# Chapter 2: Overview of supervisory activities

## 2.1 Introduction

This chapter provides an overview of the day-to-day activities performed by the core divisions and sections of the Department during the period under review. These include the various risk specialist divisions, consolidated supervision, the review team, Pillar 3 disclosure and the Financial Stability Unit. Key Pillar 1 risks, namely credit, market and operational risk, and Pillar 2 supervisory activities, particularly with regard to liquidity risk, are also discussed. In addition, an overview of the Internal Capital Adequacy Assessment Process (ICAAP) reviews performed by the Department, including key findings, is provided. A synopsis is provided of both the Pillar 3 disclosure reviews performed during 2011 and the key initiatives related to consolidated supervision. Finally, certain key concepts related to the macroprudential supervisory approach followed by the Department are discussed.

## 2.2 Credit risk

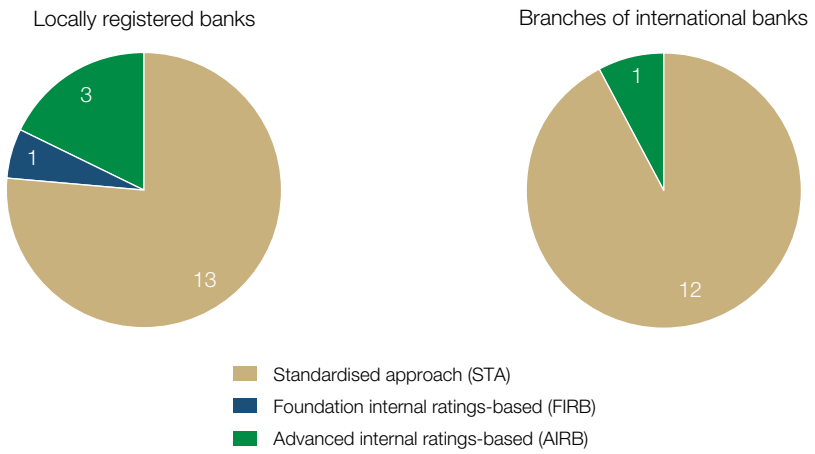
### 2.2.1 Prescribed methodologies

Under the regulatory framework employed in South Africa, banks can choose from the following three methodologies to calculate their minimum required regulatory capital relating to credit risk:

1. STA,[45] including the simplified standardised approach;
2. the foundation internal ratings-based (FIRB) approach; and
3. the advanced internal ratings-based (AIRB) approach.

The number of banks registered in South Africa using each of the aforementioned approaches is depicted in Figure 2.1.

Figure 2.1 Reporting methods applied by banks




45 STA, applicable to credit risk, is not to be confused with the TSA, which applies to operational risk (section 2.4 of this Report).

## 2.2.2 Amendments to the credit risk statutory returns

changes were made to the credit risk returns

One of the key focus areas during 2011 was the quality of regulatory reporting, with specific emphasis on the interpretation of some key aspects of the credit risk-related regulations. Discrepancies and inconsistencies were identified through trend analysis of credit risk data submitted by banks, external audit reports and peer-group analysis. Guidance was provided to banks on interpretive matters. Furthermore, changes were made to the credit risk returns to (a) incorporate the enhancements to the Basel II framework; (b) refine reporting requirements; and (c) provide guidance on interpretive matters. The amendments included, among other things, the following:

- Separation of securitisation and resecuritisation information in the form BA 500 to incorporate the resecuritisation enhancements to the Basel II framework.
- Expansion of the asset classes covered in the forms BA 200 and BA 210 to provide the Department with product-specific information (for example, unsecured lending, credit cards, and vehicle and asset finance).
- The counterparty credit risk section in the form BA 200 was refined to enable better and more consistent reporting by banks.
- The quarterly reporting requirement of classified exposures for banks that report using the STA was changed to monthly.
- The Basel-specific 1,06 scaling factor and certain other IRB-specific reporting requirements were introduced for banks that report using the IRB approach.
- Additional reporting requirements relating to geographical distribution and related-party exposures were introduced in the form BA 210 based on the requirements stipulated in the Core Principles.

## 2.2.3 Developments with regard to securitisation

### 2.2.3.1 New form BA 501: Additional securitisation information requirements

Following the secondary effects of the global financial crisis, which included the worldwide collapse of securitisation markets as reported on in the 2010 *Annual Report*, the Department commissioned the audit, tax and advisory firm KPMG to conduct an investigation into securitisation schemes operated by banks in South Africa. The final report issued by KPMG suggested that certain improvements to the existing legal framework should be considered by the Department to identify those areas where amendments were required.

the form BA 501 was introduced to support and address the shortcomings in the existing form BA 500

In this regard, the form BA 501 was introduced to support and address the following shortcomings in the existing form BA 500:

- Certain issuer special-purpose institution (SPI)[46] schemes were excluded from reporting in terms of the form BA 500 owing to securitisation exposures being captured on a bank-solo level.[47]
- The reporting of extensive credit and liquidity risk information is not required by the form BA 500. This resulted in the Department not receiving sufficient information to enable it to obtain a better understanding of the risk in the South African securitisation market.

Based on the KPMG report and the consultation process followed in conjunction with the banking industry, Banks Act Directive 1/2011 was issued in May 2011.[48] The directive pertains to all issuer SPIs of traditional or synthetic securitisation schemes relating to banks, controlling

46 An SPI refers to a company incorporated or a trust created specifically for the purpose of implementing a securitisation scheme.
47 'Bank solo' means any bank incorporated in South Africa, excluding its foreign branches, subsidiaries and associates.
48 Available at http://www.resbank.co.za/Publications/Pages/Bank-Act-directives.aspx.

companies and branches of foreign institutions that were authorised by the Department to issue commercial paper in terms of the current and prior securitisation notices. In terms of the directive, all such issuer SPIs are required to furnish the Department with specific information on a quarterly basis. The directive has been applied in respect of quarterly periods since 30 June 2011.

#### 2.2.3.2 Additional information requested as part of all new securitisation applications

Securitisation schemes may be structured in many different ways and therefore pose a number of risks, irrespective of whether it is in a primary or secondary role. The Joint Forum[49] released a "Report on Asset Securitisation Incentives – July 2011" (the Report).[50] The Report not only recognises that regulators are able to play a role in the establishment of a framework for securitisation schemes that will promote the prudent management thereof, but also that such schemes continue to be an alternative funding source for institutions which, in turn, contributes to the availability of credit to support the real economy. Among other things, the Report further recommends that authorities encourage the improvement of transparency to ensure that investors, other market participants and supervisors have access to relevant and reliable information.

an information sheet should forthwith accompany new securitisation applications

In order to assist the Department in evaluating all the relevant risk factors when considering an application in terms of Government Notice No. 2, published in *Government Gazette* No. 30628, dated 1 January 2008 (the Securitisation Notice), it was decided that an information sheet should accompany each application submitted in respect of a new securitisation scheme in terms of the Securitisation Notice.

The information sheet was developed based on pre-sale reports issued by rating agencies rating the commercial paper issued by SPIs. The completion and submission of the information sheet will form part of the conditions of approval in respect of both bank and non-bank applicants. Banks Act Directive 1/2012 was issued in this regard in January 2012.[51]

### 2.2.4 Review of self-assessment templates submitted by banks

Every year, banks that have adopted the IRB approach to measure their exposure to credit risk are required to complete and submit a series of self-assessment templates in order to evaluate their level of compliance with the minimum requirements prescribed in the Regulations. During the course of 2011, these banks each submitted their self-assessment templates to the Department based on December 2010 data. The self-assessment templates were reviewed by the Department to identify any compliance gaps and exceptions.

#### 2.2.4.1 Identified gaps

No material gaps were identified in the self-assessments submitted in 2011.

#### 2.2.4.2 Identified exceptions

The following common exceptions were identified:

- Scope of documentation: The level of documentation of model parameters and policies in several banks was inadequate, thus making it difficult to assess their level of compliance with the minimum requirements of the Regulations. Most banks indicated that this exception would be addressed as part of their model rebuilding processes.

49 The Joint Forum was established in 1996 under the aegis of the Basel Committee, the International Organisation of Securities Commissions, and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.
50 Available at http://www.bis.org/publ/joint26.htm.
51 Available at http://www.resbank.co.za/Publications/Pages/Bank-Act-directives.aspx.

- Refreshing risk ratings: Some banks did not refresh their risk ratings within the one-year period specified in the Regulations. Business units remained focused on reducing the number of outdated reviews.
- Board and senior management responsibilities: The monitoring and reporting of rating systems to the board and senior management required improvement in some banks.
- Re-aging: There was no formal policy for the treatment of re-aged accounts in some banks.
- Minimum observation period: Some banks did not have sufficient data history available to estimate their internal risk parameters.

These exceptions will be monitored by the Department as part of its supervisory programme for 2012. In cases where exceptions were identified, banks were required to put in place plans to rectify their non-compliance and provide target compliance dates.

## 2.2.5 Internal ratings-based focused reviews

The Department continued to conduct focused credit risk on-site reviews in order to determine, among other things, whether the credit risk management practices of banks were sound; whether the models remained fit for purpose; and whether adequate levels of capital were being held for credit risk.

a risk-based approach was followed in selecting portfolios to be reviewed

A risk-based approach was followed in selecting portfolios to be reviewed, and the focus of these reviews as reported in the 2010 *Annual Report* (page 50), remained unchanged. During 2011 the Department received one application for use of the AIRB approach. The application and approval processes were similar to those applied in previous years, namely, a detailed review of the application pack submitted by the bank (in terms of Banks Act Guidance Note 4/2010);[52] off-site analysis of the bank's parallel run submissions; and on-site reviews. The applicant bank was granted approval to adopt the AIRB approach with effect from 1 January 2012.

A total of nine on-site meetings in the form of focused on-site reviews and the single new application review were conducted during the 2011 calendar year. The key findings of the reviews are as follows:

- Governance of model validation (recurring issue): The process followed for escalating issues to the designated committee or board of directors could be improved at certain banks. Given the importance of effective board oversight in terms of the approval of all material aspects of a bank's rating and risk estimation processes, this will remain a focus area during 2012.
- Annual validation of models (recurring issue): As reported in the 2010 *Annual Report*, it is the Department's view that appropriate processes and clearly documented policies are fundamental to effective IRB implementation. Even though banks focused on the performance of the prescribed annual validation, the backlog has not been fully resolved. The Department has also highlighted its concern with regard to the level and scope of the validation performed, and expects the banks to remain focused on improving the quality of the validations.
- Lending strategy and risk appetite setting: It was evident that the estimates from the IRB rating systems had been employed by most of the banks within the different business units for capital planning risk appetite, budgeting and internal risk management purposes.
- Level of compliance in terms of IRB requirements: The Department assessed the level of compliance with the minimum IRB requirements during the on-site reviews. The following instances of non-compliance were noted and will receive specific attention during 2012 to monitor progress and ensure full compliance:
  - There were instances where the effective maturities prescribed under the FIRB approach had been applied to corporate, sovereign and bank exposures, whereas banks should have calculated their own maturities when reporting according to the AIRB approach.
  - Certain instances of outdated reviews of assigned borrower and facility ratings were noted, that is, the ratings assigned were older than one year.
- Data quality: Banks remained focused on data quality. In certain instances the scope of the credit data quality reviews performed by banks' internal audit functions was extended.

52 Available at http://www.resbank.co.za/Publications/Pages/BanksActGuidance.aspx.

## 2.2.6 Processing of applications by banks to implement new or revised models and rating systems

As reported in the 2010 *Annual Report*, the Department follows a formal approval process to review applications made by banks for any material internal model changes or developments that fall outside the scope of the original approval granted for use of the IRB approaches to calculate the minimum regulatory capital requirement for credit risk prior to implementation. Various applications were received during 2011 to obtain approval to use refined or redeveloped rating systems which, in most cases, would result in a decrease in the regulatory capital requirement.

The reasons for banks applying for such significant rating system changes were the following:

- Model performance: As the performance of models deteriorated, the need for redevelopment increased.
- Recalibrations using downturn data: Banks' data history tended to be biased towards benign periods of the cycle, and several recalibrations had led to increased capital requirements with the addition of downturn data.
- Migration of portfolios from the STA to the AIRB approach: Banks migrated smaller portfolios from the STA to the AIRB approach as they built up sufficient data history and expertise in creating rating systems.
- Reassessment of granularity: During the redevelopment of rating systems, banks tended to increase segmentation to improve risk discrimination. In certain cases banks removed segmentation, which added limited value.

## 2.2.7 Focused reviews: Use of the standardised approach

During the year under review, the review team completed the cycle of focused reviews that commenced in 2008. The reviews were risk based and focused on assessing the degree of compliance by banks that had adopted the STA for the calculation of their minimum regulatory capital and reserve funds required for credit risk with the requirements of regulations 23 and 24 of the Regulations.

reviews entailed an assessment of the correctness of the risk weights assigned by banks

The reviews entailed an assessment of the correctness of the risk weights assigned by banks and confirmation of the appropriate use of eligible external credit assessment institution ratings used in the calculation of the banks' minimum required capital and reserve funds relating to credit risk. The reasonableness of credit risk classifications used and the reporting of restructured credit exposures were also considered. In addition, the reviews encompassed an assessment of the eligibility of the credit risk mitigation instruments used, the methodology applied and each bank's compliance therewith. Although the criteria used were the same for all banks, the methodology applied was adjusted depending on the processes applied and the size of the bank.

After the completion of the review cycle it became evident that in general most banks had been diligent in their implementation of the STA and had, in the main, complied with the requirements of regulations 23 and 24 of the Regulations. However, the following issues were noted:

- The incorrect use of external credit assessments to determine the appropriate risk weights.
- The assignment of incorrect credit conversion factors to off-balance-sheet exposures and counterparty credit risk exposures.
- The incorrect calculation of the granularity threshold for retail exposures.
- The incorrect classification of asset classes, which resulted in the assignment of incorrect risk weights to the exposures.
- The use of ineligible credit risk mitigation techniques for credit risk mitigation purposes.
- The credit and credit risk mitigation policies not fully incorporating the criteria for credit risk mitigation as detailed in the Regulations.

- The restructured credit exposures and the credit policies not fully complying with the requirements for classification as restructured exposures as stipulated in the Regulations.
- Instances of incorrect reporting of month-end balances instead of average daily balances were noted for BA reporting in respect of products with volatile account balances.

### 2.2.8 Long-form reviews

The main objective of the long-form reviews, as reported in the 2010 *Annual Report* (pages 50 and 51), is to report to the Registrar on the accuracy and completeness of banks' calculation of the IRB parameter estimates as outlined below:

- probability of default estimates;
- loss-given default estimates, including adjustments;
- exposure at default estimates;
- risk-weighted exposure amounts;
- amount of required capital and reserve funds relating to credit risk;
- related amounts of capital impairment; and
- amounts of expected losses.

Reports emanating from the second cycle of the long-form reviews, which commenced in 2010, were submitted to the Department during 2011. The portfolios reported on differed depending on the materiality or significance of the portfolio within individual IRB banks. By contrast, the portfolios selected by the Department for review by external auditors in 2011 covered the following:

- residential mortgage exposures;
- vehicle and asset finance exposures;
- credit card exposures;
- sovereign exposures; and
- bank exposures.

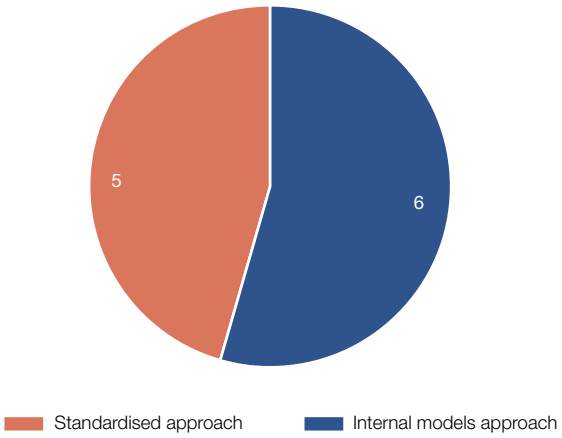
The findings of the long-form reviews were discussed with the banks, with specific focus on the progress made in addressing outstanding weaknesses.

## 2.3 Market risk

### 2.3.1 Market risk reviews

Market risk reviews conducted in 2011 by the Department concentrated on banks that had approval to use the IMA for regulatory reporting. No new applications were received for the use of the IMA during the year under review and accordingly the number of trading banks per market risk approach was unchanged, and is depicted in Figure 2.2.

Figure 2.2 Number of trading banks per market risk approach



the Department conducts both annual and quarterly reviews of IMA banks

As part of its supervisory programme, the Department conducts both annual and quarterly reviews of IMA banks to assess their continued suitability to carry on using the IMA. These reviews are not only focused on banks' models, but also on the risk drivers of the business, that is, business strategy, budgeted revenues and forecasts, new products, systems changes, risk limits and capital. The reviews complement the data already received by the Department in the form of regulatory returns and other prudential requirements of IMA banks, such as monthly back-testing and stress-testing results. A total of 26 on-site reviews, which included annual, quarterly and treasury reviews, were conducted in 2011.

### 2.3.2 Key findings

Trading conditions remained challenging in 2011 and as such, most trading banks experienced difficulty in meeting performance targets. In general, trading banks remained concerned about the sovereign debt crisis that is playing out in peripheral Europe and how it is going to affect trading conditions if it remains unresolved. Banks have modified their profit expectations for 2012 and beyond in line with their expectation of future trading environments.

With regard to banks' exposures to equities, it should be noted that these exposures are generally held for investment purposes and are included in the banking book for accounting purposes. From a regulatory perspective, equity exposure receives a capital treatment that is independent of the market risk charge, and is more punitive, attracting a risk weighting of between 100 and 400 per cent. Fifteen banks reported exposures of this nature during the course of 2011. Capital charges referred to above contributed to approximately 4,75 per cent of banks' total capital requirements. For supervisory purposes, equity risk is supervised together with market risk. Capital held for market risk made up about 2,16 per cent of the total capital requirement for the banking sector during the year under review.

### 2.3.3 Basel II.5

Among other things, Basel II.5 requires banks that make use of internal models for market risk to hold capital on a stressed value at risk (sVaR) and incremental risk charge basis where applicable. As such, the Department worked closely with the banking industry to ensure that banks would be ready to comply with the new Basel II.5 requirements. The Department reviewed sVaR methodologies from banks for approval and conducted a parallel run for a period of three months, which ended on 31 December 2011. The parallel run provided no evidence to suggest that banks would experience difficulties in meeting the resultant capital requirements of Basel II.5.

## 2.4 Operational risk

### 2.4.1 Introduction

Operational risk is defined by the Basel Committee as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.[53] The definition of operational risk includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposures to fines, penalties, punitive damages resulting from supervisory actions, and private settlements.[54]

Operational risk is inherent in all banking products, services and activities, and the effective management of operational risk has always been a fundamental element of banks' risk management programmes. As a result, sound operational risk management is a reflection of the effectiveness of the board of directors and the bank's management in administering its portfolio of products, services and activities. Effective operational risk response is about not only reducing the downsides associated with operational risk exposure and experience proactively, but also seizing the opportunities for innovation and growth that may arise.

53 Basel Committee, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel: Basel Committee, November 2005), 140.
54 Ibid.

In line with the Department's supervisory review programme, a risk-based approach has been applied to the review of banks' operational risk. The work performed during the year under review is summarised in the following sections.

a risk-based approach has been applied to review banks' operational risk

## 2.4.2 Focused operational risk reviews

A number of focused operational risk reviews were carried out during the year under review. The purpose of the reviews was, among other things, to determine whether banks had in place risk management policies and procedures to identify, assess, monitor, control and mitigate operational risk. The most prominent topics addressed during 2011 are as follows:

- Banks' operational risk strategic objectives for the next 12 months, as set by the group operational risk function.
- Recent changes to, or developments in, operational risk governance structures; operational risk human resources; information technology systems used in the management of operational risk; and the operational risk framework or policies.
- Recent changes to, or developments in, material products, activities, processes and systems that have impacted or will impact on operational risk.
- Top operational risk challenges for 2011, a list of which was compiled from international and local sources. Banks were requested to assess whether these challenges were relevant in their environment.
- Management information reports or 'dashboards' used for operational risk management.
- Internal and external audit reports related to operational risk management.

The main findings from the reviews in terms of the above-mentioned topics are detailed in the following sections.

### 2.4.2.1 Operational risk strategic objectives

The common operational risk strategic objectives identified by the majority of banks were (a) an improvement in the efficiency of risk management processes; (b) improved data collection; and (c) the integration of operational risk technology platforms.

### 2.4.2.2 Changes to operational risk governance structures, human resources, information technology systems, frameworks or policies

Almost all banks indicated that various components of the operational risk management framework were reviewed and policies were updated with new developments, improvements and discoveries. The changes to and refinement of the existing operational risk policies can be linked to the evolving nature of operational risk and changes in the external environment.

The Department recommended that banks consider practices followed by operational risk data consortiums, and recent operational risk papers published by the Basel Committee when updating or reviewing their internal loss data collection policies.

### 2.4.2.3 Changes to material products, activities, processes and systems that have impacted or will impact on operational risk

Since the business environment is not static, operational risk also continually changes. Banks were requested to discuss recent changes to, or developments in, material products, activities,

processes and systems that had impacted or would potentially impact on operational risk. The following items were commonly highlighted:

- The impact of new distribution channels, the remote opening of accounts and point of sale enablement.
- The new product approval process.
- The business initiative to focus on the client and to treat customers fairly.

#### 2.4.2.4 Top operational risk challenges for 2011

A list of top operational risk challenges for 2011 was compiled from international and local sources and a sample of banks was requested to assess whether these challenges were relevant in their environment. These challenges included the following:

- regulation;
- reputation (any operational risk failure at a financial institution is usually accompanied by reputational damage);
- stress testing and data management;
- business continuity;
- outsourcing;
- cyber terrorism or crime;
- financial crime;
- information security (including exposure to data or information leakage); and
- spreadsheet risk.

All banks in the sample responded that all of the above-mentioned top operational risk challenges were relevant in their environment. The Department was satisfied with the banks' explanation of actions taken to prepare for and mitigate the risk exposure that could ensue from the above-mentioned top operational risk challenges.

### 2.4.3 Operational risk papers issued by the Basel Committee on Banking Supervision

the Basel Committee issued two papers on operational risk in June 2011

The Department continually monitors developments with regard to operational risk. In this regard the Basel Committee issued two papers on operational risk in June 2011. The first paper, entitled "Principles for the Sound Management of Operational Risk",[55] updates and replaces the Basel Committee's 2003 paper entitled "Sound Practices for the Management and Supervision of Operational Risk". The updated version highlights the evolution of operational risk management since 2003, and is based on best industry practice and supervisory experience. The Basel Committee anticipates that sound industry practice will continue to evolve, and banks and supervisors have accordingly expanded their knowledge and experience in implementing operational risk management frameworks. A range of training reviews covering governance, data and modelling issues, loss-data collection exercises, and QISs has also contributed to industry and supervisory knowledge and the emergence of sound industry practice. The principles outlined in the paper are discussed within the context of four overarching themes, namely, (i) fundamental principles of operational risk management, (ii) governance, (iii) risk management, and (iv) disclosure. The following relevant extract has been taken from the fourth and fifth paragraphs of the paper:

> 4. Supervisors will continue to encourage banks "to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices". Consequently, while this paper articulates principles from emerging sound industry practice, supervisors expect banks to continuously improve their approaches to operational risk management. In addition, this paper addresses key elements of a bank's Framework. These elements should not be viewed in isolation but should be integrated components of the overall framework for managing operational risk across the enterprise.

55 Available at http://www.bis.org/publ/bcbs195.htm.

> 5. The [Basel] Committee believes that the principles outlined in this paper establish sound practices relevant to all banks. The Committee intends that when implementing these principles, a bank will take account of the nature, size, complexity and risk profile of its activities.[56]

The second paper issued by the Basel Committee on operational risk in June 2011 is entitled "Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches".[57] With regard to the regulatory capital-adequacy framework, the Basel Committee envisages that over time the operational risk discipline will continue to mature and converge towards a narrower band of effective risk management and measurement practices. The Basel Committee's paper in this regard seeks to improve the operational risk discipline by setting out supervisory guidelines. Consistent with SIGOR's mandate, this paper identifies supervisory guidelines associated with the development and maintenance of key internal governance, data and modelling frameworks underlying an AMA. Because operational risk is an emerging discipline, the paper is intended to be a living document. It is envisaged that as further issues are identified and expectations for convergence towards a narrower range of appropriate practices are developed, they too will be added to the document. The paper does not reduce or supersede the discretion of national supervisors to act in a manner that is consistent with their particular regulatory approaches. Instead, the publication of this paper is intended to facilitate a convergence of practices by banks and national supervisors. While the status of banks accredited to use an AMA framework will not be affected by the observations and conclusions of the paper, some AMA banks may need to amend their practices to reflect the paper's contents. The following extract serves as a closing comment on this paper:

the operational risk discipline will continue to mature and converge towards a narrower band of effective risk management

> 8. Irrespective of the risk management and risk measurement practices adopted, a bank's operational risk strategy should reflect the nature and source of the bank's operational risks for all Operational Risk Measurement System (ORMS) elements, including regular review of predictive elements against experience. The operational risk strategy should be current and reflect material changes to the internal and external environment. Risk reporting should provide a clear understanding of the key operational risks, the related drivers and the effectiveness of the internal controls. The internal reporting framework should include regular reporting of relevant information at all levels of the bank, be transparent, responsive to changes, appropriate and support the proactive management of operational risk.[58]

### 2.4.4 Conclusion

Due to the fact that operational risk management is evolving and the business environment is constantly changing, banks' management should ensure that their operational risk policies, processes and systems remain sufficiently robust. Improvement in operational risk management will depend on the degree to which operational risk managers' concerns are considered, and the willingness of banks' senior management to act promptly and appropriately on their warnings.

Although the Department is satisfied with the management of operational risk from a sectoral perspective, there is opportunity for improvement. Since the introduction of operational risk as a distinct risk type during the implementation of Basel II in 2008, banks have made good progress with regard to operational risk management. The Department will continue to encourage banks to embed operational risk management in building a sustainable business and to monitor the ongoing evolution of operational risk towards actively managing the risk rather than merely taking note of it.

banks have made good progress with regard to operational risk management

## 2.5 Liquidity risk

### 2.5.1 Liquidity risk management thematic review

In terms of Core Principle 14 (CP 14) of the Basel Committee's Core Principles, supervisors must be satisfied that banks have a liquidity management strategy that takes into account the

56 Basel Committee, "Principles for the Sound Management of Operational Risk" (Basel: Basel Committee, June 2011), 1–2.
57 Available at http://www.bis.org/publ/bcbs196.htm.
58 Basel Committee, "Operational Risk: Supervisory Guidelines for the Advanced Measurement Approaches" (Basel: Basel Committee, June 2011), 2.

risk profile of the institution. Appropriate prudential policies and processes are also required to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors also require banks to have contingency plans in place for handling liquidity problems.

the Department conducted a liquidity risk management thematic review

In order for the Department to discharge its duties relating to CP 14, it conducted a liquidity risk management thematic review based on a questionnaire that was sent out to all banks in the South African banking industry. This thematic review encompassed all areas required to be covered under CP 14, and certain additional aspects related to the Basel III framework for liquidity risk measurement, standards and monitoring. The questionnaire was used to establish the fundamental drivers, controls and governance of liquidity risk management and to evaluate the Basel III readiness of each bank through an off-site assessment. On the basis of a bank's size, its systemic relevance or apparent weakness in its liquidity risk management, a decision was made as to whether it was necessary to follow up the off-site assessment with an on-site review.

The Department places great emphasis on the importance of liquidity risk management, especially following the recent global financial crisis. Banks are encouraged to actively manage liquidity risk through ensuring that proper processes exist to promptly identify, measure, monitor and mitigate liquidity risk. Banks should also ensure that a rigorous liquidity stress-testing programme is implemented in order to determine what vulnerabilities exist. This process should assist in assessing the adequacy of a bank's funding sources to meet a potential unexpected outflow, irrespective of whether it is as a result of a bank-specific event or a market shock.

Finally, banks should take cognisance of the fact that the Department will place increased focus on liquidity risk management in order to ensure alignment with the global liquidity standards that are being introduced, namely the LCR and the NSFR.[59]

## 2.5.2 Participation in liquidity risk simulations

The recent international financial turmoil has proved that the importance of proper liquidity risk management within a formalised risk framework, commensurate with the nature and scale of business conducted by banks, has been underestimated. In its ongoing efforts to assess the adequacy and effectiveness of banks' liquidity risk management framework, the Department participated in liquidity risk simulation exercises at certain banks, which were facilitated by an independent external party. Representatives of the Department fulfilled an observatory role during these exercises.

The simulation exercises were based on a range of bank-specific balance-sheet and liquidity crisis simulation exercises that were customised to cater for banks' unique circumstances and the respective balance-sheet and crisis management teams' learning objectives. The aim was, among other things, to allow participating banks to enhance further their resilience with regard to liquidity stress in real-life scenarios, and to identify weaknesses and flaws in their liquidity contingency plans. Although planning and preparedness are extremely important, testing under stressed conditions is arguably the most important component of a bank's liquidity contingency planning.

real-life scenarios challenged experienced crisis and liquidity management teams

It became clear that the real-life scenarios not only challenged experienced crisis and liquidity management teams, but also effectively tested their respective liquidity risk and crisis management plans. Another advantage of the simulation exercises related to the opportunity for banks' executive teams to review their own crisis management actions under stressed liquidity conditions, and to ascertain whether key staff members understood the crisis risk management process and their respective roles therein. It was, from the Department's perspective, interesting to observe how these teams co-ordinated with one another, and the exercises gave the management teams a sense of their bank's overall control and communication challenges. Furthermore, crisis management teams had the opportunity to learn how to test their own crisis and liquidity stress management processes, and how to operate effectively with one another under challenging circumstances.

59 Refer to section 1.2.2.4 for a more detailed discussion of the LCR and the NSFR.

From the outset, the liquidity simulation exercises were extremely useful since they focused on testing key liquidity management components, such as banks' risk strategies and profiles; the nature of business and asset types; funding strategies; the measurement and modelling of maturities; stress testing; and the availability of liquidity buffers, to name but a few. Furthermore, the exercises also focused on concentration risk; the quality and availability of management information; skills in the treasury and balance-sheet management functions; cost and revenue optimisation; and liquidity contingency planning.

Participant banks acknowledged the usefulness of the simulation exercises, indicating that the exercises highlighted areas in which they could improve and demonstrated the need for robust and conservative liquidity risk management planning.

## 2.6 Pillar 2: Capital management

### 2.6.1 Overview of Internal Capital Adequacy Assessment Process reviews

During 2011 the Department reviewed prior years' findings in respect of the larger banks' ICAAPs in order to determine whether issues had been adequately addressed. On-site reviews conducted during 2011 focused on the following key aspects:

- The ability of banks to explain and justify differences between regulatory and economic capital requirements.
- Economic capital model developments.
- The adequacy and robustness of economic capital model validation processes.
- Capital supply to be loss absorbent in order to meet the economic capital requirements as determined by banks.
- Capital management, including the determination of internal capital buffers, and the incorporation of the Basel III framework in banks' longer-term capital plans.
- The internal use of ICAAPs by banks in respect of strategy setting, planning, risk appetite setting and monitoring, pricing, etc.

The Department will continue to benchmark local banks' ICAAPs against known international practice and international developments during 2012.

### 2.6.2 Participation in the Basel Committee on Banking Supervision Quantitative Impact Study

As mentioned previously, the Basel III implementation monitoring was conducted by the Basel Committee on a global scale in the form of QIS exercises.[60]

During 2011, two QIS exercises took place and a total of seven South African banking groups participated. The first QIS exercise was based on the end-December 2010 data and the second on the end-June 2011 data. The results of the first QIS, together with the key elements within the Basel III framework that impacted the South African banking sector, were discussed with the participating banks individually and were found to be of great value to both the Department and the banks. Areas covered as part of this QIS were, among others, the definition of capital, the leverage ratio, liquidity risk and counterparty credit risk. The Department will continue to participate in further Basel Committee QIS exercises during 2012. In addition, the Department will conduct an internal QIS on the full complement of banks registered in South Africa during 2012. The main objectives of such an exercise are to assess the impact of the Basel III framework on these banks and to raise awareness of Basel III within these organisations.

two QIS exercises took place during 2011 and a total of seven South African banks participated

60 Refer to section 1.12.2.4 of this Report.

## 2.7 Pillar 3: Disclosure

### 2.7.1 Overview of activities

During 2011 the Department's review of banks' regulatory objection for disclosure focused on the steps taken by banks to address previously identified issues. Full disclosure analyses were also conducted in respect of a selected few banks. The general observation was that much effort had been made by banks to improve their public disclosures.

Banks Act Directive 5/2011[61] was issued in terms of section 6(6) of the Banks Act, entitled "Exemption from Certain Disclosure Requirements Pertaining to Branches of Foreign Institutions", in terms of which branches of foreign institutions are exempted from certain disclosure requirements that are not relevant to them.

Banks Act Circular 5/2011[62] was issued in terms of section 6(4) of the Banks Act regarding the disclosure of capital-related information in order to standardise the disclosure of capital requirements and other capital-related matters.

### 2.7.2 Key findings

Despite the improvements noted with regard to banks' disclosure, the following areas, most of which were highlighted in the 2010 *Annual Report*, have been identified as those requiring further improvement:

- The incorrect disclosure of average amounts of gross credit exposure.
- Banks continued to disclose risk-weighted assets instead of capital requirements. However, only a small number of banks still had problems in this regard.
- Banks' disclosure of the amount of actual losses: The extent to which the said amounts differ from the bank's past experience; the factors that impact on the bank's loss experience; and the comparison of the banks' estimated and actual outcome continued to be an area in need of improvement. Correct disclosure would lead to meaningful assessments of the performance of the banks' internal rating processes.
- Not all banks disclosed the qualitative information relating to the methodology that they had adopted to assign economic capital and credit risk limits in respect of their exposure to counterparty credit risk.
- Some banks did still not disclose the cumulative amount of gains or losses that they had realised from the sale or liquidation of positions held in their banking book.

The Department will continue to monitor banks' compliance during its 2012 disclosure reviews.

### 2.7.3 Pillar 3 disclosure requirements for remuneration

certain common areas that could be improved in terms of Pillar 3 disclosure requirements for remuneration were identified

With regard to the Pillar 3 disclosure requirements for remuneration, which were finalised in the Basel Committee paper entitled "Pillar 3 Disclosure Requirements for Remuneration" dated July 2011,[63] the Department acknowledges the fact that most banks already have the required processes in place due to their compliance with the *King III Report on Corporate Governance for South Africa 2009* (*King III*) and the JSE Limited's listing requirements. However, the following shortcomings were identified as common areas that could be improved in terms of Pillar 3 disclosure requirements for remuneration:

#### 2.7.3.1 Qualitative information

- A description of the types of employee considered as material risk takers and as senior managers, including the number of employees in each group.
- An explanation of how the bank ensures that risk and compliance employees are remunerated independently from the businesses they oversee.
- A description of the ways in which current and future risks are taken into account in the remuneration processes, including disclosure on:

61 Available at http://www.resbank.co.za/Publications/Pages/Bank-Act-directives.aspx.
62 Available at http://www.resbank.co.za/Publications/Circulars/Pages/BanksActCirculars.aspx.
63 Available at http://www.bis.org/press/p110701.htm.

- an overview of the key risks that the bank takes into account when implementing remuneration measures;
- a discussion of the ways in which these measures affect remuneration; and
- a discussion of how the nature and type of these measures have changed over the past year, reasons for the change, and the impact of these changes on remuneration.

#### 2.7.3.2 Quantitative information

- The total amount of deferred remuneration paid out in the financial year.
- The number and total amount of guaranteed bonuses awarded during the financial year.
- The number and total amount of sign-on awards made during the financial year.
- The number and total amount of severance payments made during the financial year.
- A breakdown of the amount of remuneration awarded for the financial year according to Table A of Annexure A of the aforementioned Basel Committee paper on Pillar 3 disclosure requirements for remuneration. The breakdown should show the following types of remuneration awarded:
  - fixed and variable;
  - deferred and non-deferred; and
  - different forms of remuneration used (cash-based, shares and share-linked instruments, and other forms of remuneration).

### 2.7.4 Securitisation

The disclosure requirements for securitisation and resecuritisation activities, which form part of the Basel Committee paper entitled "Enhancements to the Basel II Framework" dated July 2009, became effective on 1 January 2012. Accordingly, banks' compliance therewith will be monitored during the course of 2012.

### 2.7.5 Basel III impact

In December 2011 the Basel Committee issued a consultative document entitled "Definition of Capital Disclosure Requirements",[64] which sets out the proposed detailed disclosure requirements aimed at improving the transparency of the regulatory capital base and enhancing market discipline. The Department will review banks' compliance with these requirements.

## 2.8 Consolidated supervision

### 2.8.1 Introduction

In addition to the normal activities performed in respect of consolidated supervision during 2011, the Department also had the following interactions with other regulatory authorities:

### 2.8.2 East Africa Regional Technical Assistance Center workshop on consolidated supervision

A representative from the Department was invited by the IMF to attend and make presentations at a workshop on consolidated supervision held in Mombasa, Kenya from 28 February 2011 to 3 March 2011. The four-day workshop was attended by representatives from Eritrea, Ethiopia, Kenya, Malawi, Rwanda, Tanzania and Uganda.

The East Africa Regional Technical Assistance Center (AFRITAC) is a collaborative venture between the IMF, the above-mentioned member countries, and bilateral and multilateral donors. AFRITAC originated from the IMF's response to African leaders' call for the international community to increase technical assistance to Africa.

64 Available at http://www.bis.org/publ/bcbs212.htm.

the workshop explored international standards and best practices related to consolidated supervision

The workshop was designed to explore international standards and best practices related to consolidated supervision, and the challenges faced in establishing effective arrangements in this regard. The Department was invited to participate in the workshop to outline the Bank's approach and experiences with consolidated supervision and to share the latest international developments relating thereto with the delegates.

The Department values its involvement in the East African region and will continue to support initiatives to improve the supervisory skills of regional supervisors.

### 2.8.3 China Construction Bank supervisory college

An invitation was received from the China Banking Regulatory Commission (CBRC) to attend a supervisory college of China Construction Bank (CCB) in Beijing, China in November 2011. CCB has a branch office in South Africa. Representatives of the Department attended and participated in the aforementioned college. The college was also attended by heads of related departments of the CBRC and delegates of China's Ministry of Finance, the People's Bank of China, the China Securities Regulatory Commission, the China Insurance Regulatory Commission and the State Administration of Foreign Exchange.

Host regulators of CCB's branch and subsidiary network presented their assessment of CCB's operations in their respective jurisdictions. The presentations covered areas such as the materiality of operations in the host jurisdiction, financial performance, risk assessment and planned supervisory interactions. During the supervisory college, consensus was reached on the future format of the CCB supervisory college, cross-border supervisory co-operation and information sharing. Presentations by CCB covered the following topics:

- China's current macroeconomic and financial environment;
- the development, regulatory practices and outlook of China's banking sector;
- the CBRC's regulatory framework and tools for supervising large banking groups; and
- supervision of the operations of CCB from a home-country perspective.

The supervisory college contributed to a better understanding among supervisors of the risks the CCB group is facing and the extent of supervision conducted in the different jurisdictions. The importance of the sharing of information between supervisors responsible for the supervision of the CCB group was again highlighted. Attending the supervisory college also provided the Department with the opportunity to learn more about China's banking sector, and the extent and quality of supervision conducted by the home-country supervisor.

### 2.8.4 Barclays supervisory college arranged by the Financial Services Authority

The Department was invited by the Financial Services Authority (FSA) to a Barclays supervisory college held in London, United Kingdom in December 2011. The college took place over three days and was divided into a core college, a general college and a crisis management group meeting.

The aim of the core college was for key host supervisors to exchange supervisory views on the Barclays Group. It included a discussion of work undertaken by the individual supervisory authorities and the finalisation of a joint risk assessment document. Future supervisory work plans for the Barclays Group were also discussed. In view of the Barclays Group's presence in South Africa it was decided that South Africa should be included as a member of the core college. The core college consisted of six key Barclays Group host regulatory authorities and the FSA as home regulatory authority.

The general college comprised members of the core college and ten other regulatory authorities. The general college facilitated a discussion of the Barclays Group's capital adequacy, with supervisors exchanging views regarding the supervision of the Barclays Group.

The crisis management group meeting was attended by the members of the core college, the Bank of England and the Federal Deposit of Insurance Corporation. This was the Department's first invitation to attend a crisis management group meeting, with valuable knowledge being obtained and crucial lessons learnt. From a host supervisory and learning perspective, attending the crisis management group meeting was extremely beneficial to the Department and will facilitate the further refinement of its consolidated supervisory framework.

the Department was invited to attend the crisis management group meeting for the first time

### 2.8.5 Supervisory meetings with the Financial Services Board

In its 2010 *Annual Report* the Department reported extensively on the quarterly supervisory meetings held between the Department and the Financial Services Board, with a specific focus on the South African financial conglomerate groups with significant investments in banking, insurance and securities. The objectives of these meetings are to:

- enhance supervisory information sharing;
- discuss issues that may pose a risk to the financial stability of the conglomerate groups;
- identify any regulatory arbitrage that might exist; and
- foster close working relations between supervisory teams responsible for each conglomerate group.

The Department continued with these regular meetings during 2011 as they add value to both the Financial Services Board and the Department's supervisory processes. Both regulators recognise the importance of these meetings and the prominent role they play in their respective supervisory regimes. The meetings have subsequently been included as an integral part of both regulators' supervisory processes.

the supervisory meetings add value to both the Financial Services Board and the Department's supervisory processes

### 2.8.6 Solvency Assessment and Management Insurance Groups Task Group

The Financial Services Board is in the process of developing a revised prudential regulatory regime for South African short- and long-term insurers. In 2010 a task group called the Solvency Assessment and Management Insurance Groups Task Group was formed, with an invitation being extended to the Department, industry participants and other key stakeholders to participate in the meetings. The Department continued to participate in and contribute to the task group meetings during 2011.

## 2.9 Financial stability: A macroprudential approach to supervision

The global financial crisis highlighted the need for a macroprudential approach to financial supervision. A macroprudential policy approach is one where fiscal, monetary and regulatory policies are all aimed at either changing or countering the collective behaviour of financial institutions that cause imbalances in the financial system in order to reduce the systemic risk emanating from such behaviour. This approach has become a widely-accepted method of managing system-wide risk across the entire financial sector. A macroprudential approach essentially entails overseeing, assessing and delivering appropriate policy responses to enhance the resilience of the financial system as a whole and to reduce systemic risk. As the build-up of macroeconomic and financial system risks might not always be noticed by microprudential regulators, macroprudential regulators need to analyse trends in the financial system and consider how they interact with the prudential soundness of financial institutions.

In most countries macroprudential supervision falls within the central bank's ambit of responsibilities. Even in instances where the responsibility for financial stability is not explicitly formulated in laws and mission statements, oversight of the financial system is an inherent function of the central bank on account of its pivotal role in the financial system and in view of the

fact that instability could constrain the effectiveness of central bank policies. Similarly, in South Africa there is general consensus that the Bank is best placed and has the appropriate capacity to perform macroprudential supervision effectively. The implicit responsibility of the Bank to monitor macroeconomic and financial stability risks was explicitly confirmed both in a letter from the Minister of Finance to the Governor of the Bank and in the policy document issued by the National Treasury referred to in section 1.3 of this Report, entitled "A Safer Financial Sector to Serve South Africa Better".

a financial stability unit was established in the Department in February 2011

As a result the Bank has further strengthened its financial stability functions by establishing a financial stability unit in the Department in February 2011. The main objective of the Financial Stability Unit is to assess and promote the overall soundness of the financial system in support of the broader financial stability objective of the Bank.

The main functions of the Financial Stability Unit are to research emerging issues in the local and international financial systems and to perform both quantitative and qualitative analyses utilising international standards and financial soundness indicators in order to identify the build-up of imbalances that may cause instability in the domestic financial system. A systemic crisis prevention strategy is also being developed which will include the implementation of contingency plans for facilitating systemic crisis resolution.