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 activities 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 2012 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 Credit risk reviews

Credit risk reviews conducted in 2012 by the Department mainly concentrated on banks who had been granted approval to use the IRB approach for regulatory reporting, and on a selection of banks using the standardised approach (STA).[27] The main purpose of the reviews was to assess the soundness of credit risk management practices, determine whether banks' credit risk models remained fit for purpose and focus on the risk drivers of banks' business. A total of 11 on-site meetings were held in 2012. The key findings of these reviews are as follows:

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

- *Changes to credit risk governance structures*: Some banks indicated changes to governance structures relating to model approvals and credit risk management in general. The Department recommended that these banks maintain a centralised view of credit risk, and that independent internal reviewing and challenging of models needed to remain effective.
- *Annual validation of models (recurring issue)*: The Department was satisfied with the progress made by most banks to improve the quality of validation and to resolve the backlog of issues emanating from validations. Concerns were raised regarding the capacity of, and expertise levels in, central model validation teams.
- *Level of compliance in terms of IRB requirements (recurring issue)*: After noting certain instances of non-compliance in its 2011 *Annual Report*,[28] the Department paid specific attention to these in 2012. There were, however, still certain instances of outdated reviews of assigned borrowers and facility ratings, that is, ratings older than one year. Business units remained focused on reducing the number of outdated reviews.

28 Section 2.2.5.

2.2.2 Model approvals

During the period under review the Department received two applications to use the IRB approach and after a detailed review of these applications, granted its approval. The number of banks with approval to report credit risk using the advanced IRB approach in 2012 is depicted in Figure 2.1. One applicant bank will only start reporting using the IRB approach in 2013 (and is therefore not included in Figure 2.1). Various applications received for approval to use refined or redeveloped rating systems would, in most cases, result in a decrease in regulatory capital requirements.

Figure 2.1 Reporting methods applied by banks as at 31 December 2012

2.2.3 Review of self-assessment templates submitted by banks

Banks who have adopted the IRB approach to measure their exposure to credit risk are required to complete and submit a series of self-assessment templates annually in order to evaluate their level of compliance with the minimum requirements prescribed in the Regulations. During 2012 these banks submitted their self-assessment templates to the Department based on December 2011 data.

The majority of the minor and material gaps identified pertain to risk quantification, rating system operations and design specifically relating to the use of models, the use of other quantitative validation tools, retrospective reallocation requirements, replicable rating grade criteria, retail data retention requirements, and back-testing internal estimates and related documentation. In general, most gaps relate to less material risk-rating systems. The Department has consequently noted that greater attention will have to be paid to less material models to ensure that no material concerns are caused by a summation of minor issues. Target dates have been set by the banks to resolve both recurring and recent gaps. The Department will continue to monitor the progress made in this regard in 2013 as part of its supervisory programme to ensure that banks' rating systems meet minimum requirements.

2.2.4 Credit risk long-form reviews

The use of internal models necessitated a substantial reconsideration by the Department of the scope of work to be performed by it and banks' external auditors in this regard. The long-form review process was accordingly implemented in 2009, and forms part of the risk management and audit processes of banks with approval to use the IRB approach for calculating the minimum amount of required capital and reserve funds.

Reports emanating from the third cycle of the long-form reviews, which started in 2011, were submitted to the Department during 2012. The portfolios for which information was reported covered mostly the retail asset classes. In 2012 BASA, together with the South African Institute of Chartered Accountants (SAICA) and in collaboration with the banking industry, forwarded recommendations to the Department on potential improvements to the long-form review process.

The Department considered the feedback BASA and SAICA provided, modified elements of the long-form review process to be followed as from 2013 and communicated the changes to the affected parties.

2.2.5 Basel III impact

The Basel III framework, among other things, introduced additional capital requirements relating to banks' exposures to over-the-counter (OTC) derivative instruments (derivatives), exchange-traded derivatives and securities-financing transactions. These additional capital requirements vary according to the degree to which the derivatives are traded through a CCP. The objective of the additional capital requirements is to encourage the trading of derivatives on exchanges or, in instances where derivatives are traded on an OTC basis, that they be settled through a CCP so as to reduce counterparty credit risk (CCR). In accordance with the requirements specified in the Basel III framework, an increased capital requirement for credit valuation adjustment (CVA) risk will be imposed for trades that are not settled through a CCP. Furthermore, the Basel III framework distinguishes between capital requirements for trades transacted through either qualifying or non-qualifying CCPs, with higher capital requirements being applied to non-qualifying CCPs.

During 2012 the Department worked closely with the banking industry to ensure that banks would be ready to comply with the Basel III requirements. Currently, South Africa does not have a domestically registered or domestically qualifying CCP that transacts OTC derivatives. Consequently, until such time as a qualifying domestic CCP is established for OTC derivatives, banks registered in South Africa have no alternative but to absorb the full impact of the increased capital requirements for CVA risk. In order to address this issue, the Department issued Banks Act Directive 3/2012.[29]

29 Available at http://www.resbank.co.za/Publications/Pages/Bank-Act-directives.aspx.

To assess the impact of the CCR requirements on banks' required capital, the Department collated preliminary new regulatory data required for measuring compliance with Basel III amendments for a period of two months, which ended on 31 October 2012.

2.3 Market risk

2.3.1 Market risk reviews

The Department performed both compliance-based assessments and prudential supervision of banks' market risk during the period under review. These market risk reviews mainly focused on banks with approval to use the internal models approach (IMA) for regulatory purposes, with treasury and securities reviews being undertaken. The Department completed investment risk reviews, which focused on equity risk in the banking book and residual asset risk.

2.3.2 Key findings

Following the inclusion of stressed value at risk (sVaR) in the capital base on 1 January 2012, banks' capital allocated for market risk increased substantially during the period under review.

In addition, global regulatory reforms required banks to re-evaluate their business models, resulting in the majority of trading banks moving away from proprietary trading and towards a more client-focused model. These changes were mainly driven by the need for improved capital utilisation, growth and efficiency.

Despite showing an improvement relative to previous years, the trading environment continued to prove unaccommodating. This resulted in many banks not achieving their trading performance targets. The specific challenges faced in this regard were due to both global and domestic economic developments. With continued global economic uncertainty and increasing regulatory requirements, banks are revising their future profit expectations. Encouragingly, however, is the fact that South Africa's inclusion in the Citi World Government Bond Index presented opportunities to those banks that were in a position to take advantage of this promising development.

With regard to banks' exposures to equities in the banking book, 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, the exposures are subject to a capital treatment that is independent of the market risk charge, and are more punitive. For supervisory purposes, equity risk is regulated together with market risk.

As regards the investment risk reviews conducted by the Department, it was unclear in some instances from a governance perspective which committee or representative at group level oversaw banks' group-wide investment risk activities. This raised a further concern about the adequacy of the setting of strategy, risk appetite and capital planning at several banking groups. Many banks also did not have a formal policy with prescribed limits for the assumption of residual asset risk.

2.3.3 Basel III impact

The implementation of Basel III had a minimal impact on the reporting of market risk. However, more attention was paid to the fundamental review of the trading book being undertaken by the TBG, which is expected to remain a focal point in years to come as it will bring significant change to the market risk regulatory environment by changing the manner in which capital is calculated.

2.3.4 Capital charges for market risk

Capital charges for equity risk in the banking book comprised approximately 4,31 per cent of banks' total capital requirements, whereas capital held for market risk comprised about 2,95 per cent of the total capital requirement for the banking sector as at 31 December 2012.

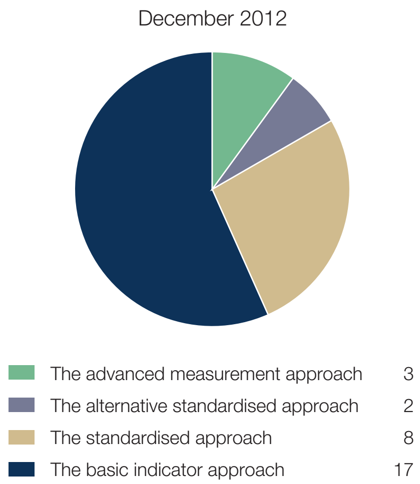
2.4 Operational risk

2.4.1 Prescribed methodologies

Banks in South Africa can choose from the following methodologies to calculate the minimum required amount of regulatory capital they have to hold for operational risk:

- The basic indicator approach (BIA)
- TSA
- The alternative standardised approach (ASA)
- The AMA.

Figure 2.2 Reporting methods applied by banks as at 31 December 2012



2.4.2 Amendments to the statutory BA returns

A key focus area of the Department's supervisory activities during 2012 was the quality of regulatory reporting, with specific emphasis on the interpretation of key aspects of the specific sections of the Regulations that dealt with operational risk. Discrepancies and inconsistencies were identified through trend analysis and peer-group analysis, in particular relating to banks that followed the AMA. Guidance was provided to the banks on possible interpretive and ambiguous matters to create standardisation across the banking industry. In addition, changes were made to the operational risk returns to enhance further regulatory reporting. These changes became effective on 1 January 2013.

2.4.3 Operational risk thematic reviews

During the year under review the Department's review team commenced with the cycle of risk-based reviews focused on assessing the degree of compliance by banks that had adopted TSA for the calculation of their minimum regulatory capital and reserve funds required to be held for operational risk.

The reviews entailed the assessment of both quantitative and qualitative aspects relating to the operational risk regulatory capital calculation in terms of the provisions of regulations 33 and 34 of the Regulations. The reviews encompassed the following:

- A follow-up of the specific requirements attached to the approval of TSA by the Department
- An assessment of banks' compliance with TSA qualifying criteria as stipulated in regulation 33(8)(b) of the Regulations
- An assessment of the accuracy of the required capital calculation relating to operational risk in terms of regulation 33(8)(c), read with regulation 33(7)(b), of the Regulations
- A reconciliation of source data to the form BA 400
- An assessment of banks' compliance with regulation 33(8)(d) of the Regulations with regard to business line mapping.

2.4.4 Focused operational risk reviews

Various focused operational risk reviews were completed during the period under review. These reviews focused on the adequacy of banks' risk management policies and their procedures to identify, assess, monitor and control or mitigate operational risk. The following major topics were covered:

- Performance against banks' operational risk strategic objectives for 2012, including key achievements and material deviations.
- Current and recent changes to, or developments in, operational risk governance structures and 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 had impacted or would impact operational risk. Banks were also requested to include changes or developments as a result of the Basel III framework.
- Management information reports or 'dashboards' used for operational risk management, including material operational risk losses.
- Self-assessment, with a specific focus on exception-based results against Basel Committee papers.
- A list of top operational risk concerns for 2012 was compiled from international sources and banks were requested to assess whether these challenges were relevant in their environment.
- An overview of the processes and procedures in terms of dealings with third-party vendors.
- Discussion of internal audit reports related to operational risk management.

2.4.5 Operational risk long-form review

During 2012 a process was initiated between the Department, external audit firms and banks with approval to use the AMA to develop a long-form review for operational risk. The objective of the review was similar to the credit risk long-form review[30] in that it would be used to report to the Registrar of Banks (the Registrar) on the accuracy and completeness of banks' calculation of regulatory operational risk capital as determined by an internal model.

30 Refer to section 2.2.4 of this Report for further details regarding the credit risk long-form reviews.

2.5 Liquidity risk

2.5.1 Implementation of enhanced liquidity risk monitoring

During 2012 the Department amended its regulatory framework to include the requirements of the Basel III liquidity framework.[31] As mentioned in the Department's 2011 *Annual Report*,[32] the most notable changes to the Basel III liquidity framework relate to the inclusion of two new ratios for measuring liquidity risk in banks, namely the LCR and the NSFR. However, it also contains suggested liquidity risk monitoring tools for supervisors.

31 The Basel III liquidity framework specifically refers to the Basel Committee document entitled "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring".

32 Section 1.2.2.2.

The purpose of the LCR is to test banks' resilience against potential liquidity stress over a 30 calendar-day period. As a standard measure, it requires banks to hold a stock of high-quality liquid assets to cover their total net cash outflows each day for the 30 calendar days following the date of reporting under a specified stress scenario. This stress scenario incorporates both bank-specific and market-wide shock elements.

The prescribed scope of high-quality liquid assets as per the Basel III liquidity framework focuses on securities issued by governments, which may be in limited supply in some jurisdictions, such as South Africa. However, the Basel III liquidity framework also outlines a few alternatives for banks in these jurisdictions, one of which is the availing of a committed liquidity facility by the relevant jurisdiction's central bank. In line with these options, the Bank has decided to make available a committed liquidity facility to banks to cover their shortfall up to a limited amount with effect from 1 January 2013. Details of the Bank's committed liquidity facility are set out in Banks Act Guidance Note 5/2012.[33]

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

Similarly, the NSFR aims to limit banks' over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance-sheet items over a one-year time horizon. The NSFR is calculated as a bank's amount of available stable funding divided by its amount of required stable funding. The NSFR is expressed as a ratio and this ratio should exceed 100 per cent. The LCR and NSFR are both subject to monitoring periods before they become statutory requirements. Formal monitoring commenced on 1 January 2013, with the LCR set to become effective on 1 January 2015 and the NSFR on 1 January 2018.

As part of the development of the LCR framework and monitoring its impact on the South African banking sector, the seven largest banking groups participated in various QIS exercises. The Department accumulated the data and assessed the impact of the LCR on banks. The information was provided to the Basel Committee, where it was analysed by country.

The Department engaged with the banking sector through BASA during the finalisation of the LCR framework and on matters pertaining to its implementation in South Africa.

2.5.2 Participation in liquidity risk simulations

The Department continued to participate in ad hoc liquidity risk simulation exercises at banks, which were facilitated by an independent external party, in order to assess the adequacy and effectiveness of banks' liquidity risk management framework. Representatives of the Department fulfilled the role of observer during these exercises.

Simulation exercises of this nature continue to be of great value to the Department and the participant banks as they test the behaviour and processes of banks under a scenario of severe liquidity shortage. The simulation exercises also highlight areas of improvement and demonstrate the need for robust liquidity risk management.

2.6 Capital management

2.6.1 Overview of Internal Capital Adequacy Assessment Process reviews and key findings

During 2012 the Department conducted focused reviews on banks' ICAAP documents, focusing specifically on improvements to banks' ICAAPs, credit risk, model validation, capital management and the use test.

2.6.2 Participation in the Basel Committee's Quantitative Impact Study

The Basel Committee continued with its semi-annual exercise to monitor the international implementation of the Basel III framework in the form of a QIS during 2012.

In September 2012 the Basel Committee published a document entitled "Results of the Basel III Monitoring Exercise as of 31 December 2011".[34] The document incorporated the impact of data submitted by participating South African banking groups.

34 Available at http://www.bis.org/publ/bcbs231.htm.

During 2012 the Department also conducted two independent domestic QIS exercises covering the full complement of banks registered in South Africa. These domestic QIS exercises were similar to the international QIS exercises conducted by the Basel Committee. Participation in these domestic QIS exercises assisted banks in familiarising themselves with the Basel III requirements in preparation for the implementation of the Basel III framework in South Africa. Moreover, the measurement of capital against the requirements of the Basel III framework enhanced the accuracy of banks' capital planning and forecasting, and will assist banks in meeting the minimum capital requirements of the Basel III framework in future.

The two domestic QIS exercises assisted the Department in determining appropriate domestic minimum capital requirements under the Basel III capital framework, and in identifying banks that would be significantly impacted by the higher Basel III capital requirements.

2.6.3 Preparation for the implementation of the Basel III framework

The Department commenced with preparations for the implementation of the Basel III framework during 2012. In addition to conducting parallel runs, internal and external training interventions and various discussions with banks' management and staff, Tier 3 legislation pertaining to capital was issued.[35]

35 Refer to Appendix 6.

2.6.4 Capital instruments to be phased out under the Basel III framework

The introduction of the Basel III framework resulted in a key change to the qualifying criteria for additional Tier 1 capital instruments and Tier 2 capital instruments. Instruments that adhere to the qualifying criteria in terms of the Basel 2.5 framework will be phased out over a ten-year period with effect from 1 January 2013. However, those instruments that meet the qualifying criteria under the Basel III framework will not be phased out. Banks were requested to provide information on their capital instruments that will be phased out.

2.6.5 Domestic systemically important banks

In October 2012 the Basel Committee released a document entitled "A Framework for Dealing with Domestic Systemically Important Banks", which essentially details a set of principles with which D-SIBs have to comply and a list of bank-specific factors for assessing the impact should a D-SIB fail. These bank-specific factors include size, interconnectedness, substitutability, financial institution infrastructure and complexity. The Basel Committee's D-SIB framework also introduced a higher loss-absorbency (HLA) requirement that will be implemented through an extension of the capital conservation buffer. The Department is in the process of formulating its D-SIB methodology to identify D-SIBs in South Africa, and to allocate appropriate HLA requirements for them. To assist banks with their capital planning, during 2013 the Department will inform banks of their D-SIB classification and their individual HLA requirements.

The HLA requirement will be phased in together and in parallel with the capital conservation and countercyclical buffers, that is between 1 January 2016 and 31 December 2018, before becoming fully effective on 1 January 2019.

2.7 Pillar 3: Disclosure

2.7.1 Overview of activities

During the period under review the Department continued to assess banks' reports published in compliance with the regulatory requirements for public disclosure, also known as 'Pillar 3' disclosures. The key objective was to identify areas of non-compliance. No significant changes were noted with regard to format, layout or location of banks' Pillar 3 disclosures.

The Basel Committee issued a document entitled "Composition of Capital Disclosure Requirements"[36] in June 2012 which outlined detailed Pillar 3 disclosure requirements to improve transparency of regulatory capital and enhance market discipline.

The Department will focus on the additional disclosure requirements emanating from the alignment of the Regulations with Basel III.

36 Available at http://www.bis.org/publ/bcbs221.htm.

2.8 Consolidated supervision

2.8.1 Delegates from the Reserve Bank of Malawi

Following a request from the International Monetary Fund (IMF) in June 2012 and in accordance with the Department's commitment to improving the supervisory skills of regional supervisors as reiterated in its 2011 *Annual Report*,[37] the Department hosted two delegates from the Reserve Bank of Malawi (RBM) for two weeks in September 2012. The visit formed part of the IMF's East Africa Regional Technical Assistance Centre's (AFRITAC) collaborative programme, and the RBM representatives received conceptual and practical training on performing consolidated supervision.

37 Section 2.8.2.

2.8.2 Supervisory meetings with the Financial Services Board

In view of the implementation of a twin peaks model of financial regulation in South Africa as discussed in section 1.4 of this Report, interaction between the Bank and the Financial Services Board is becoming increasingly important as consolidated supervision of financial groups requires ongoing collaboration between the two regulators. During 2012 the Department continued to meet regularly with the Financial Services Board as the meetings add value to both regulators' supervisory processes.

2.8.3 Solvency Assessment and Management: Insurance Groups Task Group

During 2012 the Department continued to participate in, and contribute to, the work of the Solvency Assessment and Management Insurance Groups Task Group, which had been established to address a proposed revised regulatory capital regime for South African short- and long-term insurers.

2.9 Anti-money laundering and countering the financing of terrorism

2.9.1 Off-site supervision

As part of the Department's off-site AML/CFT supervisory process, it held quarterly meetings with South Africa's five largest banks. These meetings were also attended by representatives of the Financial Intelligence Centre (FIC). The discussions were aimed at engaging with banks on the issues and challenges banks faced in terms of the FIC Act. Issues emanating from international best practice standards, such as the FATF Recommendations, were also discussed. The meetings assisted the Department in establishing whether sufficient controls and systems were, in fact, being put in place to prevent the banks from being used for money-laundering and terrorist-financing purposes.

The Department also held meetings with the external auditors of banks before an external audit to exchange information relating to banks' compliance with the FIC Act and the Money Laundering and Terrorist Financing Control Regulations.

2.9.2 Interaction with external stakeholders

In strengthening the combating of money laundering and terrorist financing, representatives of both the Department and the FIC met on a quarterly basis during 2012 to discuss issues of mutual interest relating to the implementation of the FIC Act. Regular meetings were held with other supervisory bodies, mostly before an AML/CFT on-site inspection to share information about accountable institutions in banks supervised by different supervisory bodies.

The Department attended the Financial Intelligence Centre Act Enforcement Forum (FEF) meetings arranged by the FIC during the period under review. The FEF provides a platform for supervisory and other regulatory bodies to share information and supervisory practices relating to the FIC Act.

2.9.3 On-site inspections

The on-site AML/CFT supervisory process aims to ensure that banks comply with the legislative requirements, and implement and maintain robust structures, policies, processes and procedures.

Inspections were conducted to assess whether banks complied with the requirements of the FIC Act. The duration of inspections was determined by the relevant bank's risk assessment and the areas to be assessed during the inspection. Banks were notified at least 30 days before the date of the inspection.

2.10 Co-operative banks

In view of the fact that all data and relevant information pertaining to co-operative banks are contained in the *Combined Annual Report of the Supervisors of the Co-operative Banks Development Agency and the South African Reserve Bank*,[38] this data and information will not be repeated in this Report.

38 Available at http://www.resbank.co.za/Publications/Reports/Pages/CombinedAnnualReport.aspx.