Chapter 1: Registrar of Banks' review

1.1 Introduction

During 2009 the South African banking sector continued to experience a challenging operating environment, characterised by a cyclical downturn in domestic economic conditions and worsened by the aftermath of the 2007/08 international financial market crisis. Consumer spending remained subdued, the level of impaired advances in existing asset portfolios of banks continued to increase and lending criteria applied by banks were tightly controlled. However, notwithstanding these difficult circumstances, the banking system remained stable and profitable, and capital levels were adequate throughout 2009.

banking system remained stable and profitable, and capital levels were adequate

From an international perspective, regulatory and supervisory standard-setting bodies, such as the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (the Basel Committee), continued their respective processes of developing and issuing guidance and standards to strengthen the resilience of the financial sector in general and the banking sector in particular. The Bank Supervision Department (the Department) of the South African Reserve Bank (the Bank), as always, closely monitored and considered developments on the international regulatory and supervisory fronts in an ongoing effort to promote the soundness of the domestic banking sector through the effective and efficient application of international regulatory and supervisory standards.

This chapter will cover in more detail the key responses of standard-setting bodies to the international financial market turmoil and provides a high-level overview of key banking-sector trends, including the level of concentration in the banking sector. It also contains details of the steps taken by the Department to address the main findings of the International Monetary Fund (IMF) *2009 Article IV Consultation: Staff Report* (the Staff Report). Furthermore, this chapter reviews the Department's role in facilitating the optimisation of banks' compliance with anti-money laundering (AML) and the combating of the financing of terrorism (CFT) measures and it provides an overview of the Financial Stability Institute high-level meeting on developments in financial markets and supervisory responses. In addition, it covers topics such as the Department's thematic review of incentive schemes of banking institutions, its participation in international regulatory and supervisory fora, and skills development-related issues.

1.2 High-level overview of the banking sector

1.2.1 Key banking-sector trends

As at the end of December 2009 there were 31 banking institutions reporting data to the Department (excluding 2 mutual banks, but including 1 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, 1990), namely Ithala Limited) and 42 international banks with authorised representative offices in South Africa.

31 banking institutions and 42 representative offices

Of the nominal value of the total South African banking-sector's shares in issue at the end of December 2009, foreign shareholders held 47,5 per cent, domestic shareholders held 30,4 per cent and minority shareholders held 22,1 per cent.

Total banking-sector assets amounted to R2 967 billion at the end of December 2009, compared with R3 177 billion at the end of December 2008, representing negative year-on-year growth of 6,6 per cent. Total assets of the four largest banks accounted for

banking-sector assets amounted to R2 967 billion gross loans and advances declined by 2,6 per cent

84,6 per cent of total banking-sector assets (December 2008: 84,4 per cent). Gross loans and advances declined by 2,6 per cent from R2 316 billion at the end of December 2008 to R2 257 billion at the end of December 2009 (December 2008: 9 per cent increase). Homeloans and term loans remained the largest component of gross loans and advances, representing approximately 50 per cent thereof, followed by lease and instalment debtors at 10,5 per cent and commercial mortgages at 9,7 per cent.

At the end of December 2009 banking-sector total equity and liabilities amounted to R2 967 billion. Total deposits, amounting to R2 366 billion, represented 85,4 per cent of banking-sector liabilities of R2 769 billion at the end of December 2009 (December 2008: 79,6 per cent). Fixed and notice deposits accounted for 27,4 per cent of total banking-sector deposits at the end of December 2009 (December 2008: 24,9 per cent), while call deposits represented 18,0 per cent, negotiable certificates of deposit 18,0 per cent, current accounts 16,8 per cent and other deposits 10,5 per cent of total banking-sector deposits (December 2008: 22,0 per cent, 16,2 per cent, 17,4 per cent and 10,2 per cent respectively). Deposits from corporate customers constituted the largest portion of total banking-sector deposits, namely 42,6 per cent at the end of December 2009, followed by retail customers and bank deposits, which accounted for 22,3 per cent and 13,7 per cent respectively.

Tier 1 capital-adequacy ratio improved to 11,0 per cent

The total capital-adequacy ratio of the banking sector improved during 2009, increasing from 13 per cent at the end of December 2008 to 14,1 per cent at the end of December 2009. The Tier 1 capital-adequacy ratio also improved from 10,2 per cent at the end of December 2008 to 11,0 per cent at the end of December 2009. Total banking-sector equity increased by 9,5 per cent during the 12 months to December 2009 and amounted to R198,2 billion at the end of December 2009. Share capital and retained earnings cumulatively represented approximately 91 per cent of total equity throughout 2009 (share capital 44,3 per cent and retained earnings 46,8 per cent). The financial leverage ratio for the South African banking sector reduced from 17,9 times at the end of December 2008 to 15,7 times at the end of December 2009.

Off-balance-sheet items expressed as a percentage of banking-sector total assets increased from 11,5 per cent at the end of December 2008 to 13,4 per cent at the end of December 2009, mainly due to a slowdown in the growth of banking-sector assets during the period.

banking sector remained profitable throughout 2009

The banking sector remained profitable throughout 2009. However, profitability levels were negatively impacted, mainly by an increase in credit losses and operating expenses. Gross operating income amounting to R149,7 billion for the year ending December 2009, remained at a level similar to that recorded in December 2008, namely R149,2 billion, while operating profit amounted to R 35,2 billion (December 2008: R44 billion). The banking sector's return on equity (ROE) and return on assets (ROA) ratios, calculated on a smoothed basis (i.e., utilising a 12-month moving average), deteriorated during 2009 to 15,9 per cent and 0,94 per cent respectively at the end of December 2009 (January 2009: 20,7 per cent and 1,2 per cent respectively). For the year ending December 2009, credit losses and operating expenses rose to R35,5 billion and R76,5 billion respectively (December 2008: R29,7 billion and R73,4 billion respectively).

statutory liquid asset holdings exceeded the prescribed requirement

The liquid assets held by the banking sector increased by 20 per cent during 2009 and the statutory liquid asset holdings of the sector exceeded the minimum prescribed requirement by 46,3 per cent (December 2008: 15,5 per cent). Liquid assets held by the banking sector exceeded the statutory liquid asset requirement throughout 2009.

credit ratios continued to deteriorate during 2009

Credit ratios continued to deteriorate during 2009, but at a slower rate compared with 2008. Impaired advances (i.e., advances in respect of which a specific credit impairment has been raised) increased by 47,5 per cent between December 2008 and December 2009, and amounted to R134,0 billion at the end of December 2009 (December 2008: R90,8 billion). Impaired advances to gross loans and advances deteriorated to 5,9 per cent at the end of December 2009 compared with 3,9 per cent at the end of December 2008. The deterioration in this ratio was exacerbated by the impact of negative annual growth of 2,6 per cent in gross loans and advances at the end of December 2009. However, the banking sector reported a slight decline of 0,5 per cent (month on month) in impaired advances in December 2009, the first decline since the commencement of the credit down-cycle.

1.2.2 Concentration in the South African banking system

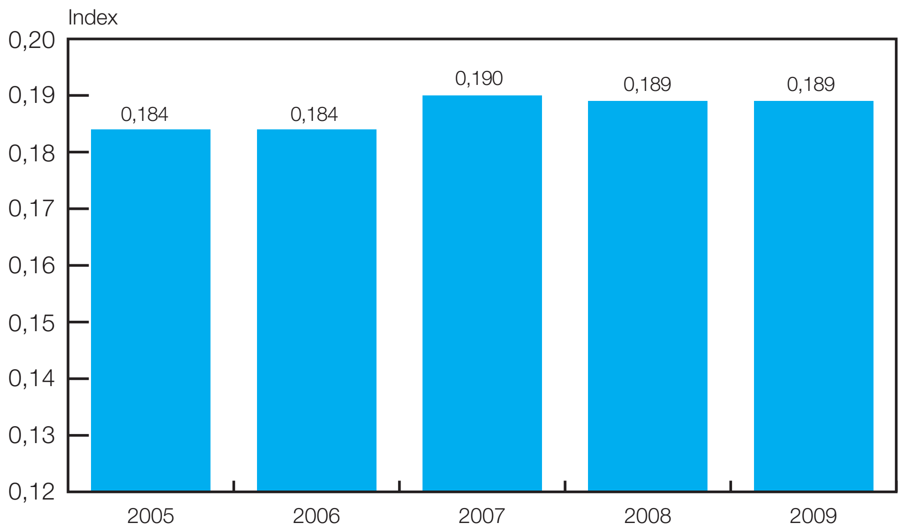
The Herfindahl–Hirschman Index (H-index) is a commonly accepted measure of market concentration in a banking system. The index is calculated by squaring the market share, in terms of total assets, of each bank in the system and subsequently summing the squares. It takes into account the relative size 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.

The level of concentration in the South African banking sector, measured using the H-index, is presented in Figure 1.1. The index amounted to 0,189 at the end of December 2009 (December 2008: 0,189). The index has remained high due 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 510 billion and accounted for 84,6 per cent of banking-sector assets at the end of December 2009 (December 2008: 84,4 per cent).

the four largest banks accounted for 84,6 per cent of banking-sector assets

Figure 1.1 H-index for the South African banking system (2005–2009)



1.3 International Monetary Fund Article IV Consultation 2009

1.3.1 Staff Report for the 2009 Article IV Consultation

Staff Report for 2009 Article IV Consultation completed on 20 July 2009

The IMF's annual bilateral discussions (under Article IV of the IMF Articles of Agreement) with South African officials were held during June and July 2009. The Staff Report in respect of South Africa was completed on 20 July 2009 and published on the IMF website.[1] A Public Information Notice (PIN) (No. 09/114), summarising the views of the IMF's Executive Board as expressed during its discussion of the Staff Report, is also available on the website.

An extract from the above-mentioned PIN, relating specifically to the banking sector, states the following:

> Directors found reassuring the authorities' assessment that the banking sector remains well capitalised and adequately provisioned. Nonetheless, to meet increasing risks, they recommended that the authorities continue engaging with banks to ensure that provisions and capital buffers remain adequate. Directors welcomed efforts to follow up on the 2008 Financial Sector Assessment Program Update recommendations, and encouraged further strengthening consolidated supervision and exploring ways to reduce banks' reliance on short-term wholesale funding.

banking system remained liquid and well capitalised

The Staff Report broadly described the financial sector as "remaining vigilant" and indicated that the banking system remained liquid and well capitalised. This was as a result of South African banks' low leverage ratios, sound profitability and limited exposure to foreign assets and foreign funding. Therefore, during the global financial crisis South African banks required no liquidity support from either the central bank or the government, in contrast with the experience of banks in many other countries. Impaired advances rose as the economy weakened, household debt remained near historic highs, and borrowers were subjected to the unfolding recession and rising interest rates during the period 2006 to 2008. Nevertheless, the IMF's analysis of macrofinancial linkages suggests that the overall assessment of solvency risks to South African banks, as well as feedback effects from the real sector, remains small; likely reflecting the South African banks' strong capital position and generally high profitability.

1.3.2 Key findings

banking-sector risks identified in Staff Report

The banking-sector risks identified in the Staff Report, in addition to the above-mentioned risks are summarised below, followed by comments on the progress made by the Department in addressing the recommendations from the 2008 Financial Sector Assessment Program (FSAP) Update, in square brackets.

- The IMF stated that the credit risks to the banking system were mitigated by supportive macroeconomic policies, coupled with features of the South African financial system. Significant monetary policy easing had lowered lending rates, while more stringent bank loan origination standards and a decline in the demand for credit had moderated credit growth. In addition, and in the light of the intricacies of the recent global crisis, it was highlighted that South African banks held most of the mortgages they originated, which encouraged them to engage in negotiations with distressed homeowners to put in place alternative repayment arrangements. Also of

1 www.imf.org.

significance to the IMF was the fact that the South African legislative framework enabled banks to claim other assets of defaulting borrowers, thereby mitigating incentives to default, including on foreclosed properties with negative equity.

- South African banks' reliance on short-term wholesale corporate deposit funding was again highlighted and described as a long-standing structural risk. The 2008 FSAP Update recommended the implementation of a deposit insurance system to counter such risks and to induce household savings to migrate from unguaranteed liquid financial instruments to competing bank deposits, thereby strengthening the banks' retail base. An analysis of the extent to which deposit insurance could provide incentives for increasing the scale of retail bank deposits was also advised. The Staff Report further recommended that it would be useful for the Bank and the Financial Services Board jointly to explore ways to reduce the risks associated with banks' reliance on short-term wholesale deposits.

  reliance on short-term wholesale corporate deposit funding highlighted

  [The Department has engaged National Treasury and the Financial Services Board on the structural make-up of the financial sector. Discussions are ongoing. Furthermore, liquidity risk management formed the basis of the Department's discussions during 2009 with the boards of directors of banks and liquidity risk thematic reviews were conducted at various banks. In addition, liquidity simulation exercises were performed at two of the large South African banks. More simulation exercises are planned for execution during 2010. The Department also continues to monitor and consider developments in liquidity risk issued by the FSB and the Basel Committee.]

- In line with the 2008 FSAP Update recommendations, it was highlighted that the dominance of the financial system by a few large financial conglomerates with cross-border share holdings and cross-sector activities also posed structural risk. These conglomerates combine banking, securities trading and insurance in a single organisation. It was stated that, as the recent global crisis had illustrated, even when banks are well managed, as is the case in South Africa, there is a risk that the sectoral supervisory arrangements could miss potentially systemic linkages. Therefore, it was again recommended that the authorities should seek to identify potential information and regulatory gaps relating to conglomerate activity by enhancing the work of the existing high-level Bank–Financial Services Board Committee, and the already-established working-level joint Bank–Financial Services Board Committee to help guide the work of supervisory colleges covering individual financial conglomerates. The Staff Report suggested regular reporting on the work of these committees to senior policy-makers in order to assess whether further action, including possible changes to legislation, would be required to minimise regulatory gaps and strengthen consolidated supervision. It also suggested that a formal analysis of systemic linkages based on a matrix of exposures within and across financial conglomerates be considered.

  minimise regulatory gaps and strengthen consolidated supervision

  [During 2009 the Department reviewed and strengthened its working relationship with the cross-sectoral regulatory authorities to enhance the supervision of banking groups further. Regular supervisory meetings between the Department and the Financial Services Board were instituted for the three largest South African banking and insurance groups. The main purpose of the supervisory meetings was to enhance information sharing, identify issues of mutual relevance and to work together towards greater consistency in the supervisory approach of the two supervisory bodies, where appropriate. The Department is also planning to host a supervisory college in 2010 with African supervisors where South African banking groups have a presence.]

- The IMF estimates suggested that, on balance, markets had a positive outlook with regard to South African banks' credit risk. A staff paper estimated probabilities of default for the four largest banks and macrofinancial linkages for the period 2000 to 2009, based on equity price data. The paper found that although South African banks' probabilities of default had recently increased, they were significantly lower than those of several large international banks based in mature economies. Furthermore, feedback from the real economy-to-solvency risk in the banking sector was limited, but shocks from the banking sector had significant effects on the exchange rate and gross domestic product (GDP) growth.

supervision of banks had generally intensified since late 2008

- The Staff Report further indicated that the supervision of banks had generally been intensified since late 2008 in response to rising financial sector risks. On-site supervision, including the assessment of banks' stress-testing practices, risk models and risk management practices, was intensified. Off-site stress-testing utilising supervisory data, in line with the recommendations of the 2008 FSAP Update, was carried out biannually. The stress-testing exercise in the last quarter of 2008 showed that even under a severely unfavourable macroeconomic scenario the capital-adequacy ratios of none of the systemically important banks would fall below the regulatory minimum. Overall, the Staff Report stated that authorities were of the view that banks were provisioning adequately for the increase in impaired loans and that banks' capital, which comprised predominantly Tier 1 capital, remained at comfortable levels to meet the increasing risks.

  [The Department continued to focus on the above-mentioned issues raised as part of its ongoing supervisory review and assessment process.]

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

The Department acknowledges its role and remains committed to facilitating the optimisation of banks' compliance with AML and CFT measures.

1.4.1 Mutual evaluation of South Africa

final report on the evaluation of South Africa's AML/CFT measures

During March 2009 the Financial Action Task Force (FATF), an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and the financing of terrorism, published a final report on the evaluation of South Africa's AML/CFT measures. The evaluation was done mutually by the FATF and the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). The full mutual evaluation report (MER) was debated and adopted on 26 February 2009 at a plenary meeting of the FATF and was made available publicly on 27 March 2009.[2]

The MER presents an overview of the key findings on South Africa's AML/CFT framework aimed at combating money laundering and the financing of terrorism. It also provides details of the measures required to criminalise money laundering and the financing of terrorism, and to provide for the forfeiture of the proceeds of crime in accordance with international standards. It is noted in the MER that South African authorities have established comprehensive mechanisms to co-operate on operational matters relating to the implementation of these measures.

South African AML/CFT framework could be enhanced further

A number of general areas are identified in the MER where the South African AML/CFT framework could be enhanced further, namely

2 A copy of the report can be viewed at http://www.fic.gov.za.

- customer due diligence conducted by financial and other institutions, including the identification of certain types of customers, such as the beneficial owners of legal persons and politically exposed persons;
- customers' particulars should accompany electronic funds transfers;
- the disclosure of cross-border cash transfers;
- the supervision of compliance by financial and other institutions with obligations flowing from AML legislation;
- improving the transparency of the ownership and control structures of legal persons and trusts; and
- protecting non-profit organisations from abuse for the purpose of laundering money and financing terrorism.

1.4.2 Key findings

The key findings of the MER included the following:

- Good progress had been made in developing a system to combat money laundering and the financing of terrorism since the previous FATF mutual evaluation in 2003.
- Money-laundering offences are in line with the Vienna and Palermo Conventions.
- Provisions for criminalisation of the financing of terrorism were comprehensive.
- The Financial Intelligence Centre (FIC) appeared to be operating effectively.
- The scheme for confiscating the proceeds of crime is comprehensive.
- The Financial Intelligence Centre Act, 2008 (Act No. 11 of 2008) (FICA) imposes customer due diligence record keeping.
- Suspicious transaction reporting and internal control requirements are in place.
- FICA covers the majority of financial institutions, and non-financial businesses and professions.
- The mechanisms for co-operation among South African authorities on operational matters to combat money laundering and the financing of terrorism are effective.
- South Africa can provide a wide range of mutual legal assistance, including the possibility of extraditing its own nationals.

Recommendations for follow-up actions that will impact on the private sector, included the following:

recommendations for follow-up actions

- Improving provisions on customer due diligence.
- Improving powers for supervisors to supervise and enforce compliance, and increased action by supervisors to ascertain compliance levels and sanction non-compliance among financial and non-financial institutions.
- Introducing measures to regulate people who provide a domestic money remittance service.

Recommendations in the MER for follow-up actions by the public sector included the following:

- Increasing the priority to be given to money-laundering investigations and prosecutions relative to underlying profit-generating offences.
- Improving legislation (e.g., amendments to FICA to improve customer due diligence provisions in line with new standards).
- Introducing measures for the regulation of people who provide a domestic money remittance service.
- Improving transparency of the ownership and control structures of legal persons and trusts.

- Requiring the assessment of potential risks of the financing of terrorism posed within the non-profit organisation sector.
- Developing and maintaining comprehensive statistics on actions taken against money laundering.
- Developing unique South African trend and typology reports, case studies and best practices.

South Africa is required to provide the FATF (as part of the normal processes following the adoption of an MER) with a progress report during 2011 reflecting on the steps that have been taken to improve in the areas mentioned above.

In July 2009 the FIC and the Department held discussions to determine the various tasks to be completed and the two offices' respective responsibilities to ensure that the relevant areas highlighted in the MER were addressed to enhance South Africa's overall level of compliance with the FATF Recommendations further.

1.4.3 Financial Action Task Force mutual evaluation stakeholder feedback sessions

FIC hosted two FATF mutual evaluation stakeholder feedback sessions

In July 2009 the Director of the FIC hosted two FATF mutual evaluation stakeholder feedback sessions to provide feedback to the industry on the process followed by, and the findings of, the MER. The first session was held with private-sector stakeholders in Sandton, Johannesburg, on 14 July 2009. The second session with public-sector stakeholders was held in Pretoria on 16 July 2009.

1.4.4 A workshop with the President of the Financial Action Task Force

On 25 August 2009 the FIC hosted a workshop which was also attended by the President of the FATF, Mr Paul Vlaanderen. The workshop, which was attended by the Department, focused on the following:

- The relationship of the FATF with the Group of Twenty Finance Ministers and Central Bank Governors (G-20) and the dynamics and processes of the G-20 to consider financial regulatory reform measures.
- The matter of "tax havens", the Organisation for Economic Co-operation and Development (OECD) processes and the listing of certain jurisdictions that did not comply with FATF Recommendations.
- The relationship between taxation and money-laundering issues, including trade-based laundering.
- Recent developments in the FATF, including the consideration of procedures in the International Co-operation Review Group to identify non-co-operative jurisdictions and the implications thereof.

1.4.5 Financial Intelligence Centre Act, 2008 (Act No. 11 of 2008), as amended

proposal made to amend Schedule 2 to FICA

In 2009 the proposal was made that Schedule 2 to FICA, which designated the Bank as one of the supervisory authorities, be amended to confer supervisory powers relating to AML/CFT to specific departments in the Bank, that is, the Bank Supervision and Exchange Control departments. The President of the Republic of South Africa assented to the amendments to other sections of FICA on 27 August 2009. The amendments will come into effect on a date to be determined by the Minister of Finance by notice in a *Government Gazette*.

1.5 Financial Stability Institute: High-level Meeting on Recent Developments in Financial Markets and Supervisory Responses

1.5.1 Background

The Financial Stability Institute (FSI) was created in 1999 by the Bank for International Settlements (BIS) and the Basel Committee in order to assist financial sector supervisors globally in improving and strengthening their financial systems.

key objectives of the FSI

The key objectives of the FSI are to

- promote sound supervisory standards and practices, and to assist in the implementation of such standards globally;
- disseminate to supervisors across the globe the latest information on market products, practices and techniques to assist them in adapting to ongoing change and innovation in the financial sector;
- help supervisors develop solutions to their respective challenges by sharing experiences during seminars, discussion forums and conferences; and
- assist supervisors in employing the practices and tools that will allow them to meet everyday demands and tackle more ambitious goals.

The attainment of these objectives is facilitated by means of conferences, high-level meetings, discussion forums and seminars that are hosted by the FSI globally. During these sessions participating supervisory bodies focus on and discuss various relevant topics.

1.5.2 High-level meeting in Cape Town

recent developments in financial markets and supervisory responses

In this regard the FSI, jointly with the Department, hosted a high-level meeting in Cape Town on 29 and 30 January 2009. The focus of this meeting was on recent developments in financial markets and supervisory responses thereto. The high-level meeting was organised as a joint forum for heads of supervisory authorities from the Africa continent, and a limited number of representatives of Basel Committee member countries and the private sector. The key objective of the meeting was to share participants' views on the latest international developments, including Basel II and the international financial market crisis and its impact.

Core Principles remained the basis of supervision

The meeting was chaired by Mr Josef Tošovský, Chairperson of the FSI, who commenced the proceedings with introductory remarks, followed by a keynote address by Mr Nout Wellink, Chairperson of the Basel Committee and President of the Netherlands Bank, on the future of supervision in view of the developments flowing from the international financial market crisis. Mr Wellink stated that, in essence, the future of supervision was to "go back to basics". The Core Principles for Effective Banking Supervision (the Core Principles), first issued by the Basel Committee in September 1997 and revised in 2006, remained the basis of supervision and full compliance with these principles should remain a core focus of supervisors across the globe. Mr Wellink noted that many of the problems identified during the financial crisis were the result of the failure to adhere to core governance and risk management principles, and a lack of proper knowledge and understanding of the core business, sophistication and risk exposure of banking institutions and groups by members of the board of directors of those institutions. From a supervisory perspective, the Core Principles specifically highlight all of the aforementioned as focus areas for supervisors. For example, Core Principle 7 requires supervisors to be satisfied that banks have comprehensive risk management processes in place, which includes board and senior management oversight, to identify, evaluate, monitor and control or mitigate all material risks, and to assess banks' overall capital adequacy in relation to their risk profile.

broadened scope to include a macroeconomic perspective

Mr Wellink stated that the financial architecture was changing and supervisors should ensure that they broadened their scope to include a macroeconomic perspective of the risks impacting on the banking industry. It was also important to focus on and further enhance the interaction between supervisors, banking groups and other non-bank financial institutions, thereby identifying and addressing any possible regulatory gaps. Mr Wellink added that the Basel Committee had begun drafting comprehensive guidelines for co-operation between the various supervisory bodies. Other key focus areas included cross-border supervision and regulation in order to deal with cross-border crisis issues appropriately, and further Pillar 2 guidance and methods that could reduce the impact of procyclicality on regulatory capital of financial institutions.

lessons learnt from the international financial market crisis

Mr Roger Cole, the then Director of Banking Supervision and Regulation of the Board of Governors of the United States (US) Federal Reserve System (the Fed), provided a high-level synopsis of the Fed's response to the crisis which focused on stabilising systemically important financial institutions, providing additional liquidity assistance to the market, and stronger supervisory and regulatory systems. Mr Cole provided some insight into lessons learnt from the international financial market crisis, including the importance of prudent valuation practices, stress testing and contingency planning, and the role of the board and senior management in ensuring proper governance and controls within financial institutions.

CEBS' stance on future institutional setting and actions

Ms Kerstin af Jochnick, Head of Prudential Supervision of the Finansinspektionen, Sweden and Chair of the Committee of European Banking Supervisors (CEBS), provided an overview of the role of CEBS, with particular focus on its role during the financial crisis, which revolved mainly around co-operation and co-ordination among CEBS members, analysis of supervisory implications of national rescue plans implemented and crisis events surrounding individual institutions. Ms Jochnick also touched on CEBS' stance on future institutional setting and actions to contribute to the restoration of confidence in the financial markets, which included the following:

- The establishment of colleges for supervisors for all cross-border banks in the European Union (EU).
- The establishment of networks of national experts.
- Reinforced institutional arrangements between CEBS, the Banking Supervision Committee of the European System of Central Banks and the European Central Bank (in particular in the context of risk assessment).
- Issuance of further guidance and recommendations.
- CEBS guidance and recommendations to be implemented timely and adequately at a national level.

key strategic responses of the Basel Committee to developments in financial markets

Mr William Coen, Deputy Secretary General of the the Basel Committee provided a high-level overview of the key strategic responses of the Basel Committee to the developments in financial markets subsequent to the international financial market crisis. The responses of the Basel Committee were focused on the following areas:

- Capital adequacy (e.g., risk coverage, quality and composition, procyclicality and supplementary measures).
- Risk management and supervisory review (e.g., supplementary Pillar 2 guidance and counterparty credit risk).

- Liquidity risk management and supervision (e.g., principles and guidance issued in respect of sound liquidity risk management and supervision, sound stress-testing practices and the assessment of banks' financial instrument fair value practices).
- Cross-border co-operation.
- System-wide (macroprudential) approach to supervision.

Mr Coen proceeded to provide brief comments in respect of a Basel II consultative package released on 16 January 2009 which included the following:

- Revisions to the Basel II market risk framework.
- Guidelines for computing capital for incremental risk in the trading book.
- Proposed enhancements to the Basel II framework.

Mr Coen also provided a high-level overview of the supervisory expectations in respect of liquidity risk, referring mainly to the Principles for Sound Liquidity Risk Management and Supervision issued by the Basel Committee in September 2008.

Mr Arthur Murton, Director, Division of Insurance and Research, Federal Deposit Insurance Corporation (FDIC), US, provided some introductory remarks on the main events leading up to the international financial market crisis, and discussed the efforts and initiatives of the US Treasury and the FDIC in response to the crisis. He also discussed the responses of deposit insurers globally, including the increases in insurance coverage limits and the future of deposit insurers. He concluded by providing a high-level overview of the Core Principles for Effective Deposit Insurance Systems,[3] which were issued in June 2009.

consistent regulatory approach towards credit-rating agencies

Mr Greg Tanzer, Secretary General, International Organisation of Securities Commission (IOSCO), Spain, provided some thoughts on a consistent regulatory approach towards credit-rating agencies (CRAs). Mr Tanzer provided a high-level overview of the CRA Code of Conduct issued by IOSCO in 2004, which covered the quality and integrity of the rating process; the independence of CRAs and the avoidance of conflict of interest; the responsibilities of CRAs towards investors and issuers; and the disclosure of the CRA code. Mr Tanzer also discussed the revisions that were made to the CRA Code of Conduct during 2008 and the declaration by the G-20 on 15 November 2008 to exercise strong oversight over CRAs, consistent with the agreed and strengthened international code of conduct. Mr Tanzer concluded by providing insight into the IOSCO priorities for 2009, which included the following:

- Greater collective CRA discussions with IOSCO.
- The development of a cross-border framework for co-operation with regard to the assessment of CRAs using a consistent global regulatory approach based on the IOSCO CRA Code of Conduct.

role of CRAs in providing independent opinions on creditworthiness

Ms Vickie Tillman, Executive Vice-President, Standard & Poor's Rating Services (S&P) discussed the role of CRAs in providing the market with independent opinions on creditworthiness. Ms Tillman highlighted the fact that ratings by CRAs had to be regarded as only one of many tools that market participants should use. She stated that the recent credit market dislocation raised concerns about credit ratings and their use, and resulted in a loss of confidence in credit ratings by market participants. Restoring confidence would require greater emphasis on

3 A copy of the report can be viewed at http://www.bis.org/publ/bcbs156.htm.

- transparency at all stages of the capital-raising and investment process;
- the use of investor tools beyond credit ratings and the prospectus attached to new securities; and
- accountability, that is, a clear delineation of responsibilities at each stage of the capital-raising and investment process.

Further steps to be taken in order to restore confidence in CRAs included the following:

- Strengthening the integrity of the ratings process.
- Enhancing ratings models and processes, and staff training.
- Greater transparency with regard to the ratings process and the risks that would lead to CRAs reviewing ratings assumptions.
- Enhancing the outreach programme to help market participants consider ratings appropriately.

In closing, Ms Tillman highlighted some of the actions that S&P had implemented including the following:

- An Ombudsman for S&P was appointed in February 2009.
- S&P revised its ratings criteria to incorporate a measure of stability into its investment grade ratings, in order to mitigate severe downgrades in highly leveraged securities.
- S&P held regular meetings with the Audit Committee of the McGraw-Hill board of directors to review S&P's compliance and governance structures.
- S&P implemented "look-back" reviews for analysts who leave the firm to work for other financial institutions.
- An analyst rotating programme was implemented in terms of which analysts are only allowed to rate a particular client for a maximum of five years.
- S&P was conducting reviews of all the models it used.
- S&P developed a ratings user manual which was publicly available online.

IFRSs accepted as basis from a prudential regulation perspective

Mr Karl-Heinz Hillen, Head of Division Accounting, Deutsche Bundesbank, Germany, made some comments on the similarities and differences between International Financial Reporting Standards (IFRSs) and prudential regulation. He highlighted the fact that IFRSs were accepted as a basis from a prudential regulation perspective with certain prudential filters and supervisory fair value guidance being applied. He also discussed the role of IFRSs during the financial market turmoil, with particular reference to the following:

- The impact of the requirements of International Accounting Standard (IAS) 39 (categories of assets and liabilities, and the valuation hierarchy).
- The impact of changing from mark-to-market to mark-to-model valuations.
- Reclassification.
- Incurred loss versus expected loss.
- Procyclicality.
- Transparency.

Mr Mike Brown, the then Financial Director, Nedbank Limited, South Africa, discussed the relationship between IFRSs and prudential regulation with specific reference to the concept of fair value, which was regarded as a controversial topic and the different objectives of IFRSs compared to the objectives of Basel II. He noted support for recommendations made by international standard-setting bodies to converge international accounting standards to a single global standard and to move towards standardisation of derivative instruments, but without hindering innovation.

He also made some comments on the transformation of the nature of liquidity risk due to financial innovation and global market developments. He listed the following factors that contributed positively to liquidity risk management by domestic banks:

transformation of the nature of liquidity risk

- Domestic banks had low levels of securitised funding.
- The relative size of the domestic conduit business was small.
- South Africa had a strong and well-functioning interbank market.
- There was limited global credit contagion in the South African money market.
- South Africa maintained a robust macroeconomic policy framework.

However, Mr Brown stated that factors that negatively impacted liquidity risk management in South Africa included the following:

- Banks increasingly relied on professional funding sources. South Africa had a high degree of liquidity mismatching.
- Low levels of retail deposits.

Mr David Scott, Adviser at the World Bank, discussed the World Bank's response to the international financial market crisis, including the implications for risk-based supervision. He highlighted the fact that some concerns existed regarding the long-term impact of the international financial market crisis, in particular the impact of government actions during the crisis period from a prudential regulation perspective.

Mr Errol Kruger, Head of the Department provided a brief overview of the events leading up to the international financial market crisis and the impact of the crisis from a South African perspective. He provided some insight into the supervisory actions taken in South Africa that had mitigated the severity of the impact of the crisis on the domestic banking industry. He stated that the supervisory focus going forward would be to

supervisory focus going forward

- continue to monitor international developments and their potential impact on the domestic markets;
- continue to interact with South African banks and monitor them closely;
- ensure regular supervisory communication with banks' management and boards;
- ensure regular communication with other appropriate supervisors (domestically and globally); and
- remain in regular contact with the press and media to avoid misunderstandings in the market.

Mr Kruger also stated that the international financial market crisis highlighted important governance issues, including the following:

important governance issues highlighted by financial crisis

- The quality of board members and the effectiveness of boards.
- The effectiveness of board subcommittees.
- Senior management oversight.
- The appropriateness of incentive schemes.
- The appropriateness of new product approval processes.
- The effectiveness of risk management processes.

Mr Kruger described some of the key experiences of the Department during and after the implementation of Basel II. He stated that the overarching goals of Basel II were to promote greater financial stability through greater risk sensitivity and better risk management, and better governance and capital management. He described the stages of the Basel II implementation, which process commenced during 2001. Post-Basel II implementation challenges included the refinement of the Department's organisational structure, the risk-based supervisory process applied, and its information technology systems to cope with the increased complexity and volume of information submitted by banks. He highlighted the fact that ongoing industry interaction and guidance were key to the successful implementation of Basel II. The key challenges for supervisors with regard to the implementation of Basel II included the following:

- The attraction and retention of suitably skilled staff.
- Staff training.
- Ongoing development of the risk-based supervisory process.
- The optimisation of operational structures.
- Change management.
- Maintenance of an appropriate information technology and data infrastructure.
- Development and maintenance of appropriate management reporting and disclosure processes.

key challenges faced by banks

Mr Kruger briefly discussed some of the key challenges faced by banks, namely
- ensuring proper planning with regard to, and implementation of, Basel II;
- attracting and retaining appropriately skilled and experienced staff;
- ensuring the availability and quality of data;
- developing and maintaining appropriate information technology systems; and
- change management.

"pitfalls" to the successful implementation of Basel II

He concluded by listing possible "pitfalls" to the successful implementation of Basel II that needed careful consideration, namely
- avoiding an "adopt-at-all-cost" strategy;
- ensuring that financial sector safety and soundness were priorities;
- ensuring compliance with Basel I, the Core Principles and IASs;
- ensuring the achievement of Basel II preconditions for implementation;
- guarding against leaving too little time for parallel runs and field testing; and
- ensuring that appropriate resources were in place prior to commencing with the implementation of Basel II.

Ms Gill Marcus, the then Chairperson of the Board of Directors of Absa Group Limited, South Africa, provided some thoughts and led an active debate on the following issues:

- The appropriateness of the size of boards of directors and the effectiveness of boards.
- The need for more competition in concentrated banking industries.
- The responsibilities of non-executive members of the boards of directors of banks.
- The importance of the independence of mind of non-executive directors.
- The need for non-executive board members to have an appropriate level of understanding of banking and the risks to which banks were exposed.
- The importance of a good relationship between banks and their supervisors.
- The management of concentration risk in banking systems, with particular focus on the so-called too-big-to-fail concept and whether the concept still applied.

Mr Alvir Alberto Hoffmann, Deputy Governor, Central Bank of Brazil, provided a high-level overview of certain aspects of the Basel II implementation process in Brazil. He described the three phases of the Basel II implementation project, which was launched by Brazil in 2001. It was highlighted that the initial focus during Phase 1 was on the implementation of the simpler approaches in terms of Basel II, whereas the application and validation of the more advanced approaches would be the focus during Phases 2 and 3 of the project.

comments on the implementation of Basel II from a regional perspective

Mr Ousman Sowe, Chairperson of the Committee of Bank Supervisors in West and Central Africa (CBSWCA), The Gambia, also shared some comments on the implementation of Basel II from a regional perspective. He stated that the member countries of CBSWCA were committed to the implementation of Basel II, but that implementation would be at the discretion of each of the individual countries, guided by country-specific circumstances. Owing to the small size and limited level of sophistication of the various CBSWCA member countries' financial systems, it was expected that most would initially adopt only the standardised approaches available in respect of credit and market risk, and the basic indicator approach for operational risk. Mr Sowe highlighted the fact that the priority in most CBSWCA member countries remained the implementation of the Core Principles and full compliance with these principles. Key challenges to the CBSWCA member countries' successful implementation of Basel II included the lack of appropriate comprehension of Basel II due to its complexity, the costs involved in its implementation, a lack of resources in terms of both staff numbers and appropriate skills, and a lack of rating agencies in some member countries.

success factors in respect of the implementation of Basel II

Mr Paul Smith, Chief Risk Officer of the Standard Bank of South Africa Limited, provided brief comments on the success factors in respect of the implementation of Basel II from a commercial bank's perspective. The following key factors were mentioned:

- The importance of early planning and preparation.
- Implementation should be a "team effort" between the bank and the regulator.
- There should be active involvement from line managers and not only from risk management and finance functions.
- There should be strong oversight by the board of directors.
- Basel II implementation should be a national commitment.

Mr Smith stated that the key post-implementation benefits for his institution were a better understanding of the risks to which they were exposed, improved decision-making, improved management performance measures and a better understanding of the capital impact of risk exposures.

1.6 Incentive schemes of banking institutions

1.6.1 Background

In its 2007 *Annual Report* the Department highlighted the following:

> There are usually two key concerns raised about banks' incentive schemes. First, the schemes are misaligned, that is, they are linked to short-term performance, rather than the long-run interests and objectives of the institution. Second, these schemes have significant upside with no or limited downside and therefore may influence behaviour that could encourage excessive risk-taking.
>
> Misalignment between incentive schemes and the long-run objectives of banking institutions include mismatches between the timing of employees' bonus payments and the actual realisation of profits from their activities; inadequate recognition and remuneration of risk

management professionals, that is, their 'exclusion' from incentive schemes; and the provision of funding to business units based on income potential, without considering the level of risk these units undertake.

thematic review of South African banks' incentive schemes during 2008

The above discussion was a precursor to the Department's thematic review of South African banks' incentive schemes during 2008.

Internationally, several initiatives were undertaken in respect of incentive schemes during 2009, the most important of which follow.

1.6.2 Financial Stability Board guidance on compensation

It has been widely accepted that the structure of incentive schemes at financial institutions was one of the contributing factors to the financial crisis that began in 2007. As a result, in April 2009 the FSB issued FSB Principles for Sound Compensation Practices (the Compensation Principles) which are intended to apply to significant financial institutions. It is intended that these principles should be implemented by banking institutions and be reinforced through the supervisory process at national level.

In September 2009 the FSB published FSB Principles for Sound Compensation Practices: Implementation Standards (the Compensation Standards) to its Compensation Principles. The Compensation Standards were a response to a request by the G-20 to submit to the Pittsburgh Summit detailed specific proposals on corporate governance reforms, global standards on pay structure, and greater disclosure and transparency in order to enhance adherence to the Compensation Principles. The Compensation Standards do not fully cover all aspects of the Compensation Principles. However, they prioritise areas that should be addressed by banking institutions and supervisors to achieve effective global implementation of the Compensation Principles.

The Compensation Standards broadly cover the following key areas:

Compensation Standards cover key areas

- *Governance*: It is required of significant financial institutions to have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors. Furthermore, they prescribe the composition and objectives of the remuneration committee, while addressing the remuneration and performance measurement of risk and compliance staff.
- *Compensation and capital*: The total variable compensation of significant financial institutions should not limit their ability to strengthen their capital base. Supervisors should limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.
- *Pay structure and risk alignment*: The full range of current and potential risks should be taken into account in determining the size and allocation of variable compensation. Deterioration in the financial performance of an institution should generally lead to a contraction of the institution's total variable compensation, with such contraction reflecting the degree of deterioration. Senior management and employees responsible for the risk exposure of the institution should have a larger variable component as part of their total compensation. In addition, it is prescribed that a deferral system should be in place in respect of variable compensation, that is, variable compensation should not be paid once off, but rather staggered over a number of years.

- *Disclosure*: It is prescribed that an annual report on compensation should be disclosed to the public on a timely basis. Such disclosure should include areas such as the decision-making process related to the compensation policy; the key features of the compensation system and aggregate quantitative information.
- *Supervisory oversight*: Supervisors are required to ensure the effective implementation of the Compensation Principles and Compensation Standards in their respective jurisdictions. In the event of non-compliance, supervisors are required to act promptly.

The Department commenced participation in a thematic review conducted by the FSB on the implementation of the Compensation Principles and Compensation Standards, which will form part of the areas of focus during 2010. Furthermore, in order to support implementation efforts, the Basel Committee published the consultative paper, *Compensation Principles and Standards Assessment Methodology* (the Methodology) in October 2009. The Methodology, a final version of which was released in January 2010, is a guide that enables supervisors to review banking institutions' compensation practices and assesses their compliance with the Compensation Principles and Compensation Standards.

participation in a thematic review conducted by the FSB

1.6.3 The Department's review of South African banks' incentive schemes

In view of the risk posed by inappropriately structured incentive schemes, the Department conducted a thematic review of all South African banks' incentive schemes during 2008. The salient issues that emerged from the reviews are discussed below and, as a range of banks were reviewed, only the general high-level outcomes are discussed. Some of the statements made and views expressed may not reflect the practices of certain banks.

- *Main purpose of incentive schemes*: The main purpose of banks' incentive schemes was to attract, motivate, reward and retain talented and exceptionally performing employees and leaders. It was highlighted that a shortage of skilled employees in the banking and broader financial sector led to banks competing for a limited pool of talent. Furthermore, incentive schemes were viewed as an important component of the total compensation package of employees, with cash incentives highlighted as having become increasingly more important for the retention of staff.

main purpose of banks' incentive schemes

- *Design, range and functioning of incentive schemes*: As incentive schemes change the behaviour of staff, the effective functioning of these schemes is critical.
  – *Alignment with the objectives of the institution*: Banks aligned their incentive schemes with the performance and risk management of the institution. Performance measures included ROE, growth in earnings and activity and cost-to-income levels. These various performance measures had hurdle rates that needed to be attained by business units and the bank as a whole, prior to any incentives being considered. In this way, the success of the organisation and business units determined the bonus of individuals. Risk management was both implicitly and explicitly built into incentive schemes. Some institutions were of the view that their general risk management framework ensured that employees would not 'chase' excessive bonuses by way of inappropriate risk-taking, as internal controls and exposure limits would prevent such behaviour. Other

alignment of incentive schemes with performance and risk management of institution institutions incorporated an explicit risk management component in assessing individuals and in awarding bonuses. Notwithstanding this approach, all institutions believed that failure to comply with organisational controls, values and culture resulted in a reduced bonus payment, both at individual and business unit level.

– *Range of incentive schemes*: Various schemes were identified during the review. However, they could broadly be grouped into two categories, namely cash-based schemes and share-based schemes.
  - o Cash-based schemes were predominantly short term, while share-based schemes were longer term in nature. In certain instances where cash-based payments were very large, these payments were staggered over a few years. Generally, it was observed that cash-based payments were skewed to the short term, that is, in excess of 80 per cent of the payments were made in the short term. In addition, it was observed that there was significant differentiation in respect of cash-based schemes, that is, a very large proportion of the pool allocated to individuals who performed exceptionally.
  - o In the case of share-based payments, these shares vested after three to four years only and therefore participants received no payments in terms of the scheme in the event of their leaving the organisation before the three- to four-year period. Share-based schemes were, in the main, reserved for more senior employees of the organisation. Furthermore, it was highlighted that these schemes were not backdated and therefore the benefits were based on the future performance of the organisation only.

functioning of incentive schemes found to be relatively transparent

– *Functioning and controls*: The functioning of incentive schemes was found to be relatively transparent. Banking organisations allocated a total bonus pool based on the performance of the consolidated institution, while business unit allocations were determined by performance contribution at business unit level. However, cognisance was taken of the risk and allocated capital. Individual employee incentives were a function of the bonus pool allocated to the business unit, the performance of the individual and the individual's team as a whole. Furthermore, adherence to the business unit and organisational value system, culture and risk appetite was also considered.

  Banks highlighted that they were comfortable with the functioning of their incentive schemes since they conducted regular industry benchmarking exercises, while one institution advised that its internal and external audit functions were tasked with identifying control weaknesses and breakdowns as a result of the bank's incentive schemes.

banks' boards of directors managed the highest level of approvals

• *Role of board remuneration subcommittee (Remco)*: It was noted that banks' boards of directors managed the highest level of approvals. However, Remcos were mandated to perform the following functions:

  – Shape the organisation's remuneration policy.
  – Determine the remuneration for executives.
  – Determine the structure of compensation packages for staff.
  – Determine incentive pools at organisational and business unit level.
  – Design incentive schemes.
  – Review top individual bonus awards.

  Following from the above, Remcos were ultimately responsible for creating work environments that stimulated performance and aligning employees' interest with that of the organisation. This process had to take place while preserving the value and culture of the institution.

- *Monetary value of incentive payouts*: Annual total incentive pools were found to exceed 10 per cent of organisations' net profit before tax. Investment banking and trading business units received the highest relative proportion of bonus pools. Banks highlighted that these business units had the highest number of highly skilled staff, produced a large contribution to the overall performance of the institution and were the business units that were most exposed to competition from the South African branches of foreign financial institutions. In addition, certain banks highlighted that they were losing staff to international banks that were engaged in investment banking and trading.

investment banking and trading business units received the highest relative proportion of bonus pools

- *Conclusion*: South African banking organisations have generally sound principles embedded in their incentive schemes, including
  – alignment with the objectives of the organisation as a whole;
  – business unit bonus pools determined by overall performance of the organisation;
  – consideration of risk management in the performance assessment process; and
  – incorporation of team and business unit performance in individual assessments.

banking organisations have generally sound principles embedded in incentive schemes

However, the following issues that require banks' further attention were identified:

issues that require banks' further attention were identified

- Cash-based incentive schemes were very skewed towards the short term. This phenomenon may result in employees being rewarded for activities that appear positive in the short term. However, such activities may result in large losses before maturity.
- Short-term bonus awards exhibited large-scale differentiation. This may result in excessive individualism, to the detriment of the team, the business unit and the organisation.

  During 2009, the Department closely followed international developments regarding financial institutions' compensation schemes by way of its participation in the activities of the Basel Committee and other international fora, such as the FSB, while continuing discussions with banks where required.

1.6.4 Initiatives planned for 2010

Initiatives planned for 2010 include engagement with all South African banks on the Compensation Principles and Compensation Standards in order to assess their levels of compliance. In addition, the aforementioned documents will be considered for incorporation into the amended bank regulatory framework that is anticipated to become effective in 2011. Furthermore, a review of the Department's supervisory review and evaluation process relating to compensation principles and standards applied by banks will be conducted.

1.7 The international financial market turmoil: Responses by standard-setting bodies

1.7.1 Introduction

comprehensive package of measures to strengthen trading-book capital and enhance the Basel II framework

The sub-prime and international financial market crisis that started in 2007 revealed fundamental weaknesses in international financial markets. In response to these weaknesses, international standard-setting bodies such as the G-20, the FSB and the

Basel Committee announced various initiatives, strategies, and new or amended requirements and standards covering a wide range of areas. In its *Annual Reports* of 2007 and 2008, the Department comprehensively covered matters such as the background to, and causes of, the crisis and the weaknesses that were identified that required specific attention or correction.

During July 2009, the newly expanded Basel Committee[4] approved a comprehensive package of measures to strengthen the 1996 rules governing trading-book capital for banks and banking groups, and to enhance the three pillars of the Basel II framework. The aforementioned package forms part of the Basel Committee's broader programme to strengthen the regulatory capital framework. The key aims of the broader programme are to introduce new standards to

- promote the build-up of capital buffers that can be drawn down in periods of stress;
- strengthen the quality of bank capital;
- introduce a leverage ratio as a backstop to the Basel II risk-sensitive measures;
- introduce measures to mitigate any excess cyclicality of the minimum capital requirement; and
- promote a more forward-looking approach to provisioning.

As part of the aforementioned comprehensive packages of measures the Basel Committee issued the following three documents in July 2009:

i *Enhancements to the Basel II framework*.
ii *Revisions to the Basel II market risk framework*.
iii *Guidelines for computing capital for incremental risk in the trading book*.

The measures contained in the above-mentioned documents materially impact on the regulation and supervision of banks and banking groups. The amended trading-book rules, which are scheduled to take effect at the end of 2010, include a stressed value-at-risk (VaR) requirement and the introduction of higher capital requirements for banks and banking groups to capture the credit risk associated with complex trading activities.

Basel II enhancements

The Basel II enhancements referred to above include the following:

- Measures to strengthen the treatment for certain securitisations in Pillar 1 of the Basel II framework, which deals with minimum capital requirements.
- The introduction of higher risk weights for resecuritisation exposures, often referred to as 'collateralised debt obligations' (CDOs) of asset-backed securities (ABSs), to better reflect the risks inherent in these products.
- Measures to raise the credit conversion factor (CCF) for short-term liquidity facilities granted to certain off-balance-sheet conduits.
- Requirements for banks to conduct more rigorous credit analyses of externally rated securitisation exposures.
- Supplemental guidance under Pillar 2 of the Basel II framework, which deals with the supervisory review process. This guidance also incorporates the Compensation Principles, issued by the FSB in April 2009 and addresses the flaws in risk management practices revealed by the crisis and raises the standards for
  - managing bank-wide governance and risk;
  - capturing the risk of off-balance-sheet exposures and securitisation activities;
  - managing risk concentrations; and

4 At its March 2009 meeting, the Basel Committee took a decision to expand its membership by inviting representatives of Australia, Brazil, China, India, Korea, Mexico and Russia. At its meeting in June 2009 the Basel Committee further expanded its membership with the addition of representatives of Argentina, Indonesia, Saudi Arabia, South Africa, Turkey, Hong Kong SAR and Singapore.

  - providing incentives for banks to better manage risk and returns over the long term.
- Pillar 3 of the Basel II framework, which deals with market discipline or public disclosure, was enhanced to strengthen disclosure requirements for securitisations, off-balance-sheet exposures and trading activities. The purpose of the additional disclosure requirements is to help reduce market uncertainties pertaining to the strength of banks' balance sheets related to capital market activities.

It is envisaged that the amended Pillar 1 capital requirements and Pillar 3 disclosure requirements will be implemented in South Africa with effect from 1 January 2011, while the further Pillar 2 supplemental guidance either already forms part of the Department's regulatory and supervisory framework or is in the process of being incorporated.

1.7.2 Responses by the G-20

During 2009, the G-20 held various summits to discuss the effects of the international financial market and economic crisis, and to take concerted and decisive actions in that regard. On 25 September 2009, following the Pittsburgh Summit, the G-20 issued a leaders' statement[5] and a progress report on the actions taken or to be taken to promote financial regulatory reform.

the G-20 held various summits to discuss the effects of the international financial market and economic crisis

According to the leaders' statement, the G-20, among other things, pledged the following:

- Confirmed the commitment of countries to doing everything necessary to ensure recovery, to repair the financial systems and to maintain the global flow of capital.
- Agreed to ensure that the regulatory system for banks and other financial firms reins in excessive risk-taking that led to the crisis.
- Agreed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter (OTC) derivatives market and to create more powerful tools to hold large global firms to account for the risks they took. Standards for large global financial firms should be commensurate with the cost of their failure. For all these reforms, the G-20 has set strict timetables.
- The establishment of the FSB to include major emerging economies and welcomed its efforts to co-ordinate and monitor progress in strengthening financial regulation.
- Substantial progress in strengthening prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges and reinforcing international co-operation.
- Enhanced and expanded the scope of regulation and oversight, with tougher regulation of OTC derivatives, securitisation markets, CRAs and hedge funds.
- Committed to taking action at national and international levels to raise standards together so that national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage.
- Committed to conducting robust and transparent stress tests as needed.
- Strike an adequate balance between macroprudential and microprudential regulation to control risks.
- Called on the G-20 members to reach agreement on an international framework of reform in the following critical areas:

agreement on an international framework of reform

5 The complete leaders' statement and progress report are available from the G-20 website at http://www.g20.org/pub_communiques.aspx.

– *Building high-quality capital and mitigate procyclicality*: The G-20 committed to developing by the end of 2010 internationally agreed rules to improve both the quantity and quality of bank capital, and to discourage excessive leverage. The rules will be phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by the end of 2012. The national implementation of higher levels and better quality of capital requirements, countercyclical capital buffers, higher capital requirements for risky products and off-balance-sheet activities, as elements of the Basel II capital framework, together with strengthened liquidity risk requirements and forward-looking provisioning, will reduce incentives for banks to take excessive risks and create a financial system better prepared to withstand adverse shocks.

The G-20 supports the introduction of a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting.

aligning compensation with long-term value creation

– *Reforming compensation practices to support financial stability*: Excessive compensation in the financial sector has both reflected and encouraged excessive risk-taking. Reforming compensation policies and practices is an essential part of the efforts to increase financial stability. The G-20 fully endorsed the implementation standards of the FSB aimed at aligning compensation with long-term value creation and not with excessive risk-taking. These standards include the following:

o Avoiding multi-year guaranteed bonuses.
o Requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback, and to be vested in the form of stock or stock-like instruments, as long as the created incentives aligned with long-term value creation and the time horizon of risk.
o Ensuring that compensation for senior executives and other employees that have a material impact on the firm's risk exposure align with performance and risk.
o Making firms' compensation policies and structures transparent through disclosure requirements.
o Limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.
o Ensuring that compensation committees overseeing compensation policies are able to act independently.

Supervisors are expected to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary, to offset additional risks, apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices.

OTC derivative contracts should be traded on exchanges

– *Improving OTC derivatives markets*: All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest. Furthermore, OTC derivative contracts should be reported to trade repositories and non-centrally cleared contracts should be subject to higher capital requirements.

prudential standards for systemically important institutions

– *Addressing cross-border resolutions and systemically important financial institutions by the end of 2010*: Systemically important financial firms should develop internationally consistent firm-specific contingency and resolution plans. Furthermore, authorities should establish crisis management groups for the major cross-border firms and a legal framework for crisis intervention, as well as improve information sharing in times of stress. Resolution tools and frameworks should be developed for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future. Prudential standards for systemically important institutions should be commensurate with the costs of their failure. The FSB is expected to propose by the end of October 2010 possible measures, including more intensive supervision and specific additional capital, liquidity, and other prudential requirements.

- Called on international accounting bodies to redouble their efforts to achieve a single set of high-quality, global accounting standards within the context of their independent standard-setting process and completing their convergence project by June 2011.

- Committed to maintaining the momentum in dealing with tax havens, money laundering, proceeds of corruption, terrorist financing and prudential standards. In this regard the G-20
  – stands ready to use countermeasures against tax havens from March 2010; and
  – welcomes the progress made by the FATF in the fight against money laundering and the financing of terrorism, and calls on the FATF to issue a public list of high-risk jurisdictions by February 2010.

The G-20's progress report on the actions taken or to be taken to promote financial regulatory reform was also issued on 25 September 2009 and covered a wide spectrum of key focus areas, including matters related to the following:

- *The establishment of the FSB*: The G-20 Leaders at the London Summit, held in April 2009, transformed the Financial Stability Forum (FSF) into the FSB, with an expanded membership and a broadened mandate to promote financial stability. The FSB held its inaugural meeting in June 2009 and has established the internal structures needed to address its mandate.

  These new structures include a Steering Committee and three Standing Committees for the assessment of vulnerabilities; supervisory and regulatory co-operation and standards implementation. The FSB also established a Cross-border Crisis Management Working Group and an Expert Group on Non-co-operative Jurisdictions. These groups have all commenced with their work programmes.

expanded membership and a broadened mandate to promote financial stability

- *International co-operation*: Systemically important financial firms are required to develop internationally consistent firm-specific contingency and resolution plans. Authorities are required to establish crisis management groups for the major cross-border firms and a legal framework for crisis intervention, as well as to improve information sharing in times of stress.

  Work on the implementation of the FSB Principles for Cross-border Co-operation on Crisis Management is ongoing. Schedules for firm-specific cross-border contingency planning discussions have been set out to take place in 2009 and the first half of 2010. The FSB Cross-border Crisis Management Working Group is preparing a list of the main elements to be included in contingency planning discussions, including a template for "de-risking" plans to be prepared by the firms. De-risking plans will cover options the firms would need to consider to exit risky positions and scale back their activities, in an orderly fashion and without government intervention.

  Supervisory colleges have been established for more than 30 large and complex financial institutions identified by the FSB as needing college arrangements.

firm-specific cross-border contingency planning discussions

Progress has been made in the two major international initiatives under way on bank resolution frameworks, namely the Cross-Border Bank Resolution Group (CBRG) of the Basel Committee and the initiative by the IMF and the World Bank on the legal, institutional and regulatory framework for national bank insolvency regimes.

In September 2009 the CBRG published, for consultation, a report that included recommendations for authorities on effective crisis management and resolution processes for large cross-border institutions. The IMF is producing papers on a Framework for the Cross-Border Resolution of Insolvent Financial Institutions. The first paper examines key legal and policy issues.

Following Executive Board discussion, a second paper to be published by the IMF will set out recommendations for the resolution of these issues, which is scheduled for completion in 2010.

- *Prudential regulation*: The G-20 reached agreement in respect of various matters relating to prudential regulation, including the following:

predominant form of Tier 1 capital must be common shares and retained earnings

– *To raise the quality, consistency and transparency of the Tier 1 capital base*: The predominant form of Tier 1 capital must be common shares and retained earnings. Deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity or its equivalent. The definition of capital will be harmonised across jurisdictions and all components of the capital base will be fully disclosed so as to allow for comparisons across institutions to be made easily.

address any excessive cyclicality of minimum capital requirements

– *To introduce a framework for countercyclical capital buffers above the minimum requirement*: The framework will include capital conservation measures such as constraints on capital distributions. The Basel Committee will review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build-up and release of capital buffers. The Basel Committee continues to work on approaches to address any excessive cyclicality of minimum capital requirements.

The Basel Committee also actively engaged with accounting standard setters to promote more forward-looking provisions based on expected losses. The International Accounting Standards Board (IASB) is working to enhance its provisioning standards and guidance on an accelerated basis, including by considering a proposed impairment standard based on an expected loss approach to loan loss provisioning.

stressed liquidity coverage ratio requirement

– To introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.

– To introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting. The main elements of how a leverage ratio would work in practice have been formulated, and development work is taking place on important practical details. Calibration of a leverage ratio will be part of an impact assessment to be conducted in 2010.

At the end of 2009, the Basel Committee issued concrete proposals in respect of various components of the aforesaid matters, including the quality, consistency and transparency of the capital base, capital buffers and capital conservation measures, and minimum global standards for liquidity. These proposals are discussed in more detail elsewhere in this report.

- *The scope of regulation*: Prudential standards for systemically important institutions should be commensurate with the costs of their failure. In this regard, the FSB in the 12 months to September 2010 will be developing proposals to reduce the systemic risks posed by large and complex financial institutions.

  In addition, the Basel Committee has established a working group on macroprudential supervision that will cover, among other things, supervisory tools to address the externalities of systemically important banks.

  working group on macroprudential supervision

  Aside from the work on addressing procyclicality, the FSB and its members are developing quantitative tools to monitor and assess the build-up of macroprudential risks in the financial system. These tools aim to improve the identification and assessment of systemically important components of the financial sector and the assessment of how risks evolve over time.

  Initiatives are under way to promote the establishment of central clearing counterparties for credit default swap (CDS) contracts, with an initial focus on CDS indices. The Basel Committee is also considering revisions to ensure that capital requirements for OTC derivatives adequately reflect the risks of derivatives, taking into account the benefits of central clearing, the impact of collateralisation and other counterparty credit risks. In this regard, new standards will be issued during 2010.

  promote establishment of central clearing counterparties for credit default swap contracts

- *The transparent assessment of regulatory regimes*: All FSB members have undertaken, or are about to undertake, a review of adherence to international regulatory and supervisory standards through the FSAP and Reports on the Observance of Standards and Codes (ROSC).

- *Compensation*: Many national initiatives are under way to implement the FSB's Compensation Principles. A number of supervisory actions have also been taken to assess compliance by the industry with the FSB's Compensation Principles, through requests for self-assessment, assessments by the supervisors themselves, or both. These initiatives are broadly consistent in substance and have affected both regulatory frameworks and supervisory actions and practices.

  national initiatives under way to implement FSB Principles

  The Basel Committee, the International Association of Insurance Supervisors (IAIS) and the IOSCO are working to support consistent implementation of the FSB's Compensation Principles across jurisdictions. IOSCO is considering incorporating the FSB's Compensation Principles into its Principles for Periodic Disclosure.

  The IAIS has initiated work on the development of a standard and guidance paper on remuneration that will take into account the FSB's Compensation Principles for cross-sectoral consistency purposes. The Basel Committee incorporated the aforesaid principles in Pillar 2 of Basel II in July 2009, with the expectation that banks and supervisors begin implementing the new Pillar 2 guidance immediately.

The FSB has developed specific standards for implementing its Compensation Principles, which could be incorporated into supervisory measures and will complete a review of actions by national authorities to implement the principles by the end of March 2010. Supervisors are expected to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary, to offset additional risks, and to apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices.

adherence to co-operation and information-sharing standards

- *Tax havens and non-co-operative jurisdictions*: The G-20 committed itself to fighting non-co-operative jurisdictions and to maintaining the momentum in dealing with tax havens, money laundering and prudential standards. Furthermore, the G-20 welcomed the establishment by the FSB of an Experts Group under the Standing Committee for Standards Implementation that will develop criteria for identifying jurisdictions of concern due to a combination of their weakness and systemic importance; develop an approach and a toolkit of progressive and proportionate measures to engage non-compliant jurisdictions; identify jurisdictions of concern based on the criteria approved by the committee; develop an evaluation process to complement FSAP and ROSC assessments; assess compliance for jurisdictions of concern, using FSAP and ROSC information and mutual evaluations; and engage non-compliant jurisdictions as appropriate. Progress is also being made towards promoting adherence to co-operation and information-sharing standards in the financial regulatory and supervisory area.

  Furthermore, the G-20 agreed that the FATF should revise and reinvigorate the review process for assessing compliance by jurisdictions with AML/CFT standards, using agreed evaluation reports where available. The G-20 also welcomed the progress made by the FATF in the fight against money laundering and terrorist financing, and called on the FATF to issue a public list of high-risk jurisdictions by February 2010.

various discussion documents, exposure drafts and/or proposed new accounting standards

- *Accounting standards*: To date, the IASB has published various discussion documents, exposure drafts and/or proposed new accounting standards or guidance, among other things, to improve standards for the valuation of financial instruments, reduce the complexity associated with some accounting standards for financial instruments, strengthen accounting standards for loan-loss provisioning, enhance certain disclosure standards, and to improve accounting standards for off-balance-sheet exposure and valuation uncertainty. The IASB is working with supervisors and the Basel Committee in key areas to resolve matters of mutual interest.

national and regional initiatives ongoing to strengthen oversight of CRAs

- *Credit-rating agencies*: In March 2009, IOSCO published a report assessing the degree to which CRAs have adopted codes of conduct that reflect the updated provisions of the IOSCO Code of Conduct Fundamentals for CRAs. The report found that a larger proportion of the CRAs reviewed had taken steps to incorporate the provisions of the IOSCO CRA Code into their codes of conduct than when they were previously surveyed for IOSCO's first implementation review in 2007. National and regional initiatives are ongoing to strengthen oversight of CRAs.

  The Basel Committee is also reviewing proposals to address a number of inappropriate incentives arising from the use of external ratings in the regulatory capital framework, such as insufficient independent risk assessment by banks and "cliff" effects.

1.7.3 Responses by the Basel Committee: Proposals to strengthen global capital and liquidity regulations

At its December 2009 meeting, the Basel Committee approved for consultation a package of proposals to further strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector.

Along with the measures taken by the Basel Committee in July 2009 to strengthen the Basel II framework, the proposals announced on 17 December 2009[6] form part of the Basel Committee's comprehensive response to address the lessons learned from the crisis related to the regulation, supervision and risk management of global banks.

proposals announced on 17 December 2009 form part of the Basel Committee's comprehensive response

Through its reform package, the Basel Committee aims to strengthen, among other things, banks' risk management and governance, transparency and disclosures, and the resolution of systemically significant cross-border banks.

The Basel Committee's reforms form part of the global initiatives to strengthen the financial regulatory system that have been endorsed by the FSB and the G-20 at their Pittsburgh Summit.[7]

One of the main reasons the economic and financial crisis became so severe was that the banking sectors of many countries had built up excessive on-balance-sheet and off-balance-sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the re-intermediation of large off-balance-sheet exposures that had built up in the shadow banking system.

The crisis was further exacerbated by a procyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability.

crisis further exacerbated by a procyclical deleveraging process and interconnectedness of systemic institutions

To address the market failures revealed by the crisis, the Basel Committee is proposing to introduce a number of fundamental reforms to the international regulatory framework. The reforms strengthen bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions during periods of stress. The reforms also have a macroprudential focus, addressing system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.

fundamental reforms to the international regulatory framework

The micro- and macroprudential approaches to supervision are interrelated, as greater resilience at the individual bank level reduces the risk of system-wide shocks. It is expected that the capital and liquidity proposals issued for consultation by the Basel Committee will

- result in more resilient banks, and a sounder banking and financial system; and
- promote a better balance between financial innovation and sustainable growth.

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6 The complete documents containing the Basel Committee's proposals to further strengthen global capital and liquidity regulations with a view to promoting a more resilient banking sector are available at https://www.bis.org/list/bcbs/from_01012008/index.htm.

7 http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

consultative documents to further strengthen global capital and liquidity regulations

The Basel Committee's consultative documents to further strengthen global capital and liquidity regulations cover the following key focus areas:

- *Raising the quality, consistency and transparency of the capital base*: It is critical that banks' risk exposures are backed by a high-quality capital base. The proposed amendments will ensure that the banking system is in a better position to absorb losses on both a going concern and a gone concern basis. For example, under the current Basel Committee standard, banks could hold as little as 2 per cent common equity to risk-based assets, before the application of key regulatory adjustments.

predominant form of Tier 1 capital must be common shares

  The proposal is to strengthen the component of the Tier 1 capital base that is fully available to absorb losses on a going concern basis, thus contributing to a reduction of systemic risk emanating from the banking sector. In this regard, the predominant form of Tier 1 capital must be common shares and retained earnings.

  The remainder of the Tier 1 capital base must comprise instruments that are subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.

innovative hybrid capital instruments phased out

  Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses, currently limited to 15 per cent of the Tier 1 capital base, will be phased out.

  The Basel Committee will calibrate the minimum requirements for the overall level of capital, Tier 1 capital, and the predominant form of Tier 1 capital as part of the impact assessment to be conducted.

  In addition, Tier 2 capital instruments will be harmonised and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated.

  Finally, to improve market discipline, the transparency of the capital base will be improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the reported accounts.

strengthen the risk coverage of the capital framework

- *Strengthening the risk coverage of the capital framework*: One of the key lessons of the crisis has been the need to strengthen the risk coverage of the capital framework. Failure to capture major on-balance-sheet and off-balance-sheet risks, and derivative-related exposures duly was a key destabilising factor during the financial market and economic crisis that started in 2007.

enhanced treatment introduces a stressed VaR capital requirement

  In July 2009 in response to these shortcomings, the Basel Committee issued substantial reforms to the Basel II framework that will raise capital requirements for the trading book and complex securitisation exposures, a major source of losses for many internationally active banks since 2007. The enhanced treatment introduces a stressed VaR capital requirement based on a 12-month period of significant financial stress. In addition, the Basel Committee has introduced higher capital requirements for so-called resecuritisations held in both the banking book and the trading book of banks. The reforms also raise the standards of the Pillar 2 supervisory review process and strengthen Pillar 3 disclosure requirements. The Pillar 1 and Pillar 3 enhancements must be implemented by the end of 2010, while the Pillar 2 risk management standards became effective immediately.

In addition to the aforesaid trading-book and securitisation reforms announced in July 2009, on 17 December 2009 the Basel Committee issued for consultation proposals to strengthen the capital requirements for counterparty credit risk exposures arising from derivatives, repurchase and resale transactions, and securities financing activities.

strengthen capital requirements for counterparty credit risk exposures

The proposed enhancements will strengthen the resilience of individual banking institutions and reduce the risk that shocks are transmitted from one institution to the next through the derivatives and financing channel.

The proposed strengthened counterparty capital requirements will also increase incentives to move OTC derivative exposures to central counterparties and exchanges.

- *Introducing a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration*: As mentioned earlier, one of the underlying features of the crisis was the build-up of excessive on-balance-sheet and off-balance-sheet leverage in the banking system. The build-up of leverage was also a feature of previous financial crises, for example, leading up to September 1998. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and the contraction in credit availability.

  The introduction of a leverage ratio requirement will assist in containing the build-up of excessive leverage in the banking system, and introduce additional safeguards against model risk and measurement error. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for any remaining differences in accounting.

introduction of a leverage ratio requirement

- *Introducing a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress*: The tendency of market participants to behave in a procyclical manner has been amplified through a variety of channels and through the build-up and release of leverage among financial institutions and consumers.

  The Basel Committee proposes to introduce a series of measures to address procyclicality and raise the resilience of the banking sector. The proposed measures have the following key objectives:

measures to address procyclicality

  – Dampen any excess cyclicality of the minimum capital requirement.
  – Promote more forward-looking provisions.
  – Conserve capital to build buffers at individual banks and the banking sector that can be used in stress.
  – Achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth.

  A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks. While procyclicality amplified shocks over the time dimension, the interconnectedness of many large banks and other financial institutions transmitted negative shocks across the financial system and economy. The Basel Committee is therefore also developing

developing practical approaches to assist supervisors in measuring the importance of banks practical approaches to assist supervisors in measuring the importance of banks to the stability of the financial system and the real economy, and reviewing policy options to reduce the probability and impact of failure of systemically important banks.

minimum liquidity standard for internationally active banks

- *Introducing a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio*: Strong capital requirements are a necessary condition for banking-sector stability, but by themselves are not sufficient. A strong liquidity base reinforced through robust supervisory standards is of equal importance. As with the global capital standards, the proposed liquidity standards will establish minimum requirements and will promote an international level playing field.

  The framework therefore also includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank- and system-wide level. These standards and monitoring metrics complement the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision, issued in September 2008.

The Basel Committee and international regulatory and supervisory authorities, including the Department, are mindful of the need to introduce the aforesaid measures in a manner that raises the resilience of the banking sector over the longer term, while avoiding negative effects on bank lending activity that could impair the economic recovery.

comprehensive impact assessment of the capital and liquidity standards

In this regard, the Basel Committee is initiating a comprehensive impact assessment of the capital and liquidity standards proposed in the consultative documents. In a number of proposals, the committee is still considering different options, which will be included in the impact assessment. Decisions on the final proposals and their calibration will be made only after a thorough analysis of the impact assessment and the comments received on the consultative documents. The impact assessment will be carried out in the first half of 2010. On the basis of the impact assessment, the Basel Committee is expected to review the regulatory minimum level of capital and the proposed reforms to arrive at an appropriately calibrated total level and quality of capital.

fully calibrated set of standards will be developed by the end of 2010

It is expected that the fully calibrated set of standards will be developed by the end of 2010 to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by the end of 2012. The impact or potential impact of the aforesaid initiatives and strategies undertaken, and of the various new or amended requirements or standards issued by international standard-setting bodies such as the G-20 Forum, FSB and the Basel Committee to comprehensively address the fundamental weaknesses revealed by the international financial market and economic crisis, on the regulatory and supervisory framework of the Department is discussed in more detail in Chapter 3 of this report.

1.8 Participation in international regulatory or supervisory forums

1.8.1 Southern African Development Community Subcommittee of Banking Supervisors

the Department is represented on the SADC Subcommittee of Banking Supervisors

The Department is represented on the Southern African Development Community (SADC) Subcommittee of Banking Supervisors (SSBS), a subcommittee of the Committee of Central Bank Governors (CCBG) in SADC. The key focus areas of the SSBS are the following:

- The effective implementation of the Core Principles by supervisors in the SADC region.
- Training of supervisors and the effective implementation and ongoing enhancement of risk-based supervision.

- The effective implementation and ongoing review of AML and CFT measures.
- Implementation of IASs across the SADC region.
- Harmonisation of banking supervision and legal and regulatory reforms.

During 2009 the SSBS devoted most of its attention and time to the development of a template to enable member countries to perform self-assessments in respect of their compliance with the Core Principles and to the bank supervision information technology application project to enable the electronic submission of statutory returns. In addition, the SSBS identified areas to be focused on during 2010 namely:

- The regulation of electronic money in the SADC jurisdiction due to the increased usage of cellphone banking.
- Further development of off-site monitoring of banks.

During 2009 the SSBS also identified certain training initiatives to be initiated during 2010, namely

- the SADC Training and Development Forum is in the process of developing a course on financial soundness indicators; and
- risk-based supervision.

1.8.2 Standards Implementation Group – Validation Subgroup

The Department is represented on the Validation Subgroup (SIGV) of the Standards Implementation Group (SIG), an expert subcommittee of the Basel Committee focusing on issues related to the validation of systems used by banks to generate the ratings and parameters that serve as inputs into the internal ratings-based (IRB) approaches to credit risk. Members of the SIGV meet three times annually to share their experiences in respect of the IRB approach to credit risk. The work plan of the SIGV is continuously adjusted to the outcomes of the deliberations at the Basel Committee and, since 2004, when first established, has covered a wide range of issues such as

the Department is represented on the Validation Subgroup of the Standards Implementation Group

- definitional issues;
- minimum standards in respect of supervisory data requirements;
- challenges with the accuracy of standards for estimates of probability of default (PD), loss given default (LGD) and exposure at default (EAD);
- the interpretation of minimum standards for organisational processes;
- rating systems inputs;
- the robustness of validating tools for PDs, LGDs and EADs;
- validation issues unique to retail banking portfolios;
- the criteria considered for accepting PDs in order to take into account through-the-cycle effects; and
- consideration of the design and application of supervisory benchmarking techniques.

During 2009 the SIGV focused on the following topics:

- The cyclicality of capital.
- Validation techniques including backtesting.
- The impact of rating migrations.
- The impact of increased collateralisation and the subsequent impact on risk-weighted assets.
- The impact of calibration differences and changes in the actual underlying risk of exposures on the average risk weighting of exposures.

It is envisaged that during 2010 the SIGV will continue its analysis of the impact of the global financial market crisis, and the data flowing from it, on IRB parameters.

1.8.3 Standards Implementation Group Operational Risk

SIGOR focuses on operational risk implementation issues

The Standards Implementation Group Operational Risk (SIGOR) is a permanent working group of the SIG that focuses on operational risk implementation issues.

The principal focus of SIGOR is the practical challenges associated with the successful development, implementation and maintenance of an operational risk framework that addresses the requirements and expectations of the Basel Committee's advanced measurement approach (AMA). Subgroup members share identified operational risk implementation issues within their respective jurisdictions and actively participate in developing resolution plans. Another important element of SIGOR's mandate is to facilitate the resolution of issues associated with the cross-border supervision of international banking groups under Basel II, especially in relation to operational risk.

The sharing of information and experiences among SIGOR members on the practical challenges associated with the implementation and maintenance of an operational risk framework under the AMA continued during the period under review. The following two reports were finalised during 2009:

i *Results from the 2008 Loss Data Collection Exercise for Operational Risk*.
ii *Observed Range of Practice in Key Elements of AMA*.

The above-mentioned reports were published by the Basel Committee in July 2009. South Africa's contribution to these reports and the main findings of the reports are discussed in more detail on pages 57–61 of this report. In 2009 SIGOR members continued to work with supervisors, banks, insurance brokers and insurance providers to clarify SIGOR's expectations with respect to the recognition of insurance mitigation in AMAs.

Activities planned by SIGOR for 2010 include the following:

- Developing a comprehensive response to address the significant issues identified in the above-mentioned reports and national implementation efforts.
- Continuing work to explore improvements to the standardised and basic indicator approaches.
- Assessing whether the risk management standards set forth in the paper *Sound Practices for the Management and Supervision of Operational Risk*, issued in February 2003, warrant updating and enhancements. The standards in the 2003 paper establish general supervisory expectations for the management of operational risk for banks.

1.8.4 Trading Book Group

In 2007 South Africa was invited to participate in a technical group under the Basel Committee focused on implementation guidelines of the Basel II Accord related to the trading book, named the Accord Implementation Group–Trading Book (AIG–TB). Following completion of the implementation phase of the accord the AIG structure was disbanded. However, the issues associated with the trading book remained and in 2008 the group continued functioning under the Policy Development Group, as the Trading Book Group (TBG).

ascertaining the interaction between credit and market risk

Having dealt with a number of trading-book-related issues in the past, the recent work of the group was concentrated on ascertaining appropriate and practical ways for banks to apply internal models in the calculation of capital for the risk of obligor default and other credit-related risks, and gain approval therefore in an approach that could be broadly consistent across jurisdictions. The proposed capital charge was then called the 'incremental default risk charge' (IDRC). Financial market events that unfolded during the latter months of 2007, peaking with the collapse of Lehman Brothers in late 2008, focused the importance of the group's work on ascertaining the interaction between credit and market risk. In particular, the discrepancy between capital charges for the same products held in the banking and trading books came under the spotlight. Structured products at the heart of the losses made by banks, such as synthetic CDOs, drew attention to the complexity of their pricing in both liquid and illiquid markets, and the indirect effect of credit events on their pricing.

Greater inspection of the sources of risk revealed the need to distinguish between obligor default risk, rating migration risk, the effect of market liquidity on market risk, and the effect of events such as jumps to default and mergers. This directed the work of the group. A trading strategy, known as 'correlation trading', also required careful consideration. Several alternatives were developed for banks to report these risks under standardised and modelled approaches.

In 2009 the TBG consolidated results of an impact study on the effects of implementing the IDRC that had commenced in 2008. Of the 26 banks participating in the survey, 5 were South African. The survey highlighted the effect of different standards in calculating capital requirements and the scarcity of sophisticated modelling techniques among banks.

survey highlighted the effect of different standards in calculating capital requirements

The events of late 2008 led the TBG to formulate a more wide-reaching response to the perceived insufficiency of capital for market risk, including the introduction of a stressed VaR component for banks with approval to report capital according to a VaR approach.

A further impact study was undertaken in 2009 to ascertain the effects of refined regulations for traded credit and stressed VaR. Again, the Department facilitated the participation of 5 South African banks in the study. The results of this study, which were published in October 2009, highlighted the significant effect of the proposed regulations for market risk on banks' overall capital requirements. Excluding correlation trading, the study concluded that the proposed changes to the market risk framework increase average trading-book capital requirements by two to three times. Based on the results of the study, the Basel Committee decided to retain the principles and capital calculations originally proposed in its January 2009 consultative package, as published in July 2009 in two documents, namely *Revisions to the Basel II Market Risk Framework* and *Guidelines for Computing Capital for Incremental Risk in the Trading Book*.

the Department facilitated the participation of 5 South African banks in the study

During debate around trading capital, discrepancies between capital treatment in the trading and banking books became increasingly apparent and demanding of the group's attention. Consequently, five work streams were initiated to address a fundamental review of the trading book. The Department, in co-operation with several South African banks, has contributed to studies in one of the work streams and will be a major participant in two others in 2010.

1.8.5 Regulation and supervision of microfinance activities

In 2009 South Africa participated as a member of a work stream of the Basel Committee on microfinance, the objectives of which were to identify the existing Basel Committee standards that are relevant to microfinance and to develop additional guidance or a range of practice papers for supervisors responsible for microfinance activities, with a specific focus on micro deposit-taking. This would assist countries in developing coherent approaches to regulating and supervising microfinance, and for applying the Core Principles to microfinance activities conducted by depository institutions in their jurisdictions.

applying the Core Principles to microfinance activities

In April 2009 a survey was conducted by means of a questionnaire to draw on the collective experience of supervisors globally, identify supervisory issues and to illustrate accepted practices for the regulation and supervision of microfinance activities. The definition of 'microfinance', for the purposes of the project, was couched in general terms to cover the diversity of interpretations. It encompassed the provision of limited financial services to lower income persons and smaller, often informal, businesses. The intention is to present a draft report, "Microfinance Activities and the Core Principles for Effective Banking Supervision", to the Basel Committee in 2010. The draft report will consist of the range of practices on regulating and supervising microfinance activities, and the guidance for the application of the Core Principles to microfinance activities.

1.8.6 Capital Monitoring Group

The Basel Committee has established a Basel II Capital Monitoring Group that shares national experiences in monitoring capital requirements. Issues considered include measures to ensure that banks maintain a solid capital base throughout the economic cycle.

South Africa is a member of the Capital Monitoring Group

South Africa is a member of the Capital Monitoring Group and submits regulatory data to it for further analysis. The regulatory data submitted consist of credit risk, market risk, operational risk and net qualifying capital in respect of the industry. A detailed analysis is performed by the Capital Monitoring Group, and issued to the members for discussion.

The following areas, among others, are analysed:

- The overall results for the current period.
- The relative increase in the Basel II requirements compared to the Basel I requirements.
- The impact of transitional floors.
- The share of exposures subject to the standardised approach.
- The relative impact of risk types.
- Data at portfolio level, such as portfolio sizes, average minimum required capital per exposure and risk parameters.

The results of the analysis are then fed back to the Policy Development Group, a subgroup of the Basel Committee, to support the committee in identifying and reviewing emerging supervisory issues and, where appropriate, proposing and developing policies that promote a sound banking system and high supervisory standards.

1.9 Skills development

1.9.1 Introduction

During 2009 the Department spent R887 000 on the training of approximately 107 employees. Various training interventions were arranged, such as technical and managerial courses, risk management seminars and supervisory workshops. The main purpose of the training was to

- assist staff in implementing sound supervisory standards and practices;
- keep staff abreast of the latest information on market products, practices and techniques;
- keep staff abreast of the latest developments in international financial markets and supervisory responses to the financial market crisis; and
- ensure that staff were equipped with the necessary tools and techniques in order to meet their everyday supervisory tasks.

the Department spent R887 000 on training

1.9.2 Key training interventions

Table 1.1 on page 36 depicts a list of some of the key local and international training interventions that were attended by staff members during 2009, followed by brief details regarding certain of these training interventions.

Table 1.1 Key local and international training interventions

Local	
Training intervention	Date
South African Institute of Chartered Accountants updates	10 February 2009
	27 February 2009
	30 June – 1 July 2009
	26–27 October 2009
	27 November 2009
Induction programmes (for new staff)	16 February 2009
	14 April 2009
	5 May 2009
	12–13 August 2009
Foundation courses (for new staff)	18–20 February 2009
	15–21 April 2009
	6–8, 11 May 2009
	14–19 August 2009
Moody's KMV credit portfolio engineering course	24–26 February 2009
Basel II Operational risk training programmes	25–27 February 2009
	2–4 March 2009
Global risk management presentation (by KPMG Australia)	10 March 2009
Course on treasury basics	24–25 March 2009
Advanced credit risk measurement and management course	20–21 April 2009
Institute of Internal Auditors International Conference 2009	10–13 May 2009
National Credit Act course	28 May 2009
Corporate governance and King III seminar	22 June 2009
Financial sector distress and risk analysis	27–28 July 2009
Fighting fraud seminar	24–26 August 2009
POLS management course	14–17 September 2009
KPMG IFRSs update	17 September 2009
Pillar 3 and IFRS 7 training workshop	6–9 October 2009
Business statistics and data analysis	7–9 October 2009
Credit risk portfolio models	15–16 October 2009
Companies Act and King Report update	5 November 2009
Validating and auditing internal rating systems	9–12 November 2009
Credit derivatives	11–12 November 2009
Bank risk in emerging markets	16–17 November 2009
Financial-sector distress and financial analysis	18 November 2009
Latest developments in financial instruments accounting	24 November 2009
Basel II and corporate governance	26 November 2009

International	
Training intervention	Date
FSI high-level meeting on the recent developments in financial markets and supervisory responses (Cape Town)	28–29 February 2009
Banking regulation and supervision (Gerzenzee, Switzerland)	3–22 May 2009
Advanced techniques in stress-testing seminar (Frankfurt, Germany)	17–21 May 2009
FDIC examination management course (Blantyre, Malawi)	31 May – 6 June 2009
Toronto Centre crisis preparedness programme (Stockholm, Sweden)	16–21 August 2009
Advanced bank supervision seminar (Frankfurt, Germany)	31 August – 4 September 2009
26th International Banking Supervision Seminar (Beatenberg, Switzerland)	6–11 September 2009
Financial regulation and supervision seminar (Cambridge, UK)	14–18 September 2009
MEFMI regional workshop (Dar es Salaam, Tanzania)	21–24 September 2009
FSI seminar on operational risk management and the recent financial crisis (Basel, Switzerland)	13–15 October 2009
Consolidated supervision seminar (Lusaka, Zambia)	18–22 October 2009
FSI seminar on supervisory standards and select financial stability issues (Basel, Switzerland)	3–5 November 2009
FSI seminar on practical techniques to implement Basel II (Basel, Switzerland)	10–12 November 2009

1.9.3 Local training interventions

1.9.3.1 Foundation courses

Four foundation courses were presented during the year, one of which was a week-long course presented to all graduate staff members who had recently joined the Department. These courses covered 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.
- The specialised software programs used for analysis.

1.9.3.2 Basel II operational risk training programmes

In February 2009 and March 2009 Professor Duc Pham-Hi, from the Ecole Centrale d'Electronique Graduate School of Engineering in Paris, France, conducted two operational risk training programmes of two-and-a-half days each for approximately 40 employees of the Department. The overarching objective of the specialised operational risk training was to enable participants to challenge banks effectively when reviewing their risk models. Useful insights were drawn from the trainer's practical commercial banking experience and the work he performed at the French Banking Commission, Banque de France. The key aspects covered during the programmes included the following:

key aspects covered during the programmes

- *Loss distribution approach (LDA) modelling*: Theoretical background; LDA in practice; and extracting frequency and severity from a loss database.
- *Combining severity and frequency using a Monte Carlo simulation*.
- *Scenario-based approach (SBA): Practical background:* How a combined LDA and SBA approach work, demonstration of extraction of severity and frequency from experts and calculating VaR using Microsoft Excel.
- *What to look for when reviewing banks' AMA projects, testing and back-testing*: How to view AMA capital modelling and economic capital projects in banks (using not only knowledge of their models' output and input, but also looking at their staff bias, population, top management involvement in modelling and budget, or "how not to spend money on models from which you learn nothing").

1.9.3.3 Pillar 3 and IFRS 7 training workshop

During October 2009 a two-day workshop and training exercise was provided by Mr Shamim Diouman, Manager of Risk and Regulation at the Institute of Chartered Accountants of England and Wales (ICAEW). The programme, among other things, covered the following topical areas:

- An introduction to Pillar 3 disclosure requirements: market discipline and characteristics of Pillar 3 disclosure.
- Pillar 3 disclosure requirements: The standardised approach.
- Pillar 3 disclosure requirements: The advanced approach.
- Latest amendments to Pillar 3.
- Introduction to IAS 1 and IFRS 7.

The programme provided participants with insight into the interaction of Pillar 3 disclosure with accounting disclosures and the use of public disclosures by supervisors and was further augmented and given a practical flavour with the involvement of participants in various case studies.

1.9.4 International training interventions

1.9.4.1 Banking regulation and supervision (Gerzenzee, Switzerland)

seminar was designed for central bank staff members

In May 2009 a representative of the Department attended a course on banking regulation and supervision at the Gerzensee Study Centre in Switzerland. The centre offers courses to central bankers across the globe. While the majority of the courses presented are designed for economists, it also offers courses applicable to various other areas within central banks. The seminar was designed for central bank staff members in middle management positions with several years of professional experience in central banking. Twenty-five countries attended.

The course on banking regulation and supervision reviewed the economic rationale for bank regulation and supervision. These two aspects were examined from an analytical and an institutional viewpoint. A major part of the course was to identify the sources of bank risk, such as interest rate, credit, liquidity and market risk. For this purpose, the roles and functions of commercial banks were examined thoroughly. While many of the risks are at the bank level, the macroeconomic environment influences them. A survey of the main macroeconomic factors for banks was provided. A further element of the course focused on an analysis of the manner in which regulation and monitoring could best be implemented and performed in practice. Measures such as capital requirements, deposit insurance and non-bank activity regulation were carefully examined.

1.9.4.2 Advanced Techniques in Stress Testing Seminar (Frankfurt, Germany)

To ensure that the Department stays abreast of global developments in stress-testing practices the Department will continue to work closely with other regulators, where possible, and to develop staff. To achieve this, staff attended the 3rd Stress Testing Expert Forum: Advanced Techniques in Stress Testing Seminar,[8] hosted by the IMF in Frankfurt, Germany, during May 2009. Attendance not only provided the opportunity to network with stress-testing experts from other supervisory agencies and institutions, but also provided detailed information regarding best practice in stress testing as performed by banks and supervisors.

Areas that received particular attention at the seminar included the following:

- The importance of the interaction between risk types (e.g., a spillover from a credit risk scenario to liquidity risk).
- Understanding the impact of the feedback loop between the real and financial economy.
- The importance and complexity of understanding the possibility of spillover between banks.
- The impact of globalisation in terms of cross-border effects.
- Pillar 3 disclosure.

1.9.4.3 Toronto Centre Crisis Preparedness Programme

programme also focused on the importance of a crisis management plan within a financial system

In August 2009 the Toronto Leadership Centre, in partnership with the World Bank, organised a Crisis Preparedness Programme hosted by the Sveriges Riksbank in Stockholm, Sweden. The programme, which was designed for financial regulators and supervisors, central bankers, deposit insurance and senior micro-finance officials, and attended by a representative of the Department, afforded participants the opportunity to participate in a full-scale financial market crisis simulation exercise. Participants

8 www.imf.org/external/np/mcm/financialstability/conf/051909.pdf.

assumed and practised the roles of monetary policy-makers in central banks, supervisory or regulatory authorities and deposit insurance corporations in managing a crisis arising from problems in a potential systemic financial institution. The programme also focused on the importance of a crisis management plan within a financial system. The discussions during the programme focused on the following key issues:

- *Contingency or crisis management planning for financial supervisors*: Contingency planning by financial supervisors enables them to be prepared for events that could destabilise the financial system and result in a financial crisis. Planning for unexpected events in the future, such as disasters and terrorist attacks, enables supervisors to better manage, mitigate or prevent real crises when they emerge. This could result in lower costs during a real crisis and encourages more effective supervision. Accordingly, the main objectives for contingency planning by financial supervisors are to place them in a better position to detect a crisis, to avoid or mitigate crises and to be able to manage a crisis should it occur. It was highlighted that every crisis is unique and a contingency plan cannot accommodate every potential crisis that could take place. Contingency planning is also time consuming and requires a continuous effort by, and utilisation of, senior resources to keep the plan up to date and efficient.

- *Elements of a good contingency plan*: The following aspects were covered:

  – *Understanding the financial system and the systemically important players in the system*: This could be achieved through the evaluation of financial institutions and market vulnerabilities. The major sectors and exposures within the financial system should be identified, as well as the major entities such as the payment and settlement systems. It is also important to set the basic framework and understand which entities are systemically important and to understand the major linkages within the financial system, locally and internationally. The process should enable authorities to assess the immediate impact of a crisis shock on the financial system and the channels by which it would be transmitted to other parts of the system. The different authorities involved should have a shared understanding of the criteria that will be employed to perform the aforementioned assessment and the threshold at which a problem will be judged as systemic, justifying public intervention. A framework for systemic assessment will facilitate the prioritisation of information gathering and sharing, and decision-making.

  – *Understanding the internal and external risks to the financial system*: This could be referred to as 'macroeconomic surveillance' of the financial system by identifying internal and external risks, and by monitoring any changes in the risk areas. Periods of rapid growth in credit, asset values and capital flows would be sufficient cause for concern. It is therefore critical to conduct regular stress tests to evaluate the impact of potential risks on the financial system.

understanding the internal and external risks to the financial system

  – *Identifying the parties with whom the financial supervisor would have to co-operate during a financial crisis*: This could include other government agencies, media outlets, foreign home or host supervisors of parent companies and subsidiaries or branches of local institutions. The names and contact details of key persons and co-ordinators should be readily available and all potential sources of financial assistance should be considered and in place. It needs to be clear in advance how information-sharing, assessment and decision-making among authorities are going to work in practice during a crisis. If the process is not systematic, co-ordination will fail or the full range of considerations or options will not be taken into account in making decisions. Management of the crisis will tend

identifying the parties with whom the financial supervisor would have to co-operate during a financial crisis to be reactive, rather than proactive and strategic. Inability of the authorities to respond swiftly and decisively to a crisis will add to the public costs and the reputational damage of all parties.

reviewing the legal powers and resources for managing a crisis

– *Reviewing the legal powers and resources for managing a crisis*: This could include the evaluation of crisis preparedness arrangements and inter-agency contingency plans. A list with the main steps in managing a financial crisis should be prepared. There needs to be a review of the financial sector legislation and regulations to ensure that the powers are adequate for each step of the crisis plan to be executed and action should be taken to make the necessary changes and enhancements. All resources should be adequate to manage a crisis, and contingency plans should be in place to obtain and maintain the required resources.

preparing a crisis plan to guide supervisors and others in managing a crisis

– *Preparing a crisis plan to guide supervisors and others in managing a crisis*: All past crisis events in the country and in other countries should be researched, and all lessons learnt should be noted and considered during the development of a crisis plan. The crisis management process should be agreed in advance and tested so that those involved in the process are familiar with their roles and the process can be refined and improved.

summarising the crisis plan in a user-friendly format such as a handbook

– *Summarising the crisis plan in a user-friendly format such as a handbook*: In the event of a real crisis, time is of the essence and key guidance should be summarised in an easy-to-read document, referenced to the master plan. It should be ensured that the handbook, together with the master plan, is kept up to date at all times.

strengthening legal powers, resources and crisis planning

– *Strengthening legal powers, resources and crisis planning in response to lessons from simulations*: Crisis simulation exercises will identify weaknesses in powers, resources, planning and readiness. Therefore, it is important to follow up on all weaknesses and to address them timeously. This may require changes to existing legislation, more resources might be necessary and the crisis handbook may need updating. Crisis management plans and policies should be current and not lag behind structural changes in the system.

1.9.4.4 Advanced bank supervision seminar (Frankfurt, Germany)

seminar organised for specialists working with the advanced Basel II methods

The Deutsche Bundesbank invited the Department to attend an advanced bank supervision seminar in Frankfurt, Germany in September 2009. The seminar was organised specifically for specialists working with the advanced Basel II methods to impart knowledge and expertise on the implementation of Basel II, and to share their experiences from on-site examinations of banks that adopted the IRB approach.

The seminar was attended by participants from 19 different countries and the topics that were covered included the following:

- The IRB approach, its approval processes and subsequent monitoring.
- Recent regulatory developments regarding CRAs. The discussions focused on the future role of external ratings in the calculation of banks' required capital.
- Credit risk mitigation instruments used in different countries. Common findings from on-site examinations were also shared among participants.
- Treatment of securitisation exposures, with special attention being placed on the proposals by the Basel Committee to enhance the Basel II framework relating to re-securitisation structures and liquidity facilities provided by banks.

1.9.4.5 Financial regulation and supervision seminar (Cambridge, United Kingdom)

A representative of the Department attended a financial regulation and supervision seminar in September 2009 which was hosted by Central Banking Events at Clare College, Cambridge, in the United Kingdom (UK). The seminar focused on three broad themes in respect of which participants discussed and shared their views namely:

seminar focused on three broad themes

- Lessons learnt from the financial crisis which covered, among other things, measures under consideration by the Basel Committee and the FSB, and how these measures would impact on national supervisors. In addition, there were discussions on the challenges of home-host supervisory co-ordination.
- New regulatory directions focused on changes to Basel II, frameworks for dealing with troubled financial institutions and a regulatory approach to hedge funds and OTC derivatives. There were also discussions on transparency, disclosure, accounting and valuation rules.
- Financial infrastructure and stress testing, which also included discussions on credit risk and financial stability, valuation models, capital and liquidity.

1.9.4.6 Financial Stability Institute seminar on operational risk management and the recent financial crisis (Basel, Switzerland)

The FSI hosted a seminar on Operational Risk Management and the Recent Financial Crisis in Basel, Switzerland, from 13 to 15 October 2009. The seminar was targeted at banking supervisors who are responsible for developing policy and/or supervising operational risk management. The objective of the seminar was to discuss the latest developments on operational risk management in the context of the financial crisis. In particular, the seminar provided a forum, in which a member of the Department participated, to discuss the following topics:

objective of the seminar was to discuss the latest developments on operational risk management

- Lessons for operational risk regulation and supervision arising from the financial crisis.
- Current operational risk management practices at banks.
- Operational risk loss data collection and AMA implementation during the financial turmoil.
- Recent trends in operational risk events (fraud, legal risk and issues arising from bank restructurings).
- The 2008 Basel Committee loss data collection exercise.
- Current work on Basel II implementation.

1.9.4.7 Financial Stability Institute seminar on supervisory standards and select financial stability issues (Basel, Switzerland)

The FSI held a seminar on supervisory standards and select financial stability issues in Basel, Switzerland, in November 2009 to which the Department was invited. The topics discussed during the seminar included the following:

- An overview of banking soundness and financial stability covering the interaction between accounting standards and prudential regulation, the interaction between the financial sector and the real economy, the nature of systemic risk and the cost of crises and financial instability (including the cost of the dislocation of markets/intermediation and the disruption of investment and consumption patterns).
- A central bank perspective on maintaining financial stability.
- An overview of the Core Principles and the implementation and assessment processes relating thereto, including the FSAP and the ROSC.

- The IMF's perspective on global financial stability and the challenges ahead.
- The insurance core principles and response of the IAIS to the global financial crisis. The key objective of the IAIS is the promotion of global financial stability through policyholders' protection and the promotion of efficient, fair, safe and stable insurance markets. This is achieved, *inter alia*, through the development of principles, standards and guidance, encouraging the implementation of the principles and standards, the development of assessment methodologies, encouraging co-operation amongst insurance supervisors, co-operation with other international organisations and being the representative for insurance supervision.
- An overview of current issues in governance and financial stability.
- The objectives and principles of securities regulation and response of the IOSCO to the global financial crisis. The key objectives of securities regulation included investor protection, fair efficient and transparent markets and the reduction of systemic risk. IOSCO's response to the global financial crisis entailed setting up task groups to deal with various topics, including unregulated entities with specific focus on hedge funds, unregulated markets and products focusing on securitised products, short selling, supervisory co-operation and a review of the IOSCO principles.
- Industry views on compensation practices, corporate governance and financial stability.
- Lessons learnt from the global financial crisis from a CRA's perspective and the role of CRAs. The case for regulation of CRAs was also discussed.
- The recent financial crisis and the Basel Committee's response thereto.
- Systemic risk and a macroprudential framework for supervision, including stress testing.

1.9.4.8 Financial Stability Institute seminar on practical techniques to implement Basel II (Basel, Switzerland)

seminar on practical techniques to implement Pillar 2

A representative of the Department attended a seminar on practical techniques to implement Pillar 2. The seminar, which was hosted by the IMF was held in Basel in November 2009, covered the following topics:

- Latest work of the Basel Committee on Pillar 2 implementation.
- Economic capital in a banking institution.
- Current trends and developments in economic capital and internal capital-adequacy assessment processes (ICAAPs) at banks.
- Implementation of Pillar 2 and its linkages with stress testing.
- ICAAPs analysis and Pillar 2 approach.
- Aspects of Pillar 2 supervision related to financial conglomerates.
- General principles of economic capital models.
- Implementation of Pillar 2 in various jurisdictions.
- A case study on practical techniques to implement Pillar 2.

The presenters were from the financial industry, accounting and consulting firms, banks, central banks and supervisory agencies. Interventions such as these provide invaluable input to benchmark South Africa's Pillar 2 implementation against best practice.

1.9.5 Regional co-operation

1.9.5.1 Regional Seminar on Consolidated Supervision

The FSI invited the Department to attend a regional seminar on consolidated supervision, jointly hosted by the FSI and the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), in Lusaka, Zambia, in October 2009. A senior representative of the Department attended the seminar and presented two topics, namely

- Supervision of financial groups: the South African perspective; and
- Capital-adequacy principles for a financial conglomerate.

Other important topics covered at the seminar included the scope and application of Basel II, accounting issues, aspects of risk and capital assessment as well as cross-border issues and home-host relationships. Presenters of these topics were sourced from the FSI, the FDIC in the US, the Office of the Superintendent of Financial Institutions (OSFI) in Canada, the Reserve Bank of India, the Reserve Bank of Nigeria, the Reserve Bank of Zimbabwe and Standard Chartered Bank Zambia Plc.

important topics covered at the seminar

The seminar was attended by 22 senior delegates from 12 different southern African countries. All delegates contributed to the success of the seminar and valuable information was shared between supervisors of the African region in the round table discussions that took place in the course of the seminar. Delegates were able to share and better understand the challenges supervisors face throughout the Africa region, and attained valuable knowledge and additional skills to facilitate the implementation and/or further enhancement of consolidated supervision in their various jurisdictions.

1.9.5.2 Risk-based supervision on Basel II implementation

The Department participated in a workshop in September 2009 under the auspices of MEFMI in Tanzania on risk-based supervision. The participants at the workshop represented eight African countries. The objectives were, firstly, to focus on ensuring compliance with Basel I, especially in respect of implementing a capital charge for market risk and, secondly, to share the Department's experience on the implementation of Basel II. The following topics, which were presented by a senior official of the Department, were discussed:

workshop on risk-based supervision

- The South African experience: IRB credit model approvals
  - Stages in implementation.
  - Accord Implementation Forum.
  - Process followed for IRB applications.
  - Home/Host involvement and reliance.
  - Post Basel II Implementation.

- Pillar 1: Challenges in implementing IRB
  - How well are banks implementing IRB.
  - Evaluating internal and regulatory capital requirements.
  - Challenges in validating models.

- Pillar 1: IRB: Implications for supervisors
  - Historical loss data.
  - Gaps in data maintained for banks.
  - Checklist for supervisors.
  - Recognition of external credit assessment institutions (ECAIs).

1.9.5.3 International Monetary Fund Mission: Kenya

The IMF, through its support for the development of appropriate regulatory practices, requested assistance from the Department with the implementation of regulations for market risk in Kenya. Under the branch known as 'East AFRITAC' (East Africa Regional

implementation of regulations for market risk in Kenya

Technical Centre), the IMF arranged a mission to the Central Bank of Kenya (CBK) structured around a workshop for members of staff of the Bank Supervision Department of the Central Bank of Kenya (BSD-CBK).

The CBK, with prior assistance from East AFRITAC, had prepared their legislative framework in the form of draft market risk regulations, guidelines and returns and BSD-CBK staff had received initial training in calculating market risk exposures. BSD-CBK sought assistance in further developing its draft market risk framework and training through a review of the draft regulations, guidelines and returns. In particular, BSD-CBK staff members required training on matters relating to the use of regulatory instruments in the calculation of market risk exposures.

A senior representative of the Department conducted the workshop at CBK in October 2009. The scope of the workshop covered the nature and origin of market risk, the rationale behind capital requirements for market risk and characteristics of market risk management in banks. More specifically, the mechanics of calculating capital under the standardised approach to market risk was illustrated in detail. Recommendations were made with regard to the elements of the regulatory framework and the processes involved in conducting appropriate supervision were explained. The mission was regarded as effective and subsequent interaction between the bank supervision departments of the South African and Kenyan central banks was planned for 2010.

1.9.5.4 Meeting with Namibian regulators

the Department met with senior banking supervision representatives of the Bank of Namibia

In August 2009, representatives of the Department met with senior banking supervision representatives of the Bank of Namibia (BoN). The objectives of this meeting were to:

- discuss the general impact of the global financial crisis;
- share the Department's experiences of the key challenges of implementing Basel II, including the results of the Department's assessment and analysis of the so-called "parallel runs", whereby banks were required to submit both the existing and proposed statutory returns.
- Inform the BoN of the proposed amendments to the Regulations relating to Banks, as a result of, among other things, recent publications issued by international standard-setting bodies, such as the Basel Committee, the FSB and the G-20, and the evolvement of the latest risk management practices;
- present an in-depth overview to the BoN of the Department's assessment of the adequacy of a bank's capital, including the key challenges in performing such an assessment;
- discuss the impact of the Basel II requirements on the licensing of new banks; and
- discuss the use and regulation of commercial paper in South Africa.

The BoN found the discussions beneficial as it was in the process of phasing in the implementation of the Basel II standardised approaches in Namibia.

1.10 Issues to receive particular attention during 2010

In addition to fulfilling its normal supervisory and regulatory tasks, the Department will focus specifically on the following issues during 2010:

- Ongoing review and amendment of the banking legislative and regulatory framework in South Africa to ensure that it reflects local and international market developments and complies with international regulatory standards, including responses by various standard-setting bodies in order to address specific weaknesses revealed by the financial crisis.

- Continued refinement of the Department's supervisory review and evaluation processes.

continued refinement of the Department's supervisory review and evaluation processes

- Continued participation in the various international fora to formulate further internationally-agreed requirements to strengthen the resilience of the banking sector.
- Participation in the Basel Committee's comprehensive quantitative impact assessment of the capital and liquidity standards proposed in the consultative documents released in December 2009.
- Further development and implementation of the Department's common scenario stress-testing methodology and process in respect of banks' capital adequacy and liquidity.
- Continued performance of thematic reviews focusing on backtesting of credit risk models.

thematic reviews focusing on backtesting of credit risk models

- Ongoing monitoring and assessment of the potential impact on the banking sector of the international framework for liquidity risk measurement as proposed by the Basel Committee.
- An assessment of the degree of proprietary risk taken by banks through trading off the banks' capital base and the level of residual risk resulting from client business and through market-making.
- Ongoing focused reviews of banks making use of advanced approaches to calculate credit risk, market risk and operational risk capital requirements.
- Continued monitoring of banks' compliance with AML/CFT legislation.
- Continued investigation of illegal deposit-taking by unregistered institutions and persons, and participation in consumer education initiatives.
- Ongoing training of staff to meet the challenges of the changing regulatory and supervisory landscape.

ongoing training of staff

1.11 Expression of gratitude

I wish to express my appreciation to both the previous and current Ministers of Finance, Mr Trevor Manuel and Mr Pravin Gordhan respectively, for their valued input on requests in terms of statutory requirements and in terms of ongoing general counsel. To the previous Governor of the Bank, Mr Tito Mboweni, the current Governor, Ms Gill Marcus, and Deputy Governor Xolile Guma, thank you for your co-operation, guidance and support during 2009. A word of thanks also to my colleagues with whom I serve on the Governors' Executive Committee of the Bank.

During 2009 the Department also continued its close co-operation with several individuals and organisations, locally and abroad. These include, to name but a few, 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, 1990; the Chief Executive of the Financial Services Board and his staff; the Basel Committee; the FSI; central bankers and bank supervisors, both in southern Africa and elsewhere in the world; and staff of other departments of the Bank.

Last, but not least, my sincere appreciation goes to the staff members of the Department who continued their efforts, with professionalism and enthusiasm, during a year filled with ever-increasing challenges and demands.

Errol M Kruger
Registrar of Banks