South African Reserve Bank

Bank Supervision Department

Annual Report 2009
Bank Supervision Department

Executive summary of the contents of the *Annual Report* 2009 *(summary consisting of 16 pages)*

1. Introduction

The year under review again brought with it a challenging operating environment for the banking sector, characterised by a cyclical downturn in domestic economic conditions which were worsened by the aftermath of the international financial market crisis. However, notwithstanding these difficult circumstances, the banking system remained stable and profitable, and capital levels were adequate throughout 2009.

From an international regulatory and supervisory perspective, 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) 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.

2. Chapter 1

This chapter sets out the standard-setting bodies' key responses to the international financial market turmoil. It presents a high-level overview of key banking-sector trends, including the level of concentration in the banking sector, and it contains the steps taken by the Department to address the main findings of the International Monetary Fund (IMF) Article IV Consultation Staff Report (the Staff Report). Furthermore, 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 is reviewed and an overview of the Financial Stability Institute (FSI) high-level meeting on developments in financial markets and supervisory responses is provided. 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.

The following paragraphs provide further salient information pertaining to some of the aforementioned key topics:

2.1. Concentration in the South African banking system

The level of concentration in the South African banking sector, measured using the Herfindahl–Hirschman Index (the H-Index).[1] The H-index amounted to 0,189 at the end of December 2009 (December 2008: 0,189). The H-index has remained high due to the continued dominance in terms of market share by the four largest banks in South Africa. The total balance sheet of these 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).

2.2. International Monetary Fund Article IV Consultation 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. This report broadly described the South African 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. Key findings listed in the Staff Report, all of which are in the process of being addressed by the Department, included the following:

- Credit risk to the banking system was mitigated by supportive macroeconomic policies such as the easing of monetary policy during the period, coupled with more stringent bank loan origination standards and a decline in the demand for credit, which moderated credit growth.
- South African banks' reliance on short-term wholesale corporate deposit funding was again highlighted and described as a long-standing structural risk.
- The dominance of the financial system by a few large financial conglomerates with cross-border share holdings and cross-sector activities posed structural risk.
- South African banks' probabilities of default had increased, but were significantly lower than those of several large international banks based in mature economies.
- The supervision of banks, including the assessment of banks' stress-testing practices, risk models and risk management practices had generally been intensified since late 2008 in response to rising financial sector risks.

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

In 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

[1] 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.

the FATF and the Eastern and Southern Africa Anti-Money Laundering Group. The key findings of the mutual evaluation report (MER) were discussed by the Financial Intelligence Centre (FIC) with private- and public-sector stakeholders. Key findings listed in the full MER included the following:

- Provisions for criminalisation of the financing of terrorism were comprehensive.
- The 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.

Furthermore, the MER highlighted a number of general areas where the South African AML/CFT framework could be enhanced further, including the following:

- Customer due diligence conducted by financial and other institutions.
- 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.
- The transparency of the ownership and control structures of legal persons and trusts.
- Protection of non-profit organisations from abuse for the purpose of laundering money and financing terrorism.

2.4. Financial Stability Institute: High-level meeting on recent developments in financial markets and supervisory responses

The FSI, jointly hosted a high-level meeting in January 2009 with the Department which was focused on developments in financial markets and supervisory responses thereto. The meeting was attended by the heads of supervisory authorities from various countries on 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. Topics covered at the meeting included the following:

- A high-level synopsis of the United States (US) Federal Reserve System's response to the financial market crisis.
- The role of the Committee of European Banking Supervisors, with particular focus on its role during the financial market crisis.

- 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 efforts and initiatives of the US Treasury and the Federal Deposit Insurance Corporation in response to the financial market crisis.
- The role of credit-rating agencies (CRAs) and the regulatory approach towards CRAs.
- The similarities and differences between International Financial Reporting Standards and prudential regulation.
- The World Bank's response to the financial market crisis and the implications for risk-based supervision.
- Challenges for supervisors with regard to the implementation of Basel II.
- The impact of the financial market crisis from a South African perspective.

2.5. Incentive schemes of banking institutions

The Department conducted a thematic review of all South African banks' incentive schemes during 2008 and found that South African banking organisations generally had 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.

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) in addition to its Compensation Principles. The Compensation Standards prioritise areas that should be addressed by banking institutions and supervisors to achieve effective global implementation of the Compensation Principles.

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, the Compensation Principles and the Compensation Standards will be considered for incorporation into the amended banking legislative and regulatory framework that is anticipated to become effective in 2011.

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

Fundamental weaknesses in international financial markets were revealed by the international financial market crisis that started in 2007. In response to these weaknesses, international standard-setting bodies such as the Group of Twenty Finance Ministers and Central Bank Governors (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 July 2009 the Basel Committee 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, among other things,

- 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.

On 25 September 2009, following the Pittsburgh Summit, the G-20 issued a leaders' statement in which they agreed to, among other things, the following:

- Ensure that the regulatory system for banks and other financial firms reins in excessive risk-taking that led to the crisis.
- Act together to
  - raise capital standards;
  - implement strong international compensation standards aimed at ending practices that lead to excessive risk taking;
  - improve the over-the-counter (OTC) derivatives market; and
  - create more powerful tools to hold large global firms to account for the risks they took.
- Strengthen prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges and reinforcing international co-operation.
- Enhance and expand the scope of regulation and oversight, with tougher regulation of OTC derivatives, securitisation markets, CRAs and hedge funds.
- 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.
- Conduct robust and transparent stress tests as needed.
- Strike an adequate balance between macroprudential and microprudential regulation to control risks.

In December 2009 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 in December 2009 form part of the Basel Committee's comprehensive response to address the lessons learnt from the crisis related to the regulation, supervision and risk management of global banks.

In this regard, the Basel Committee is initiating a comprehensive impact assessment of the capital and liquidity standards proposed in the consultative documents. 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 during 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. 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 a view to implementation by the end of 2012.

2.7. Participation in international regulatory or supervisory fora

The Department is represented on, and contributes to, various international regulatory and supervisory fora, including the following:

- The Southern African Development Community (SADC) Subcommittee of Banking Supervisors (SSBS), a subcommittee of the Committee of Central Bank Governors (CCBG) in SADC, which focuses on issues such as the effective implementation of the Core Principles for Effective Banking Supervision (the Core Principles) by supervisors in the SADC region, training of supervisors, and the effective implementation and ongoing enhancement of risk-based supervision.
- 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.
- The Standards Implementation Group Operational Risk, a permanent working group of the SIG that focuses on operational risk implementation issues.
- The Trading Book Group which focuses 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.
- A work stream of the Basel Committee focusing on microfinance with the objective of identifying 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.
- The Basel II Capital Monitoring Group that shares national experiences in monitoring capital requirements and considers issues such as measures to ensure that banks maintain a solid capital base throughout the economic cycle.

2.8. Skills development

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.

2.9. Regional co-operation

The Department continued to be involved at a regional level in providing input and training to regulatory counterparts in neighbouring Africa countries. These interactions included the following:

- o In August 2009 representatives of the Department met with senior banking supervision representatives of the Bank of Namibia to share the Department's experience with regard to various matters, including the
- o general impact of the global financial crisis;
- o key challenges of implementing Basel II;
- o proposed amendments to the Regulations relating to Banks;
- o Department's assessment of the adequacy of a banks' capital, including the key challenges in performing such an assessment;
- o impact of the Basel II requirements on the licensing of new banks; and
- o use and regulation of commercial paper in South Africa.

- In September 2009 the Department participated in a workshop on risk-based supervision under the auspices of the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) in Tanzania. The participants at the workshop represented eight African countries. A senior official of the Department delivered presentations to participants on the South African experience with regard to IRB credit model approvals and the challenges experienced by South African banks in implementing the IRB approaches in calculating regulatory capital.

- The Department attended a regional seminar on consolidated supervision, jointly hosted by the FSI and the MEFMI, in Lusaka, Zambia, in October 2009. A senior representative of the Department presented two topics, namely the supervision of financial groups and capital-adequacy principles for a financial conglomerate.

- The Department was requested by the IMF, through its support for the development of appropriate regulatory practices, to assist with the implementation of regulations for market risk in Kenya. A senior representative of the Department conducted a workshop for staff of the Bank Supervision Department of the Central Bank of Kenya 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.

2.10. 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 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.
- 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.

3. Chapter 2

In order to achieve one of its key objectives, namely, to promote the soundness of the banking system, the Department performs an extensive range of supervisory activities, some of which are discussed in more detail in Chapter 2 of the report under the following main headings:

- Activities relating to the supervision of Pillar 1 risks:
  - Credit risk
  - Market risk
  - Operational risk
- Supervisory activities under Pillar 2
  - Review of banks' internal capital-adequacy assessment processes
- Developments in respect of Pillar 3 disclosure
- Developments in respect of stress testing
- Consolidated supervision.

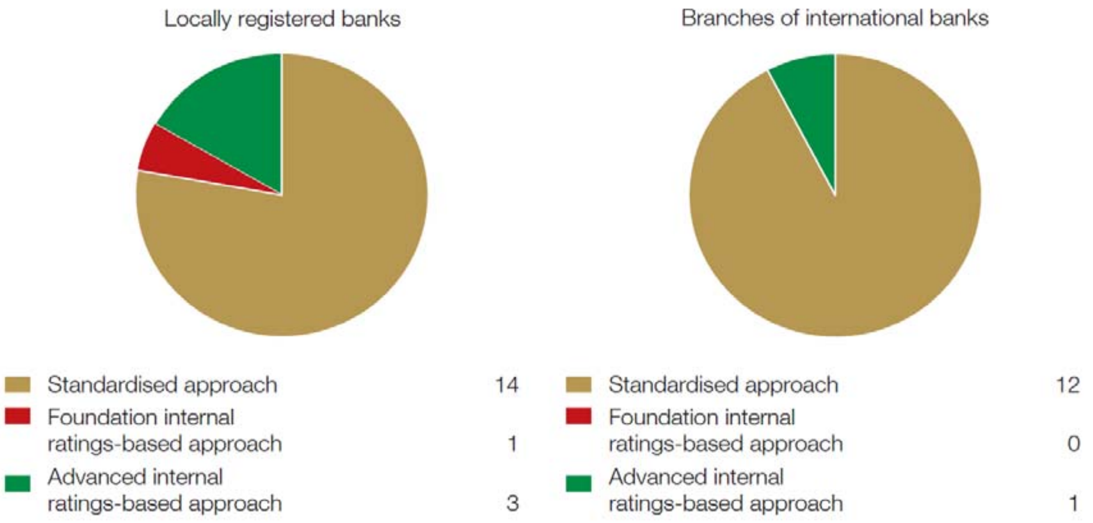
Chapter 2 furthermore contains information regarding various reviews performed and surveys initiated by this Department during 2009 and provides details of the key findings thereof, as well as further actions to be taken in that regard. In addition, the reassessment of eligible credit assessment institutions and the processing of banks' applications to implement new or revised models and rating systems, to calculate regulatory capital in respect of credit risk, market risk and operational risk are discussed.

The following paragraphs provide further salient information pertaining to some of the aforementioned key topics:

3.1. Credit risk

Under Pillar 1, banks in South Africa can choose from a menu of approaches to determine the minimum required regulatory capital relating to credit risk. As at 31 December 2009 South African banks implemented the following approaches:

Figure 2.1 Number of banks per credit risk approach (December 2009)



The credit risk-related work carried out by the Department during 2009 covered the following:

- Quantitative analysis, which included a credit risk survey and an assessment of the impact of an economic down-turn on banks' capital relative to their level of credit risk exposure.
- Review of IRB self-assessment templates submitted by banks to assess their compliance with the minimum IRB requirements as prescribed in the Regulations relating to Banks.
- Focused reviews of standardised approach (SA) requirements for credit risk to assess the degree of compliance by each bank with the SA requirements prescribed in the Regulations relating to Banks.
- Focused credit risk on-site reviews of IRB requirements.
- Processing of applications by banks to implement new or revised models and rating systems.
- Reassessment of eligible external credit assessment institutions (credit rating agencies).

3.2. Market risk

The Regulations relating to Banks include two alternative reporting methods for market risk, namely the internal models-based approach (IMA), and a standardised approach. Under approved circumstances, banks are also permitted to apply a combination of standardised and models-based reporting. At present five of the twenty-six banks exposed to market risk have permission to report according to the IMA.

Market risk reviews conducted in 2009 by the Department concentrated on banks with approval to use the IMA for regulatory reporting, while a review of the trading activities of one bank was also conducted. No new applications for using the IMA were received or processed.

Furthermore, liquidity risk management formed the basis of the Department's annual meeting with the boards of directors of banks during 2009. The Department required banks' senior management to assess their bank's compliance with principles for liquidity risk management as set out in the Basel Committee's paper *Principles for Sound Liquidity Risk Management and Supervision*, issued in September 2008. In addition, the Department initiated a thematic review of the asset and liability management (ALM) process at banks, examining the durability of liquidity risk management in the current turbulent financial climate and in the future under increasingly stressed circumstances.

3.3. Operational risk

The Department promotes sound operational risk management practices at banks and banking groups since they, in turn, contribute significantly to enhancing the soundness of the banking system. The operational risk-related work completed during 2009 includes the following:

- Operational risk reviews that focused on the following:

  - An update of changes in the business environment (with specific reference to internal and external fraud, pressure on processes, exposure to business continuity risk, outsourcing risk as a result of service providers, operational risk related to credit and market risk) and the bank's response to it from an operational risk perspective.
  - A detailed review of the management information reports or "dashboards" used for operational risk management on a group consolidated, bank, major subsidiary and material business unit level.
  - For advanced measurement approach (AMA) banks, a detailed review of the scenario approval, governance process and specific scenarios used by the bank in the AMA.

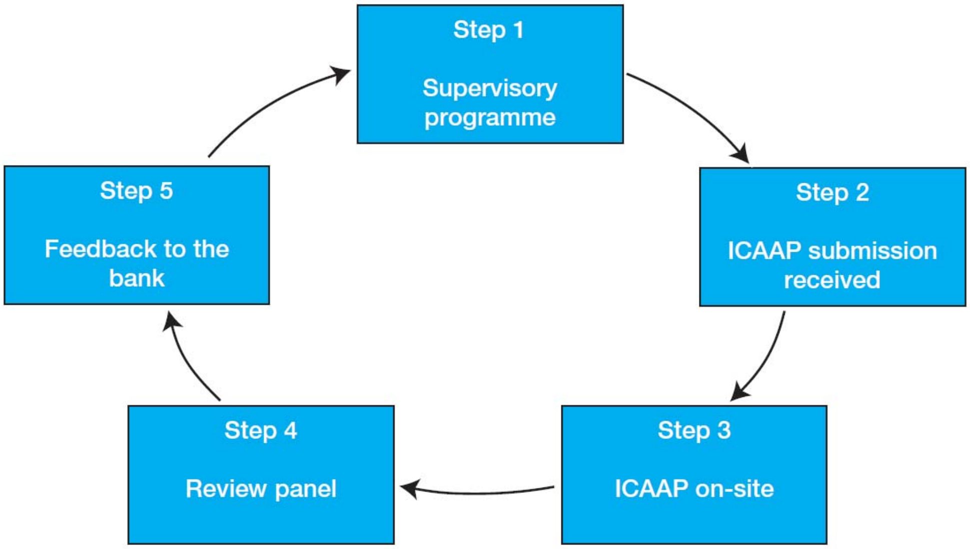
- Processing of a new application received from one of the registered banks to use AMA.

- During 2009 the Department provided participating South African banks with a customised analysis comparing their data with industry data at both the international, and where possible, regional or national levels. This was the result of an international operational loss data collection exercise (LDCE) that was performed in 2008.

3.4. Internal capital-adequacy assessment process

The adequacy of a bank's and banking group's capital needs to be assessed by both the particular bank and the Department. In terms of the Banks Act, 1990 (Act No. 94 of 1990) (the Banks Act) and the Regulations relating to Banks, banks and banking groups are required to perform an internal capital-adequacy assessment process (ICAAP) and the Department is required to carry out a supervisory review and evaluation process (SREP). The process for the assessment of an ICAAP can be illustrated as follows:

Figure 2.4 Process for the assessment of an ICAAP



Step 1: The supervisory programme is communicated to the bank together with an ICAAP submission and on-site dates.

Step 2: The Department receives the ICAAP submission on the due date. Desktop analysis of the submission is done. Communication takes place between the Department and the bank to clarify specific areas (i.e., where areas of uncertainty exist with regard to the submission or more clarity is requested). The information received is compared with the information gathered from the SREP cycle.

Step 3: The results of the desktop analysis and ICAAP submission are discussed with the bank. The bank and the Department challenge each other on their findings to ensure that a structured dialogue takes place. A conclusion is reached on the way forward. More detailed reviews may be requested on specific areas.

Step 4: The conclusion is presented to the Department's review panel for consideration. The review panel decides on the conclusion to be presented to the bank.

Step 5: The conclusion is presented to the bank and the bank is afforded an opportunity to comment.

During 2009 the Department concluded various thematic reviews of the larger banks and also commenced ICAAP reviews in respect of certain of the smaller banks. This process will be continued during 2010.

3.5. Developments in respect of Pillar 3 disclosure

With regard to Pillar 3 disclosure, the Department determined and performed an analysis of the level of disclosure by banks in South Africa. Banks that were found not to be disclosing appropriately and where the frequency of disclosure was not in accordance with the provisions of regulation 43 of the Regulations relating to Banks were identified and formally informed by the Department of their non-compliance and/or of those areas where deficiencies were identified. Emphasis was placed on small and medium banks in terms of the analysis of the disclosures.

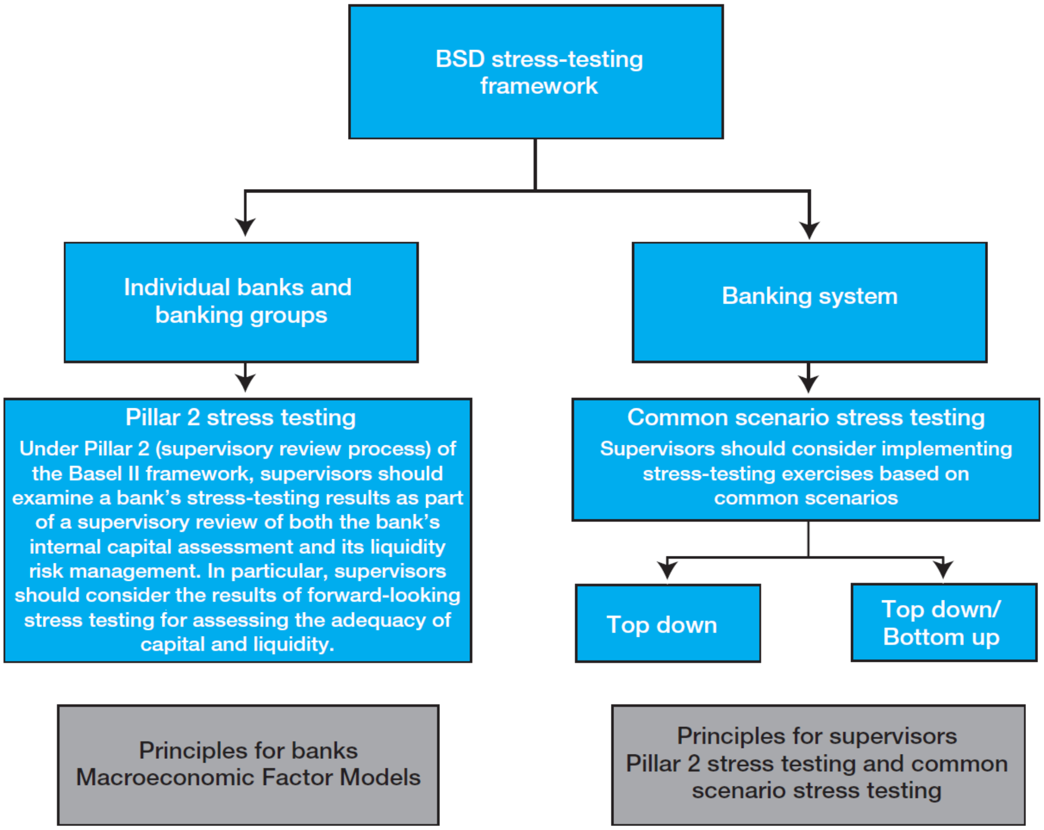
Furthermore, a template was developed in order to analyse banks' Pillar 3 disclosures. The purpose of the disclosure template is to benchmark the Pillar 3 disclosure requirements of banks against the requirements of the Regulations relating to Banks and best practice applied by the industry. This benchmarking process will be a focus area in 2010.

3.6. Stress testing

Stress testing, as defined by the Basel Committee is a risk management technique that is used to evaluate the potential effects of a specific event and/or movement in a set of financial variables on an institution's financial condition. As capital resources fall and as regulatory capital requirements are likely to rise in times of stress, stress testing is a key tool used by the regulator in understanding the appropriate level of regulatory capital to ensure that banks remain solvent during difficult times.

From a supervisory perspective, it is of paramount importance that the Department objectively establishes that South African banks are capitalised adequately. In this regard, the capital buffer, as confirmed in the stress-testing approach, forms a major element. Stress testing is an important input to the capital-adequacy process and decisions concerning the adequacy of capital buffer requirements.

The overall stress-testing framework of the Department can be summarised as follows:


BSD stress-testing framework
Individual banks and banking groups
Banking system
Pillar 2 stress testing
Under Pillar 2 (supervisory review process) of the Basel II framework, supervisors should examine a bank's stress-testing results as part of a supervisory review of both the bank's internal capital assessment and its liquidity risk management. In particular, supervisors should consider the results of forward-looking stress testing for assessing the adequacy of capital and liquidity.
Common scenario stress testing
Supervisors should consider implementing stress-testing exercises based on common scenarios
Top down
Top down/ Bottom up
Principles for banks Macroeconomic Factor Models
Principles for supervisors Pillar 2 stress testing and common scenario stress testing

As depicted in the figure above, the Department's stress-testing framework consists primarily of two main work streams, the first focusing on the stress-testing frameworks of banks and the second on common scenario stress testing performed by the Department.

The Department utilises the information obtained from the first work stream to construct a common scenario, and top-down and bottom-up stress-testing methodology. Interaction also takes place with the industry and the Research Department of the South African Reserve Bank on the construction of a severe common scenario to be used. Banks are then required to apply the aforementioned scenario in their macroeconomic factor models and to report the results, in a specified format, to the Department. In this regard the Department performed various thematic stress-testing reviews during 2009 and findings were communicated to the relevant banks.

3.7. Consolidated supervision

During the year under review the Department proactively took the following actions to further improve the consolidated supervision of banking groups:

- Regular supervisory meetings between the Department and the Financial Services Board were instituted for the three largest significant systemic banking and insurance groups in order to enhance information sharing, identify issues of mutual relevance and to work together towards greater consistency of approach.

- The Department took a policy decision to allow only the acquisition or establishment of cross-border banking operations (inwards and outwards) in instances where a memorandum of understanding (MoU) with the cross-border banking supervisor had been concluded. MoUs are entered into with local and foreign supervisors as a more formalised approach to share information and to protect the confidentiality of such information.
- The Department is planning to host a supervisory college in 2010 with those African supervisors in whose countries South African banking groups have a presence.
- In order to improve the supervision of banking groups on a consolidated basis, the Department recommended to one of the large banking groups to undergo a restructure, which restructuring would enable the Department to supervise the entire conglomerate, which was not previously the case. It is expected that the said restructure will be concluded in the course of 2010.

4. Chapter 3

A key responsibility of the Department is to ensure that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant and current. Consequently, the legal framework pertaining to banking regulation has to reflect local and international market developments, and to comply with the applicable international regulatory and supervisory standards and best practice. The Department is therefore required to review the banking legislation, that is, the Banks Act, 1990, the Mutual Banks Act, 1993 (Act No. 124 of 1993), the Regulations relating to Banks issued in respect thereof and other pieces of related banking legislation on an ongoing basis, and to make recommendations to the Minister of Finance to effect the necessary amendments.

Chapter 3 provides an overview of the key initiatives monitored and developments considered by the Department, and details of proposed amendments to the Banks Act, 1990, and the Regulations relating to Banks. Furthermore it includes information relating to illegal deposit-taking, the new Companies Act, Co-operative banks, Postbank and the King report on corporate governance for South Africa. Furthermore, it contains the Board of Review's decision taken in the review of the Registrar of Banks' decision in respect of an application for authorisation to establish a bank.

5. Chapter 4

Chapter 4 of the report features trends in the South African banking sector that are predicated on risk-based information submitted by banks during 2009. The following are some of the key highlights:

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, namely Ithala Limited) and 42 international banks with authorised representative offices in South Africa.

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 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.

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.

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 and return on assets 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).

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, 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.

6. Appendices

Appendices 1 to 5 and 7 to 10 contain useful administrative information pertaining to the banking sector. Appendix 6, in turn, contains 24 tables detailing extensive financial data predicated on risk-based information submitted by banks over a 24-month period ending December 2009.