involving the concealment of the origin of funds generated by illegal means (i.e., drug trafficking, gun smuggling and corruption).
- *Nigerian scams/advanced fee fraud* occurs when perpetrators of 419 Nigerian scams operate by sending the victim an unsolicited letter, facsimile or electronic mail message containing either an illegitimate or illegal proposal.

Consumer education seems to have been instrumental in preventing some of these scams. However, several people still became victims.

Bank on-site visits

function of the Review Team

The function of the Review Team of the Department is to support the teams responsible for the supervision of assigned banks (the analysis teams) in the execution of their duties by performing on-site reviews. The Review Team is headed by a member of the senior management of the Department and reports to one of the deputy registrars.

Assignments for the Review Team are identified by the analysis teams and focus on aspects of a bank's operations about which the analysis team requires a better understanding or which may be of concern. The assignment is formulated in terms of reference, which form the basis for the review. At least one member of the analysis team usually accompanies the Review Team on the review. A review is concluded with an internal report, a feedback meeting with the bank, and formal written communication to the bank setting out the findings and recommendations.

Basel II implementation initiatives

The Review Team also participated in the assessment of banks' Basel II implementation initiatives.

During the year under review the credit-risk management process at one of the smaller banks was reviewed. The review focused on the assessment of the effectiveness of governance from board level to the level at which credit decisions were made. The policies governing the granting of loans, and the collections and writing-off processes were analysed and their practical application was reviewed. The review concluded that credit risk management was of an acceptable standard.

A joint venture finance company formed between one of the large banks and a private-sector company was reviewed to determine the effectiveness of the corporate governance structure and to assess the extent of the credit risk to which each of the joint venture partners was exposed. It was concluded that the banking partner was not exposed to credit risk above that associated with the normal course of business.

During the last quarter of 2007 the Review Team commenced with a review of the retail banking division of one of the large banks. The objective was to gain an understanding of the governance of the credit-granting process in the division and the adequacy of the policies that had been implemented. The application of the policies will be tested.

broadened scope to include operational risk

In the past the Review Team's assignments centred mostly on the governance of the credit-granting processes in banks and the quality of their lending books. With the implementation of Basel II, the team's activities will be broadened to include assisting the Department's operational risk-related reviews.

Update on the implementation of the revised Core Principles for Effective Banking Supervision

compliance improved

As reported in the 2006 *Annual Report*, the Department embarked on a project to reach an acceptable level of compliance with the revised Core Principles during 2006. The project team established for this purpose continued to monitor the Department's compliance status on a monthly basis throughout 2007. During the year under review, compliance with the Core Principles improved as the amendments to the Banks Act, 1990 and the Regulations relating to Banks progressed, and changes were made to the supervisory process to incorporate the new supervisory actions as stipulated in the Core Principles Methodology.

The Department's policies and processes have been updated, and implementation and execution of the revised supervisory processes will commence on 1 January 2008, together with Basel II implementation. Once the new supervisory process is well entrenched, the Department will be compliant with the criteria set out in the Core Principles Methodology.

Banking Code for Responsible Credit Extension

unscrupulous and unsolicited offers

An issue of concern to the Department was the seemingly unscrupulous and unsolicited offers of retail lending activities that were emerging from banks who utilised both mail and electronic (short message service (SMS)) means of communication. The Department was also receiving an increased level of complaints from members of the public concerned about aggressive and unprofessional conduct by bank personnel, which had resulted in their being harassed and inconvenienced by such bank personnel.

unveiled a code of conduct

The Department engaged with the industry in order to resolve what was clearly unacceptable conduct, not to mention inherent poor risk management practices that would evolve from such activities. The result was that in March 2007 The Banking

Association South Africa unveiled a code of conduct, agreed to by all major consumer lending banks, setting out a standard to which banks undertake to adhere with respect to lending practices.

In terms of the voluntary code the banks undertook, *inter alia*, to abide by the following principles:

principles of code

- Customer contact for credit selling purposes will only be made between 08:00 and 19:00 from Monday to Friday and from 08:30 to 13:00 on Saturday.
- The bank representative will advise a customer, at the start of a discussion, that he or she is about to offer the customer credit and ask whether the customer would like to continue with the discussion.
- The banks will only contact customers to offer credit where banks have assessed that, on the information available to them, the customer probably has the ability to repay the facility (on the basis contemplated in the NCA).
- The banks will inform such customers upon first contact that, based on the information available to them, the preliminary assessment indicated that they would probably qualify for the product that is being offered to them and that, should they accept, they would be taken through the appropriate credit vetting and FICA processes.
- Salespeople will endeavour not to contact the customer for purposes of selling the same lending product more frequently than once every two months (excluding one follow-up contact on an offer made), unless with the consent of the customer and subject to legal requirements, such as client confidentiality.
- Compliance with all relevant legislation and agreed codes of practice.

Following the signing of the code, some banks, however, continued with their forceful overselling practices and claimed that they had resorted to such practices on account of the selling practices adopted by their competitors. A matter that raised concern is the fact that, despite the chief executive officers of such banks having committed their banks to abiding by the above voluntary code, lower-level personnel in some of their line functions completely disregarded some of the principles embodied in the said code.

completely disregarded some of the principles

In an endeavour to retain public trust and respect in the banking sector, it is important that bank personnel conduct themselves in a professional and respectful manner when dealing with the public. The Department therefore wishes to urge the chief executives of all banks to ensure that high standards of moral conduct and respect are maintained by their staff at all times in dealing with the general public.

chief executives to ensure high standards

Market risk

Market risk arises from banks conducting proprietary trading or when they are exposed to markets through imperfectly hedging client transactions. In 2007, 11 banks in South Africa reported market risk under the prevailing regulations.

Three alternative reporting methods were available to banks, that is, the internal models approach (IMA), and two standardised approaches, namely the building block approach and the simplified approach. During 2007, the Department conducted renewal reviews on three banks employing the IMA. In addition, three banks applied for initial IMA approval. Apart from assessing the modelling attributes of applicant banks, the economic, organisational, technological and procedural-related elements also came under scrutiny.

three alternative reporting methods

annual review

Banks with IMA approval participate in an annual review in order to maintain the right to use the modelled method for reporting and a quarterly appraisal of their compliance with the conditions for approval. During this process, a bank's backtesting performance, available to the Department via monthly submissions, is a key indicator of the validity of its market risk models to measure the capital required to address potential losses. When backtesting data indicate that a bank's losses exceed modelled predictions above a tolerance level, the capital requirement is adjusted by means of a multiplier. Apart from examining backtesting, banks are also assessed against various qualitative factors published in the proposed amended Regulations. Several instances occurred where the multiplier was adjusted during the year under review for both backtesting and qualitative factors. One bank received a reduced multiplier, while the multiplier was increased for two other banks due to control deficiencies.

injection of capital

Continued increases in the local interest rate indices, 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 dollar–rand exchange rate resulted in dramatic increases in volatility and the position risk of trading banks in the latter half of the year under review. The growth in risk necessitated a net injection of capital for market risk among trading banks – most banks had an increased capital requirement resulting from the volatility of their positions, while some banks reduced their positions and, consequently, their capital requirements.

Capital held for market risk made up about 4 per cent of the total capital requirement for banks during the year. Following implementation of the amended Regulations relating to Banks, the amount is expected to reduce to approximately 2,5 per cent due to the addition of operational risk to the total capital requirement, and as a result of capital held for concentration risk and counterparty risk arising from trading activities no longer regarded as being part of market risk. Under Basel II, market risk is limited to position risk, which arises from a bank's exposure to financial market movements and idiosyncratic price changes of exposure to individual companies.

As described earlier in this chapter, the Regulations relating to Banks were revised *in toto*, which included those applicable to market risk. In terms of the amended Regulations relating to Banks, five banks will report market risk according to the IMA, while the remainder will employ the standardised approaches.

Independent Regulatory Board for Auditors

As reported in the *Annual Report 2006*, the Auditing Profession Act, 2005 (Act No. 26 of 2005), was promulgated and assented to by the President of the Republic of South Africa in January 2006. In terms of this Act, the Independent Regulatory Board for Auditors (IRBA) was created.

All references in the Banks Act, 1990 to the Public Accounts' and Auditors' Act, and the Public Accountants' and Auditors' Board have been repealed and substituted with references to the Auditing Profession Act and the IRBA respectively by the proposed amended Banks Act, 1990, which will be effective from 1 January 2008.

represented on two committees

In terms of the Auditing Profession Act, the IRBA is required to establish committees to assist in the performance of its function and it may, at any time, dissolve or reconstitute any such committee. The Department is represented on two of the six permanent committees established in terms of section 20 of this Act, which are the

- Committee for Auditor Ethics established in terms of section 21(1)(b) of the Auditing Profession Act; and
- Committee for Auditing Standards established in terms of section 22(1)(h) of the Auditing Profession Act.

The National Credit Regulator

The National Credit Regulator (NCR) was established as the regulator under the National Credit Act, 2005 (Act No. 34 of 2005). The NCA was assented to by the South African President on 10 March 2006 and came into operation on 1 June 2007.

The NCR was established to promote a fair and non-discriminatory marketplace for access to consumer credit and to regulate the conduct of lenders in general. The NCR is responsible for the regulation of the South African credit industry. It is tasked with educating, researching, developing policy, registering industry participants, investigating complaints and ensuring enforcement of the NCA.

promote a fair and non-discriminatory marketplace

The NCA requires the NCR to promote the development of an accessible credit market, particularly to address the needs of historically disadvantaged persons, low-income earners and remote, isolated or low-density communities. The NCA generally applies to every credit agreement between parties dealing at arm's length and made or having an effect in South Africa.

The implementation of the NCA improved overall market conduct in terms of credit extension by credit providers. The way in which the introduction of the NCA impacted on the banking sector is difficult to determine amid the number of other local changes such as Basel II preparations and the turn in the interest-rate cycle. Banks incurred costs due to system changes, and had to adjust administrative and credit processes to accommodate the new credit extension practices.

The Department, as stipulated in the Banks Act, 1990, remains responsible for the risk management practices and prudential requirements of banks, whereas the NCR focuses on market conduct in terms of credit extension.