

Chapter 1: Registrar of Banks' review

1.1 Introduction

In its 2011 *Annual Report*, the Bank Supervision Department (the Department) of the South African Reserve Bank (the Bank) focused on the aftermath of the global financial crisis and the comprehensive regulatory reforms announced to address the causes thereof.¹ During 2012, the focus shifted towards ensuring that the Department's domestic regulatory and supervisory framework would be appropriately amended in time for the phased-in approach of the higher capital requirements introduced as part of the Basel III framework,² which commenced on 1 January 2013.

On 21 November 2012, the Minister of Finance approved the amended Regulations relating to Banks (the Regulations), which were in line with the requirements of the Basel III framework. Subsequently, on 12 December 2012, the amended Regulations were published in *Government Gazette* No. 35950 and implemented with effect from 1 January 2013. South Africa was one of 11 jurisdictions that published finalised Basel III regulations effective from 1 January 2013, along with Australia, Canada, China, Hong Kong SAR, India, Japan, Mexico, Saudi Arabia, Singapore and Switzerland.³

This chapter describes in greater detail the key international regulatory and supervisory developments in the period under review, specifically with regard to the preparations for the implementation of the Basel III framework on 1 January 2013 and the periods thereafter. Prominent domestic developments are assessed and updates provided on the implementation of a twin peaks model of financial regulation in South Africa, the strengthening of South Africa's crisis resolution framework and on financial stability trends specifically relating to the banking sector. The chapter contains a discussion on the three flavour-of-the-year topics identified for the banking sector for 2012, and an overview of the Department's new responsibilities in terms of anti-money laundering (AML) and the combating of the financing of terrorism (CFT).

1.2 Key international developments, recommendations and focus areas

1.2.1 Introduction

In its annual reports of 2007 to 2011,⁴ the Department reported comprehensively on the background to, and causes of, the global financial crisis, the specific weaknesses identified that required specific attention and correction, and the related policy responses by international standard-setting bodies such as the Group of Twenty (G-20) Forum, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (Basel Committee).

The measures introduced by the Basel Committee in July 2009 to strengthen the Basel II framework, commonly referred to as the 'Basel 2.5 framework',⁵ and the further requirements contained in the Basel III framework form part of the Basel Committee's comprehensive response to address the lessons learnt from the global financial crisis related to, among other things, the regulation, supervision and risk management of globally active banks.

Essentially, the Basel III framework presents the details of global regulatory standards on banks' capital adequacy and liquidity as agreed by the Governors and Heads of Supervision, which is the oversight body of the Basel Committee, and endorsed by the G-20 Leaders. Based on the key lessons learnt from the global financial crisis, the Basel III framework sets out requirements for higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build-up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards, namely (i) the liquidity coverage ratio (LCR) and (ii) the net stable funding ratio (NSFR).⁶

1 Section 1.1.

2 The Basel III framework essentially comprises two documents issued by the Basel Committee on 16 December 2010, namely "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" and "Basel III: International Framework for Liquidity Risk Management, Standards and Monitoring".

3 Basel Committee, press release issued in terms of "Implementation of the Basel III Framework" (Basel: Basel Committee, 14 December 2012). The press release is available at <http://www.bis.org/press/p121214a.htm>.

4 Available at <http://www.resbank.co.za/Publications/Reports/Pages/BankSupervisionAnnualReports.aspx>.

5 The Basel 2.5 framework comprises three documents issued during July 2009 by the Basel Committee, namely (i) "Enhancements to the Basel II Framework", (ii) "Revisions to the Basel II Market Risk Framework" and (iii) "Guidelines for Computing Capital for Incremental Risk in the Trading Book".

6 The LCR and the NSFR are discussed in greater detail in the Basel Committee document entitled "Basel III: International Framework for Liquidity Risk Management, Standards and Monitoring".

Furthermore, during 2012, the Basel Committee and the Joint Forum, the latter of which comprises the Basel Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), issued various documents and further requirements that materially impact on the regulation and supervision of banks and banking groups on topics such as

- a capital disclosure framework for banks;
- matters related to the internal audit function in banks;
- interim rules for the capitalisation of bank exposures to central counterparties (CCPs);
- the revised Core Principles for Effective Banking Supervision (the revised Core Principles);
- principles for the supervision of financial conglomerates; and
- a framework for dealing with domestic systemically important banks (D-SIBs).

The key matters communicated by the Basel Committee in respect of the aforesaid documents and requirements are summarised below:

1.2.2 Capital disclosure requirements

The global financial crisis revealed that insufficiently detailed disclosure by banks, and a lack of consistency in reporting across banks and jurisdictions complicated detailed assessments of banks' capital positions and comparisons across jurisdictions.

Therefore, on 26 June 2012 the Basel Committee issued final rules and a capital disclosure framework for banks, entitled "Composition of Capital Disclosure Requirements",⁷ to ensure that the components of banks' capital bases are disclosed in standardised formats across jurisdictions, thereby improving market discipline by enhancing both transparency and comparability.

Banks will be required to comply with specified components of these increased capital disclosure requirements from the date of publication of their first set of financial statements relating to a balance-sheet date on or after 30 June 2013.

1.2.3 Banks' internal audit function

On 28 June 2012 the Basel Committee issued its updated document, entitled "The Internal Audit Function in Banks".⁸ The document forms part of the Basel Committee's ongoing efforts to address banking supervisory issues, and enhance supervision through guidance that encourages sound practices in banks.

The document builds on the Basel Committee's "Principles for Enhancing Corporate Governance",⁹ which requires banks to have an internal audit function with sufficient authority, stature, independence, resources and access to the banks' board of directors (board). The document confirms that independent, competent and qualified internal auditors are central to sound corporate governance.

The Department will continue to ensure that its regulatory framework and supervisory practices promote the establishment of sound governance practices in banks in accordance with international best practices.

1.2.4 Exposures to central counterparties

On 25 July 2012, in a document entitled "Capital Requirements for Bank Exposures to Central Counterparties",¹⁰ the Basel Committee issued interim rules for the capitalisation of bank exposures to CCPs. The document gives effect to the G-20 Leaders' objective of creating incentives for banks to increase their use of CCPs, while at the same time ensuring that banks' CCPs are adequately capitalised.

The framework for capitalising exposures to CCPs builds on the document jointly issued by the Bank for International Settlements (BIS) and IOSCO entitled "Principles for Financial

7 Available at <http://www.bis.org/publ/bcbs221.htm>.

8 Available at <http://www.bis.org/publ/bcbs223.htm>.

9 Available at <http://www.bis.org/publ/bcbs176.htm>.

10 Available at <http://www.bis.org/publ/bcbs227.htm>.

Market Infrastructures”,¹¹ which principles are designed to enhance the robustness of the essential infrastructure, including CCPs, that supports global financial markets. Where a CCP is supervised in a manner consistent with these principles, exposures to such CCPs will receive a preferential capital treatment. Furthermore, in specified cases, banks are allowed to choose from one of two approaches to determine the capital required for exposures to default funds.

11 Available at <http://www.bis.org/publ/cpss101.htm>.

It is expected that further work will be done by the Basel Committee during 2013 and thereafter in respect of the rules regulating the capitalisation of bank exposures to CCPs.

1.2.5 Revised Core Principles for Effective Banking Supervision

On 14 September 2012 the Basel Committee published its revised “Core Principles for Effective Banking Supervision”,¹² which are the global standard for the sound prudential regulation and supervision of banks and banking systems.

12 Available at <http://www.bis.org/publ/bcbs230.htm>.

Drawing on lessons learnt during the global financial crisis, the revised Core Principles represent a significant step forward from the Basel Committee’s 2006 Core Principles for Effective Banking Supervision and associated methodology.

The revised Core Principles also reflect key advances in recent regulatory thinking that include

- devoting supervisory attention on a proportionate or risk-based basis, in line with the risk profile and systemic importance of banks;
- applying a broad financial system perspective that considers both the macro- and microprudential elements of effective supervision;
- adopting effective crisis preparation and management strategies, together with orderly resolution frameworks and other measures to mitigate the impact of bank failures; and
- fostering robust market discipline through sound supervisory practices in the areas of corporate governance, disclosure and transparency.

In view of the fact that the revised Core Principles are the de facto minimum standard for sound prudential regulation and supervision of banks and banking systems, the Department will continue to ensure that its regulatory framework and supervisory practices remain aligned with all relevant international best practices and standards.

1.2.6 Supervision of financial conglomerates

On 24 September 2012 the Joint Forum issued its final report on “Principles for the Supervision of Financial Conglomerates”,¹³ which aims to close regulatory gaps, eliminate areas not previously supervised and ensure effective supervision of risks arising from unregulated financial activities and entities.

13 Available at <http://www.bis.org/publ/joint29.htm>.

The Principles for the Supervision of Financial Conglomerates take into account recent updates and developments in the frameworks of the Joint Forum’s parent committees, namely the Basel Committee, IOSCO and IAIS, and cover areas such as

- supervisory powers and authority;
- supervisory responsibility;
- corporate governance;
- capital adequacy and liquidity; and
- risk management.

1.2.7 Domestic systemically important banks

In November 2011 the Basel Committee issued final rules for global systemically important banks (G-SIBs). The G-20 leaders endorsed these rules at their November 2011 meeting and asked the Basel Committee and the FSB to work on extending the framework to D-SIBs.



14 Available at <http://www.bis.org/publ/bcbs233.htm>.

In this regard, on 11 October 2012 the Basel Committee issued its framework for dealing with D-SIBs, entitled “A Framework for Dealing with Domestic Systemically Important Banks”.¹⁴

While not all D-SIBs are significant from a global perspective, the failure of such a bank could still have a highly significant impact on the domestic financial system and economy in which it is active. The Basel Committee has therefore also developed a set of principles on the assessment methodology and the higher loss-absorbency capital requirement for D-SIBs. The D-SIB framework complements the G-SIB framework by focusing on the impact that the distress or failure of a D-SIB will have on the domestic economy.

Banks identified as D-SIBs by the Department will be required to comply with the respective D-SIB requirements and principles from 1 January 2016, in line with the phase-in arrangements for the G-SIB framework prescribed by the Basel Committee.

1.2.8 Ongoing development of regulatory reforms

The Basel Committee continues its work on a range of initiatives to promote the resilience and stability of financial markets, banks and banking groups. As a member of the Basel Committee,¹⁵ South Africa, through the Department, endorses the initiatives, strategies and new or amended requirements or standards to address comprehensively the fundamental weaknesses revealed by the global financial crisis. The Department is also actively involved in developing regulatory reforms that promote the safety and soundness of the banking system, and that continue to support long-term economic growth.

15 South Africa became a member of the Basel Committee in July 2009.

1.3 Flavour-of-the-year topics for 2012

1.3.1 Introduction

Each year the Department identifies certain flavour-of-the-year topics to be discussed with banks’ boards during supervisory meetings held with banks. Accordingly, Banks Act Guidance Note 3/2012¹⁶ identified the following three flavour-of-the-year topics for 2012:

- i. Unsecured lending
- ii. Banks’ African strategies
- iii. Recovery and resolution planning.

Banks’ boards were requested to make presentations to the Department on each of the three topics. These three topics are discussed in greater detail below.

1.3.2 Unsecured lending

Following a 13,5 per cent year-on-year increase in the South African banking sector’s total unsecured gross credit exposure from R300,77 billion as at 31 December 2010 to R341,36 billion as at 31 December 2011 and a subsequent 29,3 per cent year-on-year increase to R441,27 billion as at 31 December 2012, the Department deemed it appropriate to gain a more in-depth understanding of banks’ strategies, risk management approach and exposure to unsecured lending. Unsecured lending includes credit cards, overdrafts, personal loans and financing provided to small and medium enterprises (SMEs) in the retail sector.

The following discussion on unsecured lending is based on the presentations made by banks’ boards, and is limited to those banks that actively extend unsecured loans to retail customers.

In general, banks defined ‘unsecured lending’ as loans where no form of collateral or security had been placed to support the loan. The governance structures varied from bank to bank, and banks expressed an increasing risk appetite for unsecured credit exposure. Most banks had an approved target level or a predetermined risk-and-return ratio in terms of which they intended to grow their exposure to unsecured lending.

16 Available at <http://www.resbank.co.za/Publications/Pages/BanksActGuidance.aspx>.

As at the time of the presentations, some banks were offering unsecured personal loans of up to R230 000 with repayment terms of up to 84 months. The average loan amount and repayment period differed between banks, depending on their target market and risk appetites. Unsecured loans were mainly extended to formally employed South African citizens between the ages of 18 and 65.

All banks indicated that they applied risk-based pricing models that took into account the limits set by the National Credit Act, 2005 (Act No. 34 of 2005) (NCA), and confirmed that the maximum pricing charged for their retail unsecured personal loan exposures was within the requirements specified by the NCA.

The capital held by banks for unsecured loans was influenced by, among other factors, the regulatory models approved for measuring and reporting credit risk. Generally, smaller banks had less sophisticated regulatory models and therefore held proportionally more capital for credit risk than larger banks.

The Department monitors the banking sector's activities regarding unsecured lending from a prudential and a financial stability perspective. During 2012 the Department engaged with selected banks on the high growth rate in the retail category of credit exposures. The Department also noted the public comments made by various banks related to the moderating growth rates in the second half of 2012. During 2013 the Department will continue to monitor the trend in retail unsecured lending reported by the banking sector and engage with the banking sector on any potential risks arising from retail unsecured lending.

1.3.3 Banks' African strategies

The challenging global and domestic economic landscape has resulted in South African banking groups having to explore non-traditional opportunities in search of sustained growth. One such identified opportunity was the expansion of banks' operations into the rest of Africa. Therefore, banks' African strategies were included as a flavour-of-the-year topic in 2012. The following discussion on banks' African strategies is based on the presentations made by banks' boards during 2012.

Banks considered expanding into Africa through both the establishment of new operations and acquisitions. Expansion into Africa was predominantly considered a medium- to long-term strategy as banks indicated that high start-up costs and strong competition meant that acceptable returns would only materialise over time. Moreover, banks' African initiatives were integrated into their overall group strategies, rather than considered on a stand-alone basis.

The following factors were identified by banks as the rationale for pursuing business interests in Africa:

- Continued higher levels of growth experienced by Africa
- The increasing presence of South African corporates across the continent
- The increasing levels of trade flows between Africa and the rest of the world
- Higher levels of foreign direct investment in Africa
- The abundance of resources on the continent
- Favourable technological advancements to support financial-sector developments.

Certain South African banking groups are currently in the process of implementing their African strategies, with the required regulatory applications having been lodged with the Department and other relevant supervisory authorities both in South Africa and elsewhere in Africa.

1.3.4 Recovery and resolution planning

In terms of the FSB's "Key Attributes of Effective Resolution Regimes", member countries are advised to have in place recovery and resolution plans (RRPs) for all systemically important financial institutions (SIFIs). RRP's are but one of the measures recommended by the FSB

to facilitate the resolution of a SIFI without having to use public funds. The Department has therefore deemed it appropriate to include the development of RRP as one of the flavour-of-the-year topics for 2012.

RRPs comprise two components, namely a recovery plan and a resolution plan. Recovery plans are developed by banks themselves, and serve as a guide to a bank's management and board on actions to be taken to enable the bank to recover from a situation of stress on its own. Recovery plans are required to address scenarios of liquidity stress, capital inadequacy and operational disruption of critical functions. Banks are expected to identify, among other things, events that would trigger the activation of their recovery plans, clear escalation procedures and interventions required in various stressed scenarios. Registered local branches of foreign banks and subsidiaries in stressed scenarios also fall within the ambit of banks' recovery plans.

Should the recovery attempts as detailed above fail, supervisors need to have plans in place on how to resolve distressed banks, particularly if the distressed bank is systemically important. Such options are contained in resolution plans. The purpose of a resolution plan is to minimise the cost of failure of a bank and the use of public funds in resolving it, and the responsibility for developing resolution plans vests with the resolution authority, which will be the Bank under a twin peaks model of financial regulation in South Africa.¹⁷

The development and refinement of recovery and resolution plans are an ongoing process that will receive further attention during 2013. As indicated in Guidance Note 10/2012, the process of further developing recovery plans has again been identified as a supervisory focus area for 2013.¹⁸

1.4 Update on the implementation of a twin peaks model of financial regulation in South Africa

As mentioned in the Department's 2011 *Annual Report*,¹⁹ in February 2011 the Minister of Finance announced the broad policy objective of establishing a twin peaks model of financial regulation in South Africa. The decision was aimed at strengthening prudential and market conduct regulation, and at creating a more resilient and stable financial system. Under the planned twin peaks approach, prudential regulation of the financial system and selected financial market infrastructure will be the responsibility of the Bank, while market conduct regulation will fall under the Financial Services Board's jurisdiction.²⁰ At the same time, the Minister of Finance also widened the remit of the Bank to include and consider the systemic components of the financial system to ensure that the Bank is appropriately positioned to fulfil its financial stability mandate.

The shift towards a twin peaks model of financial regulation offers a suitable opportunity to streamline regulatory responsibilities and promote the importance of market conduct regulation, which has historically played a more limited role in certain South African financial subsectors, such as banking. Due to the fact that the prudential supervisory responsibilities will be concentrated in, and carried out by, one institution, namely the Bank, a twin peaks model will help to improve oversight of the financial conglomerates that dominate the South African financial system. Another advantage of a twin peaks model of financial regulation is the opportunity to consider the mechanisms required to optimise co-operation and co-ordination between financial regulators and other authorities, such as the National Treasury and the National Credit Regulator.

17 Refer to section 1.4 below for a detailed update in this regard.

18 Available at <http://www.resbank.co.za/Publications/Pages/BanksActGuidance.aspx>.

19 Section 1.3.

20 Prudential regulation of financial institutions in South Africa has historically been divided between the Financial Services Board and the Bank according to the respective institutions' activities.

A document, entitled “Implementing a Twin Peaks Model of Financial Regulation in South Africa” was finalised and subsequently published for comment by the National Treasury, the Financial Services Board and the Bank on 1 February 2013.²¹ It is expected that the twin peaks model of financial regulation will be implemented in two phases. During the first phase, which is expected to run during 2013/14, relevant legislation will be developed and tabled in Parliament to allow the regulators to deliver on their revised mandates. The first phase will also include the integration of current staff and resources of the Financial Services Board responsible for prudential supervision of insurance into the Bank. The second phase will consist of harmonising the legislative, regulatory and supervisory frameworks across the various types of regulated financial institutions and markets as far as possible and is envisaged to be completed over the medium term.²²

21 Available at http://www.treasury.gov.za/comm_media/press/2013/2013020102%20-%20Twin%20Peaks%2001%20Feb%202013.pdf.

22 National Treasury, “Implementing a Twin Peaks Model of Financial Regulation in South Africa” (Pretoria: National Treasury, 1 February 2013), 75.

1.5 Financial stability developments and trends

Global economic growth remained weak for most of 2012, and the uncertain and subdued global economic environment impacted negatively on real economic activity in South Africa. Although confidence in the financial services sector remained high during the period under review, it has still not reached its pre-crisis levels.

The South African banking sector continued to post healthy profitability numbers, supported by generally improved quality of assets. The banking sector remained adequately capitalised in terms of the current minimum regulatory requirements. Although the banking sector’s total unsecured gross credit exposure increased further during the reporting period, it remained a relatively small portion of total gross credit exposure. The total credit exposure of the five largest domestic banks to counterparties with legal jurisdiction in Greece, Italy, Ireland, Portugal and Spain remained insignificant. The domestic bond market generally performed strongly, underpinned by lower inflation and an announcement that South Africa had become eligible for inclusion in Citigroup’s World Government Bond Index.

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

In terms of section 45(1) of the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001) (the FIC Act), the Department has the responsibility to supervise and enforce banks’ compliance with the provisions of the FIC Act. To assist the Department in carrying out these duties, a total of ten staff members were appointed during the first and second quarters of 2012. All the members of the AML/CFT review team were issued with inspection certificates before the commencement of the first on-site inspection as required by section 45A of the FIC Act.

The AML/CFT team has been tasked with the responsibility of conducting both on- and off-site AML/CFT-related supervision of banks by ensuring that all banks have adequate policies and processes in place to combat money-laundering and terrorist-financing activities. In order to fulfil this function, an AML/CFT supervisory manual was developed to set out the processes and procedures to be followed by the Department in carrying out its supervisory duties.

1.7 Participation in international surveys

1.7.1 The Southern African Development Community Banking Law Survey

During the year under review the Department participated in a survey on banking law conducted by the Southern African Development Community (SADC) Committee of Banking Supervisors. As reported in the Department's 2011 *Annual Report*,²³ at a meeting held in the Democratic Republic of Congo in April 2010, the SADC Committee of Banking Supervisors proposed that a model banking law be developed for SADC member states. The survey in which the Department participated in this regard will aid the SADC Committee of Banking Supervisors to develop the envisaged model banking law.

1.7.2 The Southern African Development Community Protocol on Finance and Investment

The Department also participated in a study on banking-sector developments in SADC member countries during 2012. The study was conducted to further the goals of SADC to integrate the finance and investment sectors in the region through the Finance and Investment Protocol (the Protocol). In terms of the Protocol, SADC central banks pledged to define and implement a regional banking regulatory and supervisory strategy based on international standards; identify and measure regional banking regulatory and supervisory risks; and establish procedures for the management of such risks. As part of this initiative, SADC initiated a survey to assess the banking sector's development and its compliance with International Accounting Standards. The objectives of the study included an update on the progress each SADC member state had made in this regard. The survey broadly covered the laws relating to the preparation of financial statements for banks and their external auditors.

1.8 Participation in international regulatory and supervisory forums

1.8.1 Structure of international committees

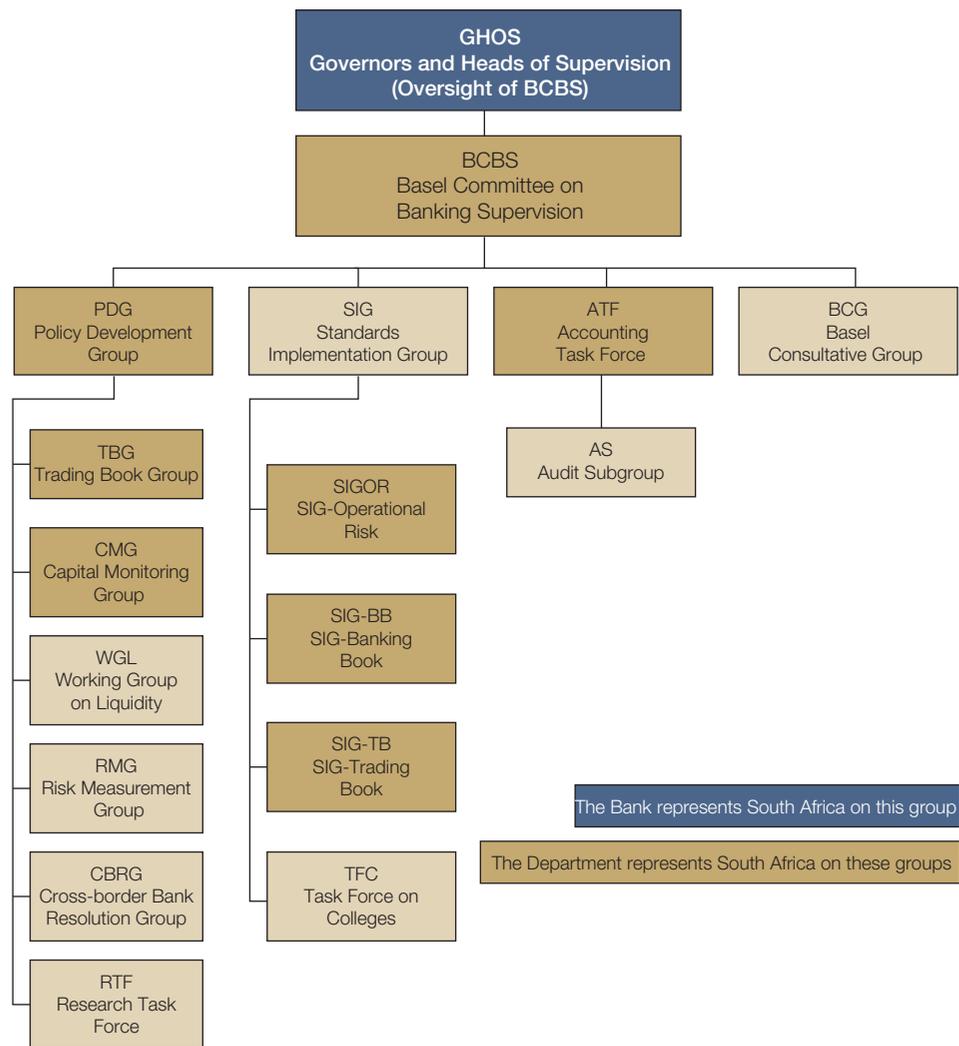
The Department represents South Africa on committees within the structure of the Basel Committee. Representation is aimed at influencing the formulation of policy and elevating the profile of South Africa as a jurisdiction with sound banking supervision practices. Policy development undertaken by some of these committees is focused on specific regulatory areas where they are mandated to develop or maintain rules approved by the Basel Committee level for inclusion in the Basel framework. Other committees in the Basel Committee's structure review the effectiveness and consistency of implementation of the Basel framework between jurisdictions and banks, and within regulatory risk areas.

The structure of the Basel Committee illustrated in Figure 1.1 prevailed through most of 2012. As the level of detail covered by the Basel framework progresses, new committees and working groups are established. These committees and groups may be of a temporary nature or become permanent elements of the Basel Committee structure. Several new groups were created during 2012.

Participation in the groups is generally by invitation, although the Department sometimes requests inclusion in some committees as the subject matter gains importance in the South African banking context.



Figure 1.1 Structure of the Basel Committee on Banking Supervision (2012)



1.8.2 Policy Development Group

The Department is represented on the Policy Development Group (PDG), which is a body that assesses the policy developments of subgroups. It serves the Basel Committee by identifying and making recommendations on policy that the Basel Committee has the discretion to adopt. It also reviews emerging supervisory issues aimed at promoting a sound banking system and high supervisory standards. The PDG has several executive subgroups and workgroups reporting to it on a wide range of risk and capital issues.

1.8.3 Trading Book Group

The Trading Book Group (TBG) deals primarily with market risk. South Africa is among the selected countries invited to comprise the TBG.

The TBG is currently concerned with addressing issues emanating from the implementation of the Basel 2.5 framework, which significantly altered the amount of capital required to be held by banks for market risk. The TBG continues to concentrate on a fundamental review of the market risk capital framework, part of which is concentrated around the debates on the relevance and definition of the distinction between the trading book and the banking book; how trading activities are defined; and how market risk charges should be addressed by appropriate levels of regulatory capital.

Discrepancies between the standardised and internal model approaches for reporting market risk are also being addressed by the TBG in order to reduce the effects of inappropriate diversification recognition and the double counting of capital. Market liquidity as a limitation to banks' ability to trade is also being assessed in the review.

During 2012 the TBG issued a consultative paper entitled "Fundamental Review of the Trading Book",²⁴ which attracted valuable comments from many industry and regulatory organisations. These comments are being considered by the TBG and will be used to refine the fundamental review.

1.8.4 Standards Implementation Group: Banking Book

The Department is represented on the Standards Implementation Group Banking Book (SIG-BB), a working group formed at the end of 2011 to assess the extent to which the calculation of risk-weighted assets (RWA) differs across banks and countries that have adopted the internal ratings-based (IRB) approach for calculating the amount of regulatory capital to be held for credit risk. In order to deliver on its mandate, the SIG-BB performed top-down RWA analysis and bottom-up portfolio benchmarking. Similarly, the Department initiated an in-country benchmarking exercise to identify differences in banks' evaluation of IRB parameters through analysing how IRB parameter estimates varied across banks for a selection of commonly held obligors. Results of this benchmarking exercise will be discussed with banks during 2013.

1.8.5 Standards Implementation Group: Operational Risk

The Department is represented on the Standards Implementation Group Operational Risk (SIGOR). SIGOR was specifically established to focus on operational risk issues. SIGOR is mandated to react and address the practical challenges related to the successful development, implementation and maintenance of an operational risk framework aligned to the Basel Committee's requirements for the advanced measurement approach (AMA). SIGOR also considers some of the implementation issues related to the simpler approaches for operational risk. In addition, SIGOR is responsible for facilitating and resolving issues associated with the cross-border supervision of international banking groups specifically in relation to operational risk.

During the year under review work continued in the following areas:

- *Fundamental review of the simpler approaches*: This effort involves the recalibration of the operational risk charge across the simpler methods, including the performance of these approaches in relation to the AMA. A possible outcome is a reduction in the number of available approaches.
- *Streamlining the AMA practices*: This is a comprehensive AMA benchmarking exercise intended to identify whether plausible benchmarks exist as a basis to reduce the range of AMA practices, in particular to eliminate unsound practices that could lead to outlier capital outcomes. In addition, the AMA benchmarking exercise aims to allow supervisors to obtain a better understanding of variances within and across banks and jurisdictions with regard to AMA capital calculations.

1.8.6 Standards Implementation Group: Trading Book

The Standards Implementation Group Trading Book (SIG-TB) was established in 2012 to analyse the reasons for differences in RWA in the trading book across different jurisdictions. This analysis is part of the wider Regulatory Consistency Assessment Programme (RCAP) initiated by the Basel Committee in 2012. The aim of the RCAP is to ensure consistent



implementation of the Basel framework, to help strengthen the resilience of the global banking system, maintain market confidence in regulatory ratios and provide a level playing field for banks operating globally.

During the period under review the SIG-TB focused on two aspects of analysis. The first was based on an examination of publicly available bank data for a selection of large banks, while the second focused on a hypothetical test portfolio exercise in which 15 internationally active banks participated. The work of the SIG-TB culminated in a report entitled "RCAP: Analysis of Risk-Weighted Assets for Market Risk"²⁵ which was published by the Basel Committee in January 2013.

The SIG-TB has been mandated to continue a more detailed analysis of the variation in RWA in the trading book, and to investigate differences in the valuation of trading book positions across different jurisdictions in 2013.

1.8.7 Capital Monitoring Group

The Basel Committee established the Capital Monitoring Group (CMG) in 2008 to monitor the level and cyclicity of minimum required capital (MRC) emanating from the introduction of the Basel II framework and subsequently the Basel 2.5 framework. This role was extended to address the effect the Basel III framework would have on MRC. The Department has participated in the CMG since its inception in 2008.

The CMG collects and analyses data from banks that have adopted one of the IRB approaches to calculate their MRC in respect of credit risk and reports the results of its analysis to the Basel Committee every six months. This analysis covers areas such as MRC, capital ratios and buffers, RWA, portfolio-level exposures, risk parameters and transitional floors. The CMG also shares its experiences in monitoring capital requirements and the levels of capital on a national basis. During the most recent exercise data from 102 banks across 15 countries was collected and analysed for inclusion in the CMG report submitted to the Basel Committee.

1.8.8 Quantitative Impact Study working group

The Basel Committee established the Quantitative Impact Study (QIS) working group under the Capital Monitoring Group to calibrate the new Basel III rules and to assess the impact thereof on participating banking groups and member countries. Having completed this phase of its mandate, the group fulfils the function of monitoring the implementation of Basel III by participating banking groups and member countries. The associated QIS takes place semi-annually with end-June and end-December reporting dates.

During 2012 the QIS working group's role and responsibilities included the development and implementation of the QIS forms and processes, and computation of various aspects related to the impact of reported data on banks both individually and collectively. The QIS working group interacted with other Basel Committee policy workstreams to develop QIS templates and the software needed to translate data submissions into impact estimates.

The scope of the QIS exercises included the impact of

- changes to the definition of capital;
- enhancements to risk coverage, including the revisions to the market risk framework, revisions to counterparty credit risk measurement and to the capital requirements for securitisations held in the banking book;
- the leverage ratio; and
- standards developed by the working group on liquidity.

The Department continued to participate in the QIS working group's activities during the period under review and will continue to do so during 2013.

25 Available at <http://www.bis.org/publ/bcbs240.htm>.

1.8.9 Capital Planning Workstream

During 2012 the Department participated in a capital planning survey conducted by the Basel Committee via the Capital Planning Workstream (CPW). This workstream is a temporary structure co-ordinated under the activities of the Capital Monitoring Group. The objective of the survey was to collect information on banks' capital planning practices and analyse it to identify the range of practices across different segments of capital planning processes in different jurisdictions in relation to the focus areas of the Basel III framework. The survey focused on gathering information on processes in six key areas of capital planning, namely general practices, governance, policy setting, risk management, stress testing and capital actions. The five largest banks in South Africa were requested to participate in the survey. In 2013 the CPW will continue to develop a paper on the range of practices for capital planning.

1.8.10 Financial Action Task Force meetings

A departmental representative attended all the meetings of the Financial Action Task Force (FATF) held in 2012. As mentioned in the Department's 2011 *Annual Report*,²⁶ the revised FATF standards on AML/CFT, better known as the 'FATF Recommendations', were adopted at the FATF plenary meeting held in February 2012. This concluded a two-year process of revising the FATF Recommendations. Having concluded the revision of the FATF Recommendations, the FATF members are in the process of updating their existing guidance papers in order to bring them into line with the new FATF Recommendations.

The new FATF Recommendations will require a new methodology and process of assessing countries' compliance with the new standards. A significant amount of time was spent during the 2012 FATF meetings on discussing the methodology to be used for the next (fourth) round of mutual evaluations. The fourth round of mutual evaluations will, in addition to assessing the technical compliance of countries with the FATF Recommendations, also assess how effective jurisdictions are in fighting money laundering and CFT.

South Africa's third-round assessment and mutual evaluation report, which was adopted by the FATF in February 2009, was discussed at the February 2012 plenary meeting. Members of the FATF plenary meeting proposed that South Africa should remain in the regular follow-up process. South Africa was accordingly asked to report to the FATF meeting in February 2013 as the FATF expected that substantive progress would have been made by South Africa regarding the passing of certain legislative amendments to AML/CFT legislation.

1.9 Participation in domestic regulatory and supervisory forums

The Department represents South Africa on numerous domestic committees, task groups and working teams who consult with industry participants and bodies, government departments and other financial regulatory authorities. The objectives of these committees are topical and range from ongoing consultation on detailed complexities in the regulatory environment to operational and systemic concerns arising from economic circumstances and the dynamics associated with the business operations of financial institutions.

One noteworthy outcome of the Department's involvement in these domestic forums during 2012 was in respect of the Liquidity Coverage Ratio Task Group, which was co-ordinated by the Banking Association of South Africa (BASA). It became evident both at this forum and through the data collection exercises conducted by the Department that South African banks would struggle to meet the higher LCR requirements prescribed by the Basel III framework. The higher LCR implicitly requires banks to invest in corporate bonds that meet or exceed an AA- credit rating. The challenge South Africa faces in this regard is that its sovereign credit rating is below this floor and none of its domestic, local-currency corporate bonds exceed the AA- rating. Consequently, no corporate bonds issued in South Africa would qualify for the LCR. The Department appealed to the Basel Committee on the grounds that the AA- floor is unrepresentative of bond liquidity in jurisdictions such as South Africa with a low sovereign rating, and that the rating floor should

26 Section 1.12.2.5.



be relative to a domestic currency rating scale. The Basel Committee agreed with South Africa's proposal in this regard and subsequently amended the relevant LCR rules to reflect this.

1.10 Regional co-operation and interaction

1.10.1 Financial Stability Institute: High-level meeting for African banking supervisors

The seventh Financial Stability Institute (FSI) high-level meeting for African banking supervisors was held in Cape Town, South Africa, in January 2012. As in previous years, the meeting was hosted jointly by the FSI and the Department.

The theme for the 2012 meeting was "Strengthening Financial Sector Supervision and Current Regulatory Practices".

1.10.2 Southern African Development Community Subcommittee of Banking Supervisors

The Department is a member of the SADC Subcommittee of Banking Supervisors (SSBS). Established by the SADC Committee of Central Bank Governors, the principal aim of the SSBS is to implement the memorandum of understanding (MoU) that was concluded on 28 July 2006 between the central banks of the SADC member states on co-operation and co-ordination in the area of banking, regulatory and supervisory matters. The MoU aims to establish a framework for co-operation and co-ordination between SADC central banks in order to promote harmonisation of banking regulatory and supervisory matters. One of the main tasks of the SSBS is to oversee the drafting of a model banking law for SADC member states. To this end, a five-member working group was formed to focus only on the drafting of the SADC model banking law. The working group comprises members of the central banks of South Africa, Zambia, Malawi and Zimbabwe.

1.10.3 Toronto Centre Crisis Preparedness Programme for SADC

The Bank hosted, for the second time, a joint programme with the Toronto Centre on "Crisis Preparedness in Interconnected Markets". The workshop, which took place from 20 to 24 August 2012, was a regional training programme for senior officials from central banks and supervisory agencies from SADC member countries. Thirty representatives from ten countries attended the programme.

1.11 Expression of gratitude

I wish to express my appreciation to the Minister of Finance, Mr Pravin Gordhan, for his input on requests in terms of statutory requirements. To the Governor of the Bank, Ms Gill Marcus, and Deputy Governor Lesetja Kganyago: thank you for your ongoing co-operation, guidance and support during 2012.

My sincere appreciation also goes to the staff members of the Department for their continued efforts and willingness to often go beyond the call of duty to meet the challenges and demands of an ever-changing supervisory and regulatory landscape.



René van Wyk
Registrar of Banks