Chapter 1

Registrar of Banks' review

The secondary effects of the international financial market turmoil, combined with cyclical economic developments in South Africa, worsened the operating environment of the banking sector during 2008, with a noticeable decline in the rate of growth in loans and advances. Furthermore, increasing pressure on consumers was clearly evident in the sharp increase in impaired advances and rising credit impairments, which impacted negatively on banks' earnings. However, notwithstanding the turmoil experienced in international financial markets and the domestic cyclical economic developments during 2008, the South African banking system again remained stable, and banks were adequately capitalised and profitable.

notwithstanding the turmoil experienced, the banking system remained stable

This chapter provides a high-level overview of, *inter alia*, the balance-sheet structure, capital adequacy, profitability and asset quality of the banking sector. Furthermore, it reviews the pilot study conducted by the International Monetary Fund (IMF) on the South African implementation of the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II), the joint IMF/World Bank Financial Sector Assessment Program (FSAP) mission to South Africa and the IMF Article IV consultation. In addition, it provides an overview of banks' compliance with anti-money laundering (AML) legislation and the Bank Supervision Department's (the Department) skills development-related issues.

High-level overview of the banking sector

As at the end of December 2008 there were 33 banking institutions reporting data to the Office of the Registrar of Banks (excluding two mutual banks; however, including one institution conducting banking business in terms of an exemption from the provisions of the Banks Act, 1990 (Act No. 94 of 1990) (the Banks Act), namely, Ithala Limited) and 43 international banks with authorised representative offices in South Africa.

The South African banking sector's capital-adequacy ratio during 2008 remained above the minimum requirement of 9,50 per cent, reaching 13,0 per cent at the end of December 2008 (January 2008: 11,8 per cent). The tier 1 capital-adequacy ratio increased to 10,2 per cent at the end of December 2008, compared with 8,9 per cent at the end of January 2008.

tier 1 capital-adequacy ratio increased to 10,2 per cent

At the end of December 2008 total banking-sector assets amounted to R3 170 billion, representing an annual growth rate of 24,5 per cent year on year (January 2008: 27,0 per cent). Total assets of the four largest banks amounted to R2 676 billion and accounted for 84,4 per cent of total banking-sector assets. At the end of December 2008, gross loans and advances amounted to R2 316 billion (January 2008: R2 103 billion) and R2 276 billion net of credit impairments (January 2008: R2 077 billion). The growth in gross loans and advances (measured year on year) eased to 9 per cent at the end of December 2008, compared with 19,2 per cent at the end of January 2008.

growth in gross loans and advances eased

At the end of December 2008 banking-sector total liabilities amounted to R2 989 billion and total equity amounted to R181 billion. Deposits represented 79,6 per cent of total liabilities (January 2008: 84 per cent). The main contributors to total deposits were fixed and notice deposits (25 per cent), call deposits (22,1 per cent) and negotiable certificates of deposit (16,3 per cent). Deposits from retail and corporate customers were the primary sources of funding and represented 63,2 per cent of total banking-sector deposits at the end of December 2008. Total equity increased from R154,4 billion at the end of January 2008 to R181 billion at the end of December 2008.

Banks reported favourable profitability ratios throughout 2008, despite the turmoil experienced in international financial markets and the domestic cyclical economic developments. The banking sector's cost-to-income ratio (unsmoothed) was

favourable profitability ratios

42,2 per cent, compared with 47 per cent at the end of January 2008. At the end of December 2008 the return on equity amounted to 28,7 per cent (January 2008: 24,1 per cent) (unsmoothed) and return on assets to 1,62 per cent (January 2008: 1,39 per cent) (unsmoothed).

liquid assets exceeded statutory requirement

Liquid assets held exceeded the statutory liquid assets requirement throughout 2008. The liquid assets held, measured against the minimum liquid asset requirement, amounted to 115,5 per cent at the end of December 2008 (January 2008: 111,1 per cent).

credit risk ratios deteriorated

Credit risk ratios deteriorated during 2008. Impaired advances[1] continued to rise, reaching R87,3 billion at the end of December 2008 (January 2008: R47,6 billion). Expressed as a percentage of gross loans and advances, the ratio deteriorated from 2,3 per cent at the end of January 2008 to 3,8 per cent at the end of December 2008. The increase in interest rates, other cyclical economic developments in South Africa and the turmoil experienced in international financial markets contributed to the deterioration in credit risk ratios.

Concentration in the South African banking system

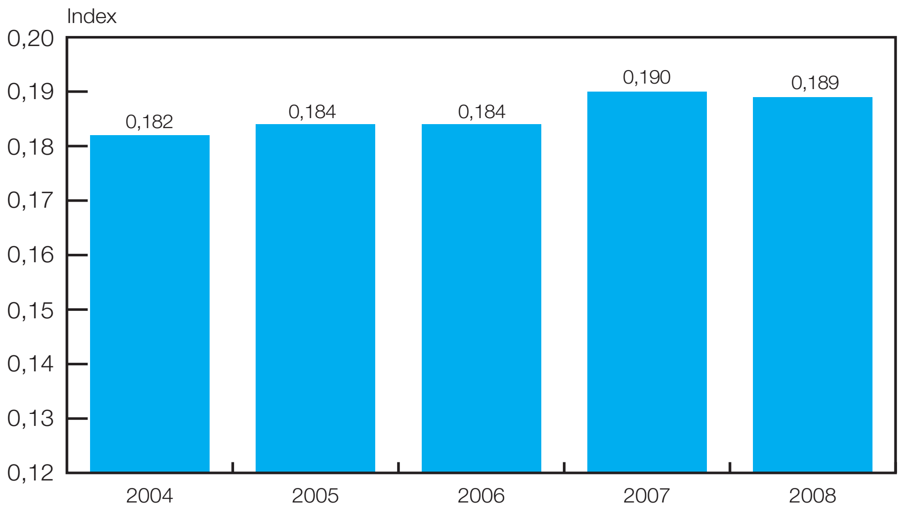
The Herfindahl–Hirschman Index (H-index) is a commonly accepted measure of market concentration in a banking system. The index is calculated by squaring the market share, in terms of total assets, of each bank in the system and subsequently summing the squares. It takes into account the relative size and distribution of the firms in a market, and approaches zero when a market consists of a large number of firms of relatively equal size. The index increases as the number of firms in the market decreases and as the disparity in size between those firms increases. The higher the index, the less competition exists in the market and vice versa.

An H-index below 0,1 indicates that there is no concentration in an industry, while an H-index between 0,1 and 0,18 is an indication of moderate concentration. An H-index above 0,18 represents a highly concentrated industry that indicates the presence of an oligopoly. An 'oligopoly' can be defined as an imperfectly competitive market structure in which a few institutions dominate the industry.

continued dominance of four largest banks

The level of concentration in the South African banking sector, measured using the H-index, is presented in Figure 1. The index amounted to 0,189 at the end of December 2008 (December 2007: 0,190 index). The high index in 2008 can be attributed to the continued dominance in terms of market share by the four largest banks. The total balance sheet of the four largest banks amounted to R2 676 billion and accounted for 84,4 per cent of banking-sector assets at the end of December 2008 (December 2007: 85,1 per cent).

Figure 1 H-index for the South African banking system (2004–2008)



International Monetary Fund Basel II assessment

Introduction

IMF pilot study

South Africa implemented Basel II with effect from 1 January 2008. During 2007, the IMF approached the Department with a request to conduct a pilot study on the South African implementation of Basel II, to which request the Registrar of Banks (the Registrar) acceded.

The purpose of the pilot study was twofold:

1. It would serve as an independent assessment and benchmarking of the South African implementation of Basel II
2. The IMF/World Bank wished to test and calibrate their joint approach to, and documentation of, the assessment of a country's Basel II implementation for FSAP and Article IV purposes.

The pilot study comprehensively covered the entire Basel II implementation process, and included visits to three banks and meetings with an auditing firm and a rating agency.

South Africa – one of only four countries

South Africa was most fortunate to be chosen as one of only four countries in respect of which the IMF/World Bank pilot study was conducted and gained much value through the effective challenge posed by the IMF/World Bank team (the study team). Canada, Peru and Spain also participated in the study.

Rationale for Basel II

Basel II has international ramifications

The implementation of Basel II by South Africa has international ramifications for the country, since the effective and efficient implementation of Basel II

- can contribute materially to the safety and soundness of a bank and banking system;
- would facilitate the access of local banks to banking markets in other jurisdictions; and
- could impact positively on the creditworthiness of South African sovereignty through the market discipline imposed on the country by the international capital markets.

Preparation

comprehensive and challenging questionnaires

The preparation for the study team's visit stretched over a number of months, and entailed the Department's respondent team studying detailed instructions, and completing two comprehensive and challenging questionnaires. In addition, the Department submitted extensive relevant information to the team during December 2007. The team used this information as the basis for their detailed desktop analysis completed prior to their visit to South Africa in January 2008.

Throughout the study team's visit to South Africa, they, at their own discretion, interviewed members of the Department intensively and tested them robustly on a range of aspects of the South African implementation of Basel II. From time to time the team called for additional supporting original evidence to substantiate statements made by members of the Department.

International Monetary Fund/World Bank report

The study team presented the Department with their final report during June 2008. The executive summary of the final IMF/World Bank report is introduced with the following

Basel II implementation process of high quality

statement: "Overall, the Basel II implementation process in South Africa has been of high quality, backed by professional and competent supervisory staff and a strong buy-in from the industry, and reflects a high degree of compliance with the criteria in the methodology."

The Department's staff members converted the recommendations contained in the IMF/World Bank report into action plans and are monitoring the implementation of these action plans on a monthly basis.

Securitisation

risk posed by securitisation vehicles, conduits and special investment vehicles

The turmoil in the financial markets, flowing from the collapse of the sub-prime market in the United States of America (USA) that started in 2007 (see pages 3–5 of the 2007 *Annual Report*), gathered momentum during 2008, resulting in large global corporate and banking failures, and unprecedented write-downs by a number of international financial institutions. Although the root cause of the crisis, in essence, derives from the risk-taking behaviour of investors, banks, consumers and other market participants, it, however, highlighted the risks posed to the soundness of financial institutions by securitisation vehicles, conduits and special investment vehicles due to the deterioration in the quality of assets housed in such vehicles. What essentially is a very useful tool to manage credit and bank funding became the largest threat to the banking sector.

independent review of all securitisation schemes

In the light thereof, and in the interest of the stability of the domestic banking sector, the Department deemed it necessary to commission an independent review of all securitisation schemes affecting banks, in order to determine whether or not such schemes were being managed proactively.

During April 2008, the Department directed all banks that were participating in securitisation activities, in terms of the provisions of section 7(1)(b) of the Banks Act, to furnish it with a report on the various risks facing banks that were involved in securitisation schemes. One of the large international locally based auditing firms was designated, in terms of the provisions of section 7(2) of the Banks Act, to compile the above-mentioned report.

"best practice" findings assist banks' management

The review of the securitisation market was akin to a due diligence exercise and provided factual evidence of the various risks facing entities that were participating in securitisation schemes. The review focused on banks participating in securitisation transactions in either a primary or secondary role. It was also intended that "best practice" findings be provided that could assist both banks' management and the Department going forward.

aspects relating to securitisation schemes

The following are some of the aspects relating to securitisation schemes and banks that were reviewed:

- Legal risk, including the potential practical ramifications for banks in the event of a premature termination of the fundamental obligations of the participants
- Accounting treatment, including valuation issues
- Regulatory compliance with the Exemption Notice relating to Securitisation Schemes (*Government Gazette* No. 30628, dated 1 January 2008), including capital requirements
- Risk management, covering, *inter alia*,
  - liquidity risk, including the maturity profile of commercial paper in issue, potential roll-over risk, risks relating to liquidity facilities and the quantification of liquidity risk under stressed scenarios;

- credit risk, including the extent of claims against credit enhancement facilities, credit risk mitigation plans, reviews of asset repurchases and replacements, and of the modelling of asset values in stressed scenarios;
- market risk, including a review of the daily market risk reporting framework and the stress-testing framework; and
- operational risk, including the governance structures and policies in place in both originating banks and special-purpose vehicles (SPVs).

The auditing firm furnished the Department with its report in November 2008. The report noted that securitisation in South Africa was not as complicated as in the USA and in European countries, and that the assets housed in South African schemes tended to have a high level of transparency. Furthermore, the assets securitised had been subjected to the same credit approval processes that applied to banks' own credit exposures. Some of the key observations included in the report are the following:

key observations relating to securitisation in South Africa

- Generally, risks related to securitisation schemes were appropriately managed by the banks reviewed.
- Top-tier South African banks, on average, sourced only 4 per cent of their total funding from securitisation, which was significantly less than those international banks that struggled during the liquidity crisis.
- In respect of accounting for securitisation schemes, the transparency of financial statements could be improved. In this regard, the developments in international accounting and disclosure requirements should continue to be monitored and followed.
- Regulatory compliance was generally acceptable.

The report made various recommendations for consideration in order to improve oversight and governance, and reduce risks that could arise with respect to securitisation schemes. These included recommendations

various recommendations

- in respect of the repurchase and replacement of assets;
- on the corporate governance role of issuer SPV directors;
- on improving reporting methodologies that would allow the Department to monitor risks faced by banks better;
- relating to liquidity risk management and stress testing; and
- on setting out areas in respect of which guidance and clarification of the regulatory requirements relating to securitisation were required.

The Department is in the process of studying the recommendations and will engage with the banking sector in a consultation process on areas where changes or amendments to legislation are considered necessary. Legislative amendments will only be effected after such consultation process.

Compliance with anti-money laundering and the combating of the financing of terrorism standards

As indicated in the 2007 *Annual Report*, this Department endorses the Core Principles for Effective Banking Supervision (Core Principles). In endorsing Principle 18 of the Core Principles, in particular, the Department continued its co-operation with the Financial Intelligence Centre (FIC). The Department remained committed to facilitating the optimisation of banks' compliance with AML and the combating of the financing of terrorism (CFT) measures.

Department committed to compliance with AML

Financial Intelligence Centre Amendment Act, 2008 (Act No. 11 of 2008)

The Financial Intelligence Centre Amendment Act, 2008 (Act No. 11 of 2008) (FICA) that was released for comment in November 2006 was assented to by the President of the

Republic of South Africa on 22 August 2008. FICA was published in *Government Gazette* No. 31365 on 27 August 2008 .

European Union Statement on Equivalence

AML/CFT measures equivalent to the EU

On 12 May 2008 the member states of the European Union (EU) participating in the EU Committee on the Prevention of Money Laundering and Terrorist Financing agreed to establish a list of countries whose application of AML/CFT measures could qualify those countries to be considered equivalent to the EU. The agreement to establish such a list was in compliance with the requirements of the Third Money Laundering Directive of the EU.

In terms of this directive, the inclusion of a jurisdiction on the list indicates that AML/CFT measures applied by a credit or financial institution based in that jurisdiction should be considered to be equivalent to those of the EU. The list is a voluntary, non-binding measure that nevertheless represents the common understanding of member states of the EU. In the United Kingdom (UK) the list is relevant to assessing whether a jurisdiction is equivalent to the extent that institutions in the UK can rely on customer due diligence practices of the institution based in the listed country.

South Africa is one of the countries outside the EU that is currently regarded as having AML/CFT systems that are equivalent to those of the EU. The listing of a country follows the results of public evaluation reports adopted by the Financial Action Task Force (FATF) on Money Laundering, FATF-style Regional Bodies (FSRBs), the IMF or the World Bank.

Anti-money laundering and the combating of the financing of terrorism evaluations

40+9 Recommendations recognised as global standard

The FATF is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering and terrorist financing. The Forty Recommendations of 2003 and the Nine Special Recommendations of 2001 of the FATF (the 40+9 Recommendations) (and issued by it) define criminal justice and regulatory measures that should be implemented to counter this problem. The 40+9 Recommendations also include international co-operation and preventative measures to be taken by financial institutions and others such as casinos, real-estate dealers, lawyers and accountants. The 40+9 Recommendations are recognised as the global AML/CFT standard.

AML/CFT evaluations are carried out according to the 40+9 Recommendations and methodology. The methodology follows the structure of the 40+9 Recommendations and is a key tool to assist assessors in preparing detailed AML/CFT assessment reports/mutual evaluation reports. The assessment of individual recommendations, as well as any findings, leads to broader conclusions on the global effectiveness of a country‘s AML/CFT system. The methodology assists assessment teams in identifying the systems and mechanisms developed by countries with diverse legal, regulatory and financial frameworks, in order to implement robust AML/CFT systems. The methodology is also useful for countries performing AML/CFT system self-assessments and is informed by the experience of the FATF and the FSRBs, based on historic mutual evaluations, the IMF and the World Bank.

Preparations for the Financial Action Task Force mutual evaluation

self-assessment

The Registrar invited a delegation from the Basel Institute on Governance (the consultant) in April 2008 to assist the Department in performing a self-assessment for compliance with the 40+9 Recommendations. The consultant provided the Department with an aide-memoire containing recommendations for consideration. The consultant also provided the Department with comments and views on the interpretation of certain sections of the FATF AML/CFT Mutual Evaluation Questionnaire (MEQ).

The mutual evaluation procedure requires countries to submit a completed MEQ to the FATF Secretariat three months prior to the actual evaluation for review by an expert team of assessors. The Department assembled a team composed of personnel from its Analysis, Review, Legal and Support divisions to focus on the completion of the MEQ.

Stakeholder preparatory workshops for the Financial Action Task Force mutual evaluation

FIC hosted three preparatory workshops

The FIC arranged and hosted three preparatory workshops for the FATF mutual evaluation of South Africa's AML/CFT regime with supervisory bodies, law enforcement agencies and government departments.

The purpose of the workshops was to prepare participants for the joint FATF/Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) on-site mutual evaluation country assessment scheduled for August 2008. The key focus areas at the workshops were to

- inform all stakeholders of the status of the MEQ already submitted to the FATF Secretariat;
- afford participants the opportunity to consider and answer typical questions that could be expected from the assessment team (e.g., to participate in a dry-run of an actual on-site assessment); and to
- give workshop participants the opportunity to ask questions and interact with the FIC and one another.

new threshold for co-operation

The preparatory workshops signalled a new threshold for co-operation in terms of AML/CFT issues for South African law enforcement agencies, regulatory bodies and government departments. The current state of preparedness was conveyed to Cabinet by means of a Cabinet Memorandum drafted by the FIC. The issues highlighted during the workshops were addressed during the assessment meetings and interviews by the respective stakeholders. The important work conducted by way of preparation for this mutual evaluation process formed the basis of future work that South Africa would have to undertake in order to enhance its AML/CFT framework.

Joint mutual evaluation conducted by the Financial Action Task Force and Eastern and Southern Africa Anti-Money Laundering Group

South Africa's AML/CFT regime benchmarked against 40+9 Recommendations

During the mutual evaluation, assessors from the FATF and ESAAMLG benchmarked South Africa's AML/CFT regime against the international standards of the 40+9 Recommendations. The assessment included a visit by an assessment team to South Africa over a two-week period during which meetings with all public- and private-sector stakeholders were held. The FIC was mandated with responsibility for co-ordinating South Africa's participation in the mutual evaluation process.

The mutual evaluation was conducted by an assessment team, which consisted of members of the FATF Secretariat and FATF experts in criminal law, law enforcement and regulatory issues. The members of the assessment team were as follows:

- Ms Valerie Schilling and Mr Kevin Vandergrift, FATF Secretariat
- Ms Yotsna Lalji, ESAAMLG Secretariat

- Mr Hay Hung Chun, State Counsel, Criminal Justice Division, Attorney-General's Chambers, Singapore (legal expert)
- Dr Michalis Mersinis, Attorney at Law, Legal Department, Hellenic Capital Market Commission, Greece (financial expert)
- Ms Indira Crum, Senior Policy Advisor, Office of Terrorist Financing and Financial Crime, United States Department of the Treasury (financial expert)
- Mr Shi Yongyan, Anti-Money Laundering Bureau, People's Bank of China (financial intelligence unit (FIU) expert)
- Mr Joseph Jagada, Chief Law Officer, Attorney General's Office, Zimbabwe (law enforcement expert).

In November 2008 the FATF Secretariat presented South Africa with a first draft of the Mutual Evaluation Report (MER) based on the information submitted in the MEQ, as well as information gathered during the on-site assessment. The report described in detail the system in place in South Africa, and assessed and rated its effectiveness. The draft MER also included individual ratings of the 40+9 Recommendations. The FIC disseminated the draft MER to all stakeholders. The findings and recommendations contained in the MER, in so far as they are applicable to the Department and the banking sector, will be used as a guide to further improve overall compliance with the FATF AML/CFT requirements.

During December 2008 the FIC held another workshop to provide feedback on further developments following the publication of the first draft MER. The draft MER and responses to it were also discussed. A key outcome of the workshop was preparations for the meeting with the assessment team in Paris, scheduled for January 2009.

Guidance Note 8/2008

decision by FATF for enhanced scrutiny of transactions

The Registrar issued Guidance Note 8/2008 to inform banks and controlling companies of the decision made by the FATF for enhanced scrutiny of transactions with certain jurisdictions and of United Nations sanctions in relation to the proliferation of weapons of mass destruction.

In particular, the FATF called on its members to implement enhanced due diligence processes with respect to the northern part of Cyprus, the Republic of Uzbekistan and the Islamic Republic of Iran.

Southern African Development Community anti-money laundering workshop

During October 2008 the Southern African Development Community (SADC) Secretariat held an AML/CFT workshop at the South African Reserve Bank Conference Centre in Pretoria. The objective of the workshop was to create an opportunity for member countries of the ESAAMLG and SADC to develop and implement appropriate national AML/CFT legislation in their respective countries in accordance with international AML/CFT standards.

International Conference of Banking Supervisors

During September 2008, the Department was represented at the International Conference of Banking Supervisors (ICBS) held in Brussels, Belgium. This biennial event, which is arranged by the Basel Committee and hosted in a different country each time, attracted supervisors and central bankers from well over 100 countries. The ICBS focused on the following topical regulatory and supervisory issues:

Cross-border dimensions to liquidity risk

The increase in cross-border flows has resulted in more integrated and intermediated financial markets. Banking institutions have large operations outside their countries of origin, some of which are systemically important in the host countries. Some large global financial institutions have begun to manage their daily liquidity demands across several jurisdictions in a centralised manner. These cross-border interdependencies raise the prospect of liquidity disruptions that could impact financial markets and settlement systems.

increase in cross-border flows

Liquidity risk supervision and supervisory approaches

Two forms of liquidity risk affect banking, namely (1) funding liquidity and (2) market liquidity. Funding liquidity refers to the risk that a bank will be unable to meet obligations as they become due, while market liquidity refers to the risk that a bank's assets, held as liquidity reserves, cannot be sold in a stressed situation without incurring unacceptable losses. It was highlighted that many banks failed to take account of several basic principles of liquidity risk management when liquidity was abundant. These inadequacies came to the fore during the international financial market turmoil. Supervisory approaches to liquidity risk have been developed mainly at a national level, thereby ensuring that each country's safety and soundness were preserved. Liquidity risk supervision in respect of internationally active banking groups has predominantly been in accordance with the principle of 'host country responsibility'.

two forms of liquidity risk

Stress testing and contingency funding plans

The international financial market turmoil has highlighted weaknesses in banks' liquidity stress testing and contingency funding plans. Banks did not perform stress tests that considered all relevant risks and their interaction in respect of liquidity risk. Furthermore, it was noted that banking groups were not able to aggregate risks across the group as more segregated approaches were followed. Off-balance-sheet items were not incorporated in stress testing, resulting in additional shortcomings in the overall liquidity risk management process. In addition, contingency funding plans were not appropriately linked to stress testing. The financial market turmoil highlighted that diversified contingency funding plans functioned most effectively under stressed conditions.

weaknesses in stress testing and contingency funding plans

Liquidity risk disclosure

Financial institutions, particularly those that have experienced financial difficulties in recent times, have been under increasing pressure from the market to disclose more information regarding positions held in the market and their risk management techniques. Despite these developments, it was noted that disclosure practices varied across banks and in certain instances were very limited. There is a general view that banks that disclose comprehensive, accurate, relevant and timely liquidity information are better able to access capital markets. In times of market disruptions, transparent liquidity disclosures enable market participants to distinguish banks with sound liquidity positions from those without, thereby mitigating unwarranted systemic effects.

increasing pressure to disclose

Identification and measurement of liquidity risk

Sound liquidity risk management enables a bank to identify, measure, monitor and control liquidity risk. Effective liquidity risk management should include a framework that comprehensively projects cash flows arising from assets, liabilities and off-balance-sheet incorporate all relevant time horizons

items. The framework should incorporate all relevant time horizons. Liquidity risk management should consider contractual, 'business-as-usual' and stressed scenarios. Finally, the liquidity risk management process should be cognisant of the business mix, complexity and risk profile of the particular bank.

Fair valuation issues

fair value increasingly applied

Fair value measurements have been increasingly applied in reported financial information. Standard financial instruments, as a result of their wide use and relatively simple structure, are reasonably straightforward to value. However, over the years financial instruments have become more complex in nature and, therefore, not as easy to value. Banks are expected to have documented policies in respect of the valuation and risk management of their financial instruments that are subject to fair valuing. Of particular importance is the valuation of these instruments during market illiquidity and, therefore, banks should apply robust valuation techniques that are able to function during stressed conditions.

Sound provisioning under International Accounting Standards Board standards

promote impairment guidance

From experience it has been noted that poor credit quality is one of the major drivers of the difficulties being experienced by banks. An inability or unwillingness to recognise deteriorating credit quality results in persistent high-risk lending by, and possible failure of, a bank. Accordingly, it is crucial to supervisors that accounting policies applied by banks reflect prudent and realistic measurements of loans and related income through adequate provisions and other accounting practices. Sound accounting standards are in the interest of better public disclosure, which aim to enhance transparency in respect of credit risk exposures, risk management practices and loan loss recognition. As a result of the concerns with banks' accounting practices, the Basel Committee had extensive dialogue with the International Accounting Standards Board (IASB) to promote impairment guidance in IASB standards that will support sound provisioning practices by banks.

Valuation, volatility and regulatory capital

challenges associated with valuing financial products

Considerable attention has been focused on bank valuations of complex or illiquid financial instruments, since inconsistency of valuations leads to increased volatility in earnings and regulatory capital. Valuation issues have several risk management implications. It is paramount that banks have robust valuation and accounting classification processes in place to address challenges associated with valuing financial products that are complex or illiquid. The key areas of focus should include governance and controls; risk management; valuation adjustments and uncertainty; and financial reporting.

Financial Sector Assessment Program

The FSAP is a joint IMF and World Bank attempt to increase the effectiveness of efforts to promote the soundness of financial systems in member countries.[2] The programme seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sectors' developmental and technical assistance needs; and to help prioritise policy responses.

resilient and well-regulated financial system essential

Surveillance, one of the main functions of the IMF, involves the monitoring of economic and financial developments, and the provision of policy advice aimed specifically at crisis prevention. In a world of increased capital flows, resilient and well-regulated financial systems are essential for macroeconomic and financial stability. The FSAP also forms the basis of Financial System Stability Assessments (FSSAs) in which the IMF addresses issues of relevance to IMF surveillance, including risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks.

A joint IMF/World Bank FSAP mission visited South Africa in May 2008 to conduct an FSAP update. The FSAP update included a stress-testing exercise that was performed by a selected number of banks (bottom-up stress testing) and the Department (top-down stress testing). The Department co-ordinated the stress-testing exercise with commendable support from the industry's banking participants. The results of the stress tests suggested that capital and reserve cushions at banks were sufficient to absorb large shocks.

capital sufficient to absorb large shocks

The FSAP's findings and recommendations were discussed with the South African authorities during the Article IV Consultation mission in June 2008. In short, the key findings from the FSSA[3] that have specific relevance to the Department are listed below, followed by the recommendations and some comments thereon.

FSAP's findings and recommendations

Key findings

South Africa's financial system fundamentally sound

- South Africa's sophisticated financial system is fundamentally sound and has so far weathered the global financial market turmoil without major pressures. Banks and insurance companies have enjoyed good profitability, capitalisation levels and reserves.
- The system faces increased macro-financial risks and financial institutions are braced for a less-benign environment. Banks are exposed to increased credit risk, given record household indebtedness and the mounting debt-service burden, and are seeing some impairment of asset quality. As mentioned above, stress tests suggest that capital and reserve cushions at banks and insurance companies are adequate to absorb large shocks.

increased macro-financial risks

- Money, foreign-exchange and capital markets are relatively well developed, but may be subject to contagion risks, given their close linkages with offshore markets.
- The framework for contingency planning and emergency liquidity assistance has been strengthened.
- The financial-sector regulatory framework is modern and generally effective. There is a need to strengthen supervision of conglomerates, with a focus on risks that span more than one sector and further to promote co-operation, consistency and effectiveness among regulators.

strengthen supervision of conglomerates

- The extensive inter-linkages in the financial sector make supervisory co-operation critical.
- Access to financial services has improved markedly in recent years.

Recommendations relevant to the Department, with the Department's follow-up comments in square brackets, are highlighted below:

Financial stability

focus on stress testing

1. Strengthen the off-site stress-testing capacity and employ this capacity to inform the regular supervisory discussions.

   [A top-down stress-testing process has been adopted. More information on this topic is available under the heading "Stress testing the South African banking system" on page 31 of this report. The Department will make a concerted effort to focus on the stress-testing of individual banks and the total banking sector in the future.]

2. Remain vigilant on credit risk in banking, stemming from retail and concentrated corporate exposures and on funding risks, resulting from reliance on short-term domestic wholesale funding.

[Vigilant monitoring of credit risk forms part of the Department's risk-based supervisory review and evaluation process.]

Systemic liquidity and crisis management

focus on liquidity and funding issues

3. Enhance focus on liquidity and funding issues, and discuss medium-term strategies to reduce banks' dependency on wholesale market funding by analysing in a collaborative exercise between the Bank, the National Treasury and the Financial Services Board (FSB), for instance, in the context of a Basel II Pillar 2 exercise and in drawing on the results of the planned study of the effects of an eventual lifting of remaining capital controls.

   [Contingency plans to be developed in conjunction with the National Treasury and FSB should the further relaxation of exchange controls be considered.]

strategies regarding crisis management

4. Review all strategies regarding crisis management as part of the work of the Financial Sector Contingency Forum (FSCF) in the light of past crisis episodes experienced globally, and consider undertaking a crisis simulation exercise relating to a macro-financial shock, such as a capital outflow or distress in a large financial sector institution.

   [The Department is represented at the FSCF and will monitor progress closely. The FSCF was created to serve as a forum for open discussions regarding contingency planning and information sharing, and represents a co-ordinated network of key contacts throughout the financial services industry. The primary objective of the FSCF is to identify potential crisis events that may threaten the stability of the South African financial sector, and to propose and obtain approval for appropriate plans, mechanisms and structures to prevent the realisation of threats or to mitigate their consequences. In support of this objective, the FSCF has various constituent subcommittees and task teams whose individual composition and positioning facilitate its unique role in the forum.]

clarify bank resolution powers

5. Clarify bank resolution powers by authorising the Registrar, who has extensive powers to safeguard the soundness of the banking system, to appoint a curator directly, limiting the need for the Minister of Finance's intervention only in those cases requiring use of public funds.

   [A bank curator is appointed by the Minister of Finance after considering such a recommendation from the Registrar. The Department has responded to the IMF that this provision serves as a check and balance in the regulatory management of distressed banks and it would not be viewed as prudent should this "four-eyes" principle be removed.]

Financial sector supervision and regulation

sound and proactive collaboration

6. Enhance day-to-day collaboration among the staff of the different sectoral regulators in respect of individual institutions and emerging risk issues. Further develop risk assessment models taking a more consistent approach across sectors, and the creation of increased central capacity at the main regulators to identify risk and allocate resources flexibly to issues as they arise.

   [The Department experiences sound and proactive collaboration with cross-sectoral regulators, but will nevertheless review its current working relationship with the cross-sectoral regulators concerned. The current identification of risks across the sectors and the sharing of information will also be reviewed.]

7. Consider a mechanism for resolving policy disagreements among different regulators and departments, and assessing trade-offs among differing policy objectives. In this regard, the Policy Board for Financial Services and Regulation was created in terms of the Policy Board for Financial Services and Regulation Act, 1993 (Act No. 141 of 1993) to ensure better cross-sectoral co-ordination, and it stands in an advisory capacity to the Minister of Finance.

   [The Department will monitor developments and participate as the need arises.]

8. Consider a more risk-sensitive approach to loans where the borrower has contributed minimum (or zero) equity, including residential mortgage loans with very high loan-to-valuation ratios.

   [The Department is in the process of assessing the risk weightings applicable to various types of loans highlighted by the IMF. Different approaches are being investigated for future implementation.]

risk-sensitive approach to loans

International Monetary Fund Article IV Consultation

In terms of Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with member countries, usually on an annual basis. An IMF team visits the country, collects economic and financial information, and discusses the economic developments and policies with officials. A *Staff Report* is prepared by the IMF, which forms the basis for discussion by the IMF Executive Board, which is followed by the issue of a Public Information Notice (PIN) summarising the views of the Executive Board. PINs are issued with the consent of the country concerned.

Following the discussions held with the IMF during June 2008, the IMF Executive Board concluded an Article IV Consultation with South Africa (PIN No. 08/137) in October 2008.[4] The findings and recommendations from the *Staff Report*, under the heading "Enhancing the resilience of the financial system", specifically applicable to the Department are highlighted below, followed by the Department's comments in square brackets:

IMF findings and recommendations applicable to the Department

1. A robust financial system is critical for maintaining macroeconomic stability and increasing the economy's resilience to shocks. South Africa's financial system is sound, underpinned by a well-established legal and financial infrastructure, and a generally effective regulatory framework. Financial institutions have enjoyed good profitability, capitalisation levels and reserves, and so far the system has weathered the global financial market turmoil without major pressures. The implementation of Basel II at the beginning of 2008 has proceeded smoothly and is largely capital-neutral for the largest banks.

South Africa's financial system sound

2. At present, financial institutions are, however, facing a less-benign environment, and are beginning to see the effects of slowing economic activity and rising interest rates on asset quality and returns. With households' indebtedness at record levels and their debt-service burden rising, the banking system is facing elevated credit risk in its household loan portfolio. Furthermore, the concentration of banks' deposits from relatively few large corporations makes their balance sheets sensitive to changes in sentiment about the relative strength of individual banks. In such an environment it is recommended that the Department continues its forward-looking proactive engagement with banks and use the scope available under Basel II to ensure that capital buffers in banks are adequate to cope with increasing risks. In addition, it would be important to monitor emerging risks closely through robust financial stability analysis, particularly regular off-site

forward-looking, proactive engagement

integrated top-down and bottom-up stress testing, including adverse macroeconomic scenarios. Such tests of systemic stability, based on individual bank data, would allow the identification of tail risks that may not be evident in aggregate top-down exercises. It is also recommended that bank liquidity and funding risks be monitored closely.

stress testing part of ongoing activities

[As part of the Basel II implementation process, the Department has implemented a revised supervisory review and evaluation process (SREP) in which these aspects have been strengthened and updated. Stress testing now also forms part of the Department's ongoing activities and interaction with banks.]

3. The IMF welcomed the strengthening of the framework for contingency planning and emergency liquidity assistance as a bulwark for mitigating the fallout should an adverse event occur. The FSCF (refer to paragraph 4 of the FSAP Recommendations above) aims to facilitate inter-agency co-ordination and preparedness for addressing crises. It was suggested that the arrangements should be tested periodically and the authorities should consider undertaking a crisis simulation exercise relating to a macro-financial shock, such as a capital outflow or distress in a large financial sector institution.

   [The Department is represented at the FSCF and is an active participant.]

South Africa's regulatory framework is modern and generally effective

4. South Africa's regulatory framework for the financial sector is modern and generally effective. It was suggested that consolidated supervision of financial conglomerates could be strengthened further. This should be possible within existing organisational arrangements by combining strong sectoral supervision with a focus on risks that cut across intermediaries within a financial group. Co-ordination among regulators and policy-makers could be strengthened, with gaps and overlaps minimised, and respective responsibilities delineated clearly.

   [A memorandum of understanding that formalises the roles and responsibilities as far as the supervision of financial conglomerates is concerned exists between the Department and the FSB. The responsibility as the lead regulator for each of the relevant financial groups has been demarcated between the authorities. The working relationship entails meeting on a quarterly basis and sharing relevant information that is supplemented by ad hoc meetings when the need arises.]

ongoing enhancement of consolidated supervisory process

5. The authorities broadly agreed with the findings and recommendations of the FSAP update. The authorities indicated that they would continue to enhance their risk analysis, including by exploring ways to conduct systemic stress testing, while protecting the confidentiality of individual bank data. The IMF encouraged the authorities to explore mechanisms used by other countries to overcome this hurdle. The authorities noted that their crisis management systems had been tested to some extent by several actual (non-systemic) crises, but agreed to consider conducting further simulations, provided they could ensure that the simulation itself did not become a source of risk. The authorities indicated that they were exploring possibilities for consolidating supervision of financial conglomerates, for instance, by establishing supervisory 'colleges' (comprising supervisors from different agencies) for each conglomerate.

   [The Department will continue to engage with the FSB, and will endeavour to enhance the consolidated supervisory process and sharing of information even further.]

Finally, to ensure co-ordination and effective monitoring of the implementation of the recommendations from the FSAP update and the Article IV Consultation, the Department established a project team that has created an all-encompassing project plan. The team meets on a monthly basis to monitor effective management of the project plan.

National Treasury initiative on Islamic financial services

regulatory framework facilitates Islamic banking

The South African banking sector is regulated by the Banks Act and the Regulations relating to Banks as published in *Government Gazette* No. 30629, dated 1 January 2008 (the Regulations relating to Banks). Notwithstanding the fact that there is no legislation dedicated solely to Islamic banking, South Africa's current banking regulatory framework facilitates Islamic banking and Islamic banking products. Banks that are registered in South Africa and provide Islamic banking products to their clients include Albaraka Bank Limited, Habib Bank Limited, HBZ Bank Limited, Absa Bank Limited and First National Bank, a division of FirstRand Bank Limited.

The National Treasury initiated a project named 'Gateway into Africa', the purpose of which was to explore the need for, and development of, Islamic financial services and instruments for southern Africa and Africa.

The Department was, along with other regulators and industry stakeholders, invited to attend an exploratory meeting that focused on the regulatory constraints to the development of Islamic financial services. This meeting resulted in the establishment of four industry-led working groups focusing on (1) Islamic banking; (2) pensions and collective investment schemes; (3) Islamic insurance; and (4) accounting and governance.

Although the project is in its infancy, the Department, along with The Banking Association South Africa and other industry players, has provided its full support. The Department is serving on the Islamic Banking working group and will consider any recommendations relating to regulatory constraints that may emerge from the aforementioned working groups.

Skills development

continuous improvement of skills base

Ensuring a workforce of adequate and appropriately skilled human resources is a challenge shared by supervisors around the world. Furthermore, with the implementation of Basel II, the need to train and retain staff with the necessary expertise and skills has been reconfirmed. The continuous improvement of the skills base of the Department is regarded as key to its success and, accordingly, considerable resources are allocated for this purpose. This includes the employment of appropriately qualified and skilled staff members, and enhancing training programmes as discussed in more detail below.

Staff training and development policy and framework

co-ordinated training plan

During the year under review, the Department further formulated its staff training and development policy and framework in order to facilitate and develop a structured and co-ordinated training plan in respect of every staff member and a training framework for the Department in general.

The policy was based on the following:

- The Skills Development Act, 1998 (Act No. 97 of 1998)
- The Human Resources Development Policy of the South African Reserve Bank (the Bank)
- The mission statements of both the Bank and the Department.

The policy objectives are to
- provide training and development opportunities to all staff members in the Department;
- structure and co-ordinate training and development in the Department in order to maximise its effectiveness and efficiency;
- establish a process in terms of which training and development in the Department would be managed effectively and would, *inter alia*,
  - reaffirm the role of line managers in controlling and managing the training plan of each staff member reporting to him or her; and
  - reiterate the importance of aligning each staff member's performance plan with his or her training plan;
- establish a Training and Development Committee (TDC) to co-ordinate, facilitate, manage and develop, on a regular basis, all education, training and development of staff in the Department, and to monitor and evaluate the general effectiveness of the various training interventions and functions;
- increase the skills of the staff in the Department to an appropriate level; and to
- use appropriate forms of training in order to achieve the above-mentioned objectives.

Guidelines and procedures for line managers on how to establish, monitor and manage training plans for staff members are included in the policy.

The TDC developed a Training and Development Framework. This framework sets out the various required skills categories, together with the criteria applicable to each skills category in relation to differentiated competency levels of staff members.

Training undertaken

During the year under review, the Department spent R2,4 million on the training of approximately 95 employees. This training enabled staff to
- implement sound global supervisory standards and practices;
- share supervisory practices and experiences; and to
- employ the practices and tools that would allow them to meet everyday demands and develop solutions to their multiple challenges.

training interventions

Training interventions consisted of, among other things, leadership and management courses, central banking seminars, and risk management workshops.

Graduate staff who joined the Department attended a week-long foundation course. The aim of this course was to provide a broad background on the following topics:

- An overview of the South African banking system
- South Africa's banking regulatory framework
- The principles of a risk-based supervisory approach.

This was also supplemented with training on specialised software programs used in the Department. Six of these courses were held during the year.

To ensure that staff members were kept abreast of the latest developments affecting the banking industry, interventions in the following areas were facilitated: accounting and auditing issues; risk management development; and fraud awareness.

International courses attended

international courses

By attending international courses, staff members were afforded the opportunity to be exposed to an international perspective on banking supervision and related topics. Furthermore, staff members were able to network with other members of the global supervisory community and exchange ideas on current topics. During the year under review, staff members attended the following courses:

- Financial Stability Institute (FSI) Seminar on Liquidity Risk at the Bank for International Settlements (BIS), in Switzerland
- FSI Seminar on International Accounting and Auditing for Banks at the BIS, in Switzerland
- FSI High-Level Meeting on the Implementation of Basel II in Africa and Other Regional Supervisory Issues, in South Africa
- Toronto Centre Banking Supervision Seminar, in Canada
- Specialised Bank Supervision Course at the Federal Reserve Bank of New York, in the USA
- South East Asia Central Banks Regional Seminar on Practical Techniques for the Management and Measurement of Operational Risk, in Brunei
- Legal Risks and Good Governance for Central Banks and Supervisors, in the UK
- FSI 25th International Banking Supervision Seminar at the BIS, in Switzerland
- FSI Seminar on Pillar 2 Implementation Issues at the BIS, in Switzerland
- Toronto Centre Banking Leadership Programme, in South Africa
- Financial Services Authority Annual International Seminar, in the UK
- Meeting on Risk Minds, in Switzerland.

Basel II training

To ensure that the Department's staff is equipped to implement international regulatory and supervisory standards, together with the latest information on market products, practices and techniques, a number of initiatives were implemented.

in-house training sessions

The Department held in-house training sessions on the following:

- The amended Regulations relating to Banks that were promulgated on 1 January 2008
- Operational risk
- Market risk
- Credit risk.

The Department renewed its subscription to *FSI Connect*, a web-based information and learning resource for financial sector supervisors around the world, established by the FSI.

A specialised three-day training course consisting of tailor-made modules developed for bank supervisors on the internal capital-adequacy assessment process (ICAAP), and the SREP was presented by a reputable London-based consultancy. The training allowed the participants to experience the SREP as part of a case study incorporating the various steps of a SREP.

The United States Federal Deposit Insurance Corporation presented a four-day training programme on operational risk in relation to Basel II. The course content enabled the participants to examine operational management frameworks, understand the challenges associated with implementing such frameworks and how to promote sound operational risk practices in banks.

Issues to receive particular attention in 2009

focus during 2009

In addition to fulfilling its normal supervisory and regulatory tasks, the Department will focus specifically on the following issues during 2009:

- Continued refinement of the Department's supervisory review and evaluation processes to support the implementation of the amended regulatory framework, which encapsulates Basel II and the revised Core Principles

- Ongoing assessment and monitoring of the South African banking industry's initiatives to deal with the impact of the financial market turmoil
- Focused reviews of banks that make use of advanced approaches to calculate credit risk, market risk and operational risk capital requirements
- Ongoing enhancement of the Department's contingency arrangements regarding systemic liquidity and crisis management
- Continued dialogue with banks' board remuneration subcommittees to encourage the application of best practice principles with regard to banks' incentive schemes
- Continued monitoring of banks' compliance with AML/CFT legislation
- Ongoing monitoring of banks' approaches to stress testing and refinement, and strengthening of the Department's own stress-testing expertise
- Ongoing participation in the initiatives and activities of international and regional bank supervisory bodies
- Continued investigation and combating of illegal deposit-taking by unregistered institutions and persons, and participation in consumer education initiatives
- Ongoing training of staff to meet the challenges of an ever-changing regulatory and supervisory landscape, both locally and internationally
- Ongoing review and amendment of the banking legislative framework in South Africa to ensure that it reflects local and international market developments and complies with international regulatory standards
- Ongoing review of the recommendations flowing from the IMF/World Bank FSAP, and Article IV reviews and the FATF mutual evaluation.

Expression of gratitude

I wish to express my appreciation to the Minister and Deputy Minister of Finance for their ongoing valued input on requests not only in terms of statutory requirements, but also in terms of general counsel. To the Governor and deputy governors of the Bank, thank you for your continuous co-operation, guidance and support. My sincere thanks also to my fellow executive general managers with whom I serve on the Governor's Executive Committee.

The Department continued receiving the co-operation of several individuals and organisations, locally and abroad. These include, to name but a few, the Chief Executive of the FSB and his staff; the senior executives of banking institutions and their external auditors; The Banking Association South Africa; the Standing Committee for the Revision of the Banks Act; various individuals in the auditing profession; staff of other departments of the Bank; the Basel Committee; and central bankers and bank supervisors, both in southern Africa and elsewhere in the world.

Finally, my sincere appreciation also goes to the staff members in the Department for their continued perseverance, professionalism and enthusiasm, particularly during the period of heightened global market turmoil.

Errol M Kruger
Registrar of Banks and Executive General Manager: Bank Supervision Department

Notes

1 Advances in respect of which a specific credit impairment was raised.
2 Refer to the IMF's website: "What the IMF does" www.imf.org/external/np/fsa/fsap.asp.
3 For the full FSSA report, refer to the IMF website: www.imf.org/external/country/ZAF/index.htm.
4 As published on the IMF's website: www.imf.org/external/country/ZAF/.