Chapter 2: Overview of supervisory activities

2.1 Introduction

This chapter provides an overview of the operations of the Department during the period under review at an industry level according to focused aspects of bank supervision that are common across banks.

2.2 Credit risk

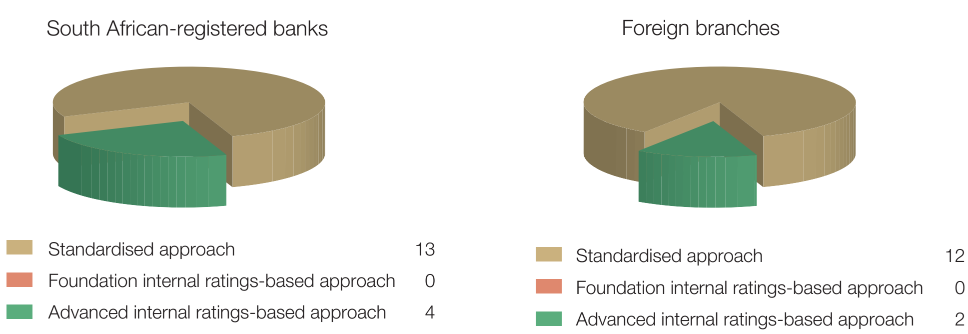
2.2.1 Introduction

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, including the simplified standardised approach;
2. the foundation internal ratings-based approach; and
3. the advanced internal ratings-based 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 as at 31 December 2013



2.2.2 Credit risk on-site reviews

During the year under review, the Department continued to perform both compliance-based and risk-focused supervision of banks, specifically addressing banks' credit risk profiles and portfolios that were, and continue to be, impacted by adverse market conditions and strained economic activity. A total of 12 on-site meetings were held during 2013, which included both prudential and model-focused reviews.

2.2.2.1 Credit risk on-site prudential reviews

The Department's supervisory activity involves regular assessment of banks' credit risk management frameworks to assess the soundness of banks' credit risk management practices. As part of its supervisory programme, a number of credit risk on-site prudential reviews were carried out by the Department during the year under review. These reviews covered specific products such as home loans, vehicle and asset finance, and personal loans. In certain instances it was required to expand discussions to incorporate wholesale portfolios. These prudential reviews assess an individual bank's policies and procedures against those of its peer group. In-depth analysis of the portfolios provided by the individual banks enhanced the industry trend analysis conducted by the Department.

2.2.2.2 Model-focused reviews

During 2013 the Department conducted credit risk model on-site reviews for all the banks that had been granted approval to use the IRB approach to determine whether banks' credit risk models remained fit for purpose. All model-related issues were reviewed and discussed, including the governance processes for model approval, planned model developments or calibrations, updates on the validation plan and model-specific discussions relating to selected validation, and long-form reports. Following a risk-based approach in selecting portfolios to be reviewed, the Department focused on retail unsecured lending, and retail and wholesale small and medium-enterprise portfolios. Any outstanding issues raised by the Department during previous reviews of validation reports and long-form reports were also discussed.

2.2.3 Review of self-assessment questionnaires

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 questionnaires annually in order to evaluate their level of compliance with the minimum requirements prescribed in the Regulations. During 2013, the assessment was based on December 2012 data.

The level of granularity in the 2013 submissions had improved from the previous year, which enabled a more detailed analysis of potential areas of concern in banks' risk-rating systems. The majority of the minor and material gaps identified pertained to risk-rating system operation and risk quantification. Although most gaps related to less material risk-rating systems, and the total amount of gaps had decreased on a year-on-year basis. Target dates had also 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 2014 as part of its supervisory programme to ensure that banks' rating systems meet minimum requirements.

2.2.4 Credit risk long-form reviews

BASA and SAICA, in collaboration with the banking industry, recommended improvements to both the long-form review process and the long-form templates used during the review. Following consultation on the proposals, the Department revised the retail and wholesale long-form templates during 2013, and issued new templates in May 2013 and November 2013 respectively.

2.2.5 Model changes

Directive 6/2013[22] regarding matters related to changes to credit risk models used for the calculation of required capital and reserve funds for credit risk by IRB banks was issued in May 2013. This directive provided the quantitative characteristics and qualitative thresholds for a material model change where prior written approval is required from the Department before implementation of the change.

During 2013 the Department received 39 notifications of non-material model changes and 33 submissions for material model changes. The Department continued to follow a robust review and approval process for each material model change and in a few instances for some of the non-material model changes. The review process could, based on complexity of the model change, include technical discussions at selected banks with model developers. The outcomes of these reviews were presented at a risk panel for final approval.

2.2.6 Credit risk survey on restructured exposures

The Department embarked on a process to obtain a clearer understanding of how banks identified and controlled restructured credit exposures and how banks reported these restructured exposures in the statutory returns submitted to the Department. The main reason for the increased focus on restructures was to alleviate the concern that banks could be

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

restructuring exposures to avoid placing accounts into arrears, thereby improving the perceived quality of their loan books.

During 2013 a questionnaire was compiled and sent to all banks seeking more information about how they treated restructured exposures. Based on the analysis of the answers received and discussion during on-site meetings, it was identified that different interpretations existed in the industry. A directive will be issued in 2014 to inform banks of the Department's required treatment of restructures.

2.2.7 Loss given default/probability of default benchmarking exercise

The recent global financial crisis revealed potential inconsistency between the different banks that employ the IRB approach to measure credit risk, specifically with respect to the interpretation of methodologies, the level of conservatism and the various elements of the IRB framework. Accordingly, the Department conducted a benchmarking exercise on banks' interpretation of the estimation of loss given default (LGD) and probability of default (PD) as described in regulation 23 of the Regulations.

The benchmarking exercise aimed to establish whether and how banks interpreted the estimation of LGD and PD as described in the Regulations differently. The exercise focused only on wholesale credit exposures to sovereigns, banks and corporates.

It is important to note that the Department neither expects banks' IRB risk parameters nor the choices of modelling these parameters to be identical across IRB banks. Owing to the benchmarking exercise's limited scope, the Department did not expect to identify all the factors that could result in significant differences in risk parameters across IRB banks. In addition, the Department accepts that in some cases there will be justifiable reasons for these differences. It was therefore neither the aim of the benchmarking exercise nor the Department's intention to advocate a move towards identical risk parameters or measurement techniques across IRB banks. Analysis of the data collected through the benchmarking exercise will consequently constitute one component of the overall analysis conducted by the Department in order to determine banks' consistency regarding the assignment of PD and LGD estimates.

The benchmarking exercise required the completion of a workbook and a questionnaire by each participating bank. The workbook requested the pre-override PD, post-override PD, point-in-time PD, through-the-cycle PD (regulatory PD), long-run LGD and downturn LGD (regulatory LGD) for 81 common corporate counterparties, 7 common domestic bank counterparties, 28 common international bank counterparties and 17 common sovereign counterparties. Additional qualitative data on the PD and LGD models used by the participating banks were also addressed.

The exercise revealed significant differences in the risk weighting of corporate, bank and sovereign exposures by the participating banks. While some of these differences could be attributed to differences in methodologies and weightings used in the modelling of PD and LGD, the composition of the relevant bank's portfolio and its risk management procedures, it was determined that expert judgement in the modelling process played a significant role in the differences and was attributable to the low default nature of the exposures. Supervisory intervention commenced on outlying banks and will continue until the Department is satisfied with the estimation of LGD and PD.

2.3 Market risk

2.3.1 Market risk reviews

The Department performed both compliance-based and risk-focused supervision of market risk during the period under review. Market risk reviews conducted in 2013 focused on banks using the internal models approach for regulatory purposes. Reviews of treasury and securities operations of certain banks were also conducted. The Department completed one review on equity risk in the banking book, with further reviews scheduled for 2014. In addition, the Department conducted counterparty credit risk reviews on selected banks.

2.3.2 Key findings

The trading environment in 2013 was shaped primarily by the news that the US Federal Reserve may reduce its monetary stimulus, and by domestic sociopolitical and economic developments. The US Federal Reserve's announcement that it would begin tapering its QE programme by the end of 2013 contributed to a weakness in the rand and a much larger impact in the bond markets, resulting in unfavourable conditions for the majority of banks. This, coupled with the poor economic performance and labour market tensions domestically, caused concerns over a possible sovereign downgrade and resulted in further challenges in banks' ability to meet their profitability targets.

Two common trends emerging among banks were the move to enhance technological efficiencies and the strategy to expand further into Africa.

2.3.3 Regulatory developments

A key focal point for the year under review was the ongoing development of a fundamental review of the trading book by the Basel Committee, as this brings with it significant changes to the market risk regulatory environment. Banks began independently analysing the impact the changes might have on their current and future business initiatives. The Basel Committee released a second consultative paper towards the end of 2013, with further work to be conducted in 2014.

2.3.4 Counterparty credit risk thematic reviews

During 2013 the Department initiated a thematic review that addressed aspects pertaining to counterparty credit risk management within the banking sector. This thematic review was aimed at gaining greater insight into how banks managed counterparty credit risk, especially in light of recent and impending regulatory reforms.

Banks were required to complete a questionnaire related to counterparty credit risk, which the Department followed up with on-site visits.

Generally, banks in South Africa either directly or indirectly address various aspects associated with counterparty credit risk management. However, banks are required to ensure that policies and processes are developed to enhance the monitoring and control of counterparty credit risk arising from OTC derivatives and, ultimately, to manage and mitigate such risk. Certain banks revealed that uncertainty regarding regulatory and international developments was a concern. Local banks feared that this might create an uneven playing field from a pricing perspective. The Department acknowledges that the South African banking sector faces certain challenges innate to the way in which banks conduct business, especially with limited clearing infrastructure being available. Further work in this area will continue during 2014 for specific banks.

2.3.5 Capital charges for market risk

Capital charges for equity risk in the banking book contributed approximately 3,57 per cent of banks' total capital requirements, whereas capital held for market risk made up about 3,09 per cent of the total capital requirement for the banking sector as at 31 December 2013.

2.4 Operational risk

2.4.1 Introduction

The year under review was yet another busy year globally for operational risk managers in which it remained a challenge for banks to align their business decisions with risk appetite. There were numerous fines levied by international regulators, several still in relation to the London Interbank Offered Rate scandal, an increase in cyber crime, threats internationally and system outages. Clients, products and business practices continue to be the largest contributor to loss data worldwide, followed by business disruption and system failure and internal fraud.

Although South Africa seemed to have come through relatively unscathed in terms of some of the above-mentioned more material events, the following did occur in 2013 and were prevalent in the local industry to varying degrees:

- Execution, delivery and process management: Process failures in terms of design or lack of processes and process failures in terms of execution (i.e., people not following processes).
- Fraud: Mostly onslaughts from an external perspective but also internal to a more limited extent.

2.4.2 Operational risk reviews

Focused operational risk reviews continued during 2013 to determine, among other things, whether banks had appropriate risk management policies and procedures to identify, assess, monitor and control or mitigate operational risk. The Department concentrated on banks that had been granted approval to use the AMA for regulatory reporting, a selection of banks using the standardised approach (TSA) and one bank using the basic indicator approach. The key findings of these reviews were as follows:

- *Operational risk strategic objectives, expansion into Africa and operational risk appetite*: Stability in the operational risk teams in some banks raised concerns for the Department. Close attention will likewise be paid to the roll-out of operational risk practices as a result of the expansion into Africa by South African banks. Various institutions also indicated that work was still being done in terms of identifying and measuring their operational risk appetite from a qualitative and quantitative point of view.

- *Operational risk governance structures*: A previous concern raised about the capacity in the operational risk quantitative analytics teams of some banks seemed to have improved somewhat during the year under review. The Department will continue to monitor this closely.

- *Management information reports or 'dashboards'*: Further progress was made during 2013 by banks to enhance the quality of their operational risk reporting. The Department nevertheless recommended that consistent and standardised reports should be considered by the different business units where possible to allow for meaningful consolidation. In addition, automated or system-generated reports to limit errors as a result of manual interventions were recommended to be utilised. Finally, reports or 'dashboards' that include all operational risk elements were also recommended to be used.

- *Desktop operational risk system (technology enabler) demonstration*: Several banks continued to make good progress in 2013 with regard to the update on and refinements to their operational risk systems. A few banks were nonetheless still struggling with the roll-out and implementation of certain modules.

- *Discussion of model descriptive statistics reports, material changes to scenarios and model validation reports (AMA banks only)*: Although the Department was for the most part satisfied with banks' model descriptive statistics reports, scenarios and model validation reports in 2013, there were some issues in terms of quality, documentation, capacity and expertise at certain banks in the central operational risk function and model validation teams.

- *Discussion of internal audit reports related to operational risk management*: Conducting independent reviews by means of internal and external audits is of cardinal importance and the Department relies to varying extents on the work performed by these parties. The closed-door discussions with internal audit assisted in forming an appropriate, comprehensive view of the level of operational risk exposure in the particular banks and contributed to the overall supervisory review and evaluation process of the Department during 2013.

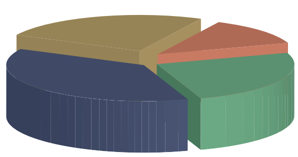
2.4.3 Processing of applications

During the year under review one bank was granted approval to calculate its operational risk exposure and regulatory capital using a more sophisticated approach. The approval was in respect of the AMA. The number of banks with approval to report operational risk using the AMA in 2013 is depicted in Figure 2.2.

Another bank received approval during the year to make use of TSA for its acquired operations in Africa.

Figure 2.2 Reporting methods applied by banks as at 31 December 2013

South African-registered banks



The advanced measurement approach	4
The standardised approach	4
The alternative standardised approach	2
The basic indicator approach	6

2.4.4 Publications and notices

Directive 11/2013[23] was published in July 2013 and deals with operational risk practices and the completion of the BA 410 return. A related guidance note, Guidance Note 4/2013,[24] was issued in July 2013 to provide details on the Department's requirements and to clarify previous ambiguities.

Furthermore, Guidance Note 2/2013[25] was issued in January 2013 to bring to the attention of banks specific international best practices related to operational risk and to clarify certain definitions and principles. Banks were requested to assess and align their operational risk practices with these principles.

2.4.5 Operational risk long-form reviews

The long-form review process for operational risk was implemented in 2013 after the template had been finalised and published on the Bank's website.[26] This forms part of the risk management and audit processes of banks with approval to use the AMA to calculate the minimum amount of required capital and reserve funds.

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

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

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

26. Available at http://www.resbank.co.za/RegulationAndSupervision/BankSupervision/TheBaselCapitalAccord(Basel%20II)/Pages/Advance-measurement-approach.aspx.

2.4.6 Capital charges for operational risk

Capital charges for operational risk comprised about 12,38 per cent of the total minimum capital requirements for the banking sector as at 31 December 2013.

2.4.7 Information technology risk

According to the Basel Committee's definition of operational risk, it is "the risk of loss resulting from inadequate or failed internal processes, people or systems or from external events".[27] Operational risk therefore highlights loss as a result of failed systems as one of the sources of operational risk. Moreover, regulation 39 of the Regulations[28] assigns responsibility for corporate governance to the board and lists technology risk as one of the risk types to be managed by the board. Owing to the relevance and importance of information technology (IT) risk in the South African banking industry, an IT Risk Analysis division was established by the Department during the year under review in order to monitor IT risk.

27. Basel Committee, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (Basel: Basel Committee, June 2006), p144.

28. Available at http://www.resbank.co.za/RegulationAndSupervision/BankSupervision/BankingLegislation/Pages/Regulations%20relating%20to%20Banks.aspx.

2.4.8 Information technology risk reviews

During 2013 the Department focused on gaining an understanding of the industry and how the larger banks especially managed IT risk. This included participating in the operational risk on-site meetings at banks. In addition, focused IT risk on-site meetings were held at various small to medium banks. Issues identified related mainly to:

- IT project governance;
- the governance of IT in general;
- business continuity (specifically disaster recovery);
- change management; and
- information security management.

A fact-finding and knowledge-sharing session was also held with a jurisdiction in the European Union to collaborate with, and learn from, its IT risk team. Knowledge gained from that visit was used to prepare a questionnaire to the domestic banking industry in order to measure IT risk. The outcome from the survey confirmed results from the on-site reviews and was similarly fed into the Department's planning for 2014. As a result of the work performed during the year under review, IT project governance was included as a flavour-of-the-year topic in 2014.

2.5 Liquidity risk

2.5.1 Regulatory developments

Following the finalisation of rules covering the LCR by the Basel Committee[29] and in line with the options provided to jurisdictions with insufficient HQLA, the Bank decided to make available a committed liquidity facility to banks to cover the shortfall. Details on this facility are available in Guidance Note 6/2013.[30]

29. Available at http://www.bis.org/publ/bcbs238.htm.

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

As part of the development of the LCR and NSFR frameworks and monitoring the impact on the South African banking sector, the seven largest banking groups participated in various QIS exercises. The Department monitored the data and the impact on the banks, and provided the data to the Basel Committee. Furthermore, the regulatory framework was amended to enable monitoring of the LCR on all banks prior to it becoming a minimum standard.

The Department also engaged with the banking sector through BASA during the year under review to monitor and discuss international regulatory developments and the impact thereof on South Africa.

2.5.2 Focused reviews

The Core Principles require supervisors to determine whether banks have in place certain minimum supervisory standards. For liquidity risk and interest rate risk in the banking book, the Department discharges its duties through a focused review process. This entails a bank providing a detailed written response to a questionnaire covering both the above-mentioned risk types, an in-depth off-site review of the bank's responses thereto and an on-site meeting.

The Department conducted several of these reviews covering both large and smaller banks during 2013 to evaluate the practices prevalent in the industry. The following major topics were covered:

- Structure and responsibility of Asset Liability Management division
- Policies and procedures
- Interest rate risk in the banking book
- Liquidity risk
- Funds transfer pricing
- Stress testing and contingency planning
- Information systems
- Internal and external reporting.

2.6 Capital management

2.6.1 Overview of internal capital adequacy assessment process reviews and key findings

During 2013 the Department mainly conducted focused reviews on banks' ICAAPs, in particular on improvements of credit risk economic capital models, capital management, stress testing, validation of economic capital and stress-testing models, and a continued focus on the use test.

On-site reviews during 2013 highlighted the following aspects:

- Banks' capital planning was robust and was regularly challenged by management. Banks' forecasted capital ratios indicated that local banks remained well capitalised in 2013.
- Large and complex banks used economic capital models to measure risks more accurately and to relate the risks to capital requirements. Given that the results of these models are used in decision-making, banks' management was encouraged to ensure that economic capital models were validated and appropriately calibrated after the financial crisis.
- The Department found that in certain instances banks applied STA to calculate capital requirements for credit risk, which was not a true reflection of the underlying risk, especially in the retail unsecured portfolios.
- The identification, measurement, monitoring and mitigation of credit concentration risk and model risk required improvements in certain banking institutions.
- It was found to be beneficial for banks to be capable of performing ad hoc stress testing to investigate the impact of any possible changes in the economic environment on a short turnaround time.

2.6.2 Participation in the Basel Committee's quantitative impact study

The biannual international Basel III implementation monitoring, conducted by the Basel Committee, continued during 2013 in the form of a QIS.

The Basel Committee published a document titled *Results of the Basel III Monitoring Exercise as of 31 December 2012* in September 2013,[31] which incorporates data of the South African participating banking groups. Furthermore, it is the intention of the Basel Committee to continue publishing the results of the Basel III monitoring exercise.

31. Available at http://www.bis.org/publ/bcbs262.htm.

The purposes of the QIS expanded to not only include Basel III implementation monitoring, but also measure the impact of other initiatives by the Basel Committee, such as data collection on partial use and roll-out. This additional data will be used to investigate the features of exposures of banks using the IRB approaches which remain under the STA.

Both the Department and the banks continued to find value in participating in these studies and will continue to participate actively in such studies.

2.6.3 Implementation of the Basel III framework

The Department implemented the Basel III framework with effect from 1 January 2013 with Directive 5/2013, issued in April 2013,[32] setting out all the capital requirements to be phased in. Various communications were sent out to banks in order to clarify uncertainties that arose, in particular Guidance Note 7/2013, issued in October 2013,[33] on the loss-absorbency requirements for additional tier 1 and tier 2 capital instruments.

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

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

2.6.4 Regulatory and economic capital data collection exercise

The Department commenced with a data collection exercise at selected banking institutions to monitor forecasted regulatory and economic capital data that will supplement the ICAAPs.

The data collected included forward-looking regulatory capital planning data. The aforementioned data will enhance the Department's assessment of capital planning at banks, the importance of which was emphasised in the Basel Committee's publication titled *Enhancements to the Basel II Framework* released in July 2009,[34] and evidenced by the work done by the Capital Planning Workstream of the Basel Committee.

34. Available at http://www.bis.org/publ/bcbs157.htm.

2.6.5 Domestic systemically important banks

In October 2013 the Department communicated the loss-absorbency capital requirements for domestic systemically important banks (D-SIBs) to the affected bank-controlling companies and banks only.

Although the D-SIB loss-absorbency requirement imposed on the affected bank-controlling companies and banks will only become effective on 1 January 2016, the Department deemed it necessary to inform the affected institutions of the requirements in advance. The rationale behind the decision was to allow banks and bank-controlling companies sufficient time to account for the higher loss-absorbency capital requirements in their capital planning and management processes.

2.7 Pillar 3: Disclosure

2.7.1 Overview of key activities

During 2013 Pillar 3 reviews focused on the assessment of quarterly, semi-annual and annual Pillar 3 reports. The key objective was to assess the quality of banks' Pillar 3 reports as published to the public.

Directive 8/2013, titled *Matters Related to the Composition of Pillar 3 Capital Disclosure Requirements*,[35] was issued in order to implement the Pillar 3 disclosure requirements of the Basel III framework.

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

2.7.2 Developments

In June and July 2013 the Basel Committee issued consultative documents titled *Revised Basel III Leverage Ratio Framework and Disclosure Requirements*[36] and *Liquidity Coverage Ratio Disclosure Standards*.[37] These documents set out Pillar 3 disclosure requirements to improve the transparency on leverage and liquidity matters, and aim to enhance market discipline. In 2014 the Department will prepare for the efficient implementation of these disclosure requirements on 1 January 2015.

36. Available at http://www.bis.org/publ/bcbs251.htm.

37. Available at http://www.bis.org/publ/bcbs259.htm.

2.7.3 Enhanced Disclosure Task Force roundtable meeting

During the year under review, the Department participated in the FSB's roundtable discussion on risk disclosure. The Enhanced Disclosure Task Force (EDTF) is an established task force of the FSB. The primary objectives of the EDTF is to develop principles for enhanced disclosures and identify leading practice risk disclosures presented in annual reports for the year ended 2011.

The purpose of the roundtable meeting was to discuss the progress, experiences and challenges on the recommendations of a survey that was conducted by the EDTF on compliance with the EDTF report titled *Enhancing the Risk Disclosures of Banks*,[38] which was published in October 2012. The report set out principles and recommendations for improved bank risk disclosures and leading disclosure practices that are designed to provide timely information to investors and other users.

38. Available at https://www.financialstabilityboard.org/publications/r_121029.htm.

2.7.4 Key findings

In 2013 some banks published their Pillar 3 disclosure requirements to the public together with their June 2013 risk reports in compliance with Directive 8/2013,[39] while others were still lagging behind in complying with these disclosure requirements.

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

The Department found that average amounts in respect of major types of gross credit exposure during the reporting period and the average gross exposure amount were not disclosed. With respect to market risk, the disclosure requirement for high, mean and low stressed value-at-risk amounts was not adhered to by all banks in 2013. In relation to remuneration, the disclosure requirement in respect of the description of ways in which future risk is taken into account in the remuneration process was not adhered to by banks in 2013.

2.8 Consolidated supervision

2.8.1 African Supervisory College

During 2013 the Department hosted a supervisory college for Standard Bank Group's (SBG) African operations. The objective of the supervisory college was to develop a better understanding of the consolidated activities of SBG in Africa, to improve and strengthen information sharing and regional co-operation between SBG's supervisors, and to discuss other relevant issues specifically pertaining to supervisory authorities on the African continent.

The college provided a platform for African regulators to cultivate a long-lasting professional relationship, and the Department intends to continue to strengthen this relationship by means of future supervisory colleges and frequent formal and informal communication.

The Department received overwhelming positive feedback from the attending delegates subsequent to the college, and remains of the view that such colleges are the way forward to ensure effective consolidated supervision. These kinds of colleges will now be held on a more frequent basis. The next supervisory college hosted by the Department will be for the Barclays Africa Group during November 2014.

2.8.2 Supervisory meetings with the Financial Services Board

South African financial conglomerate groups have significant investments in banking, insurance and securities. For this reason it was decided some years ago to have regular meetings between the Department and the Financial Services Board to discuss supervisory issues regarding these conglomerates. The objectives of these meetings were and still 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.

During 2013 the Department continued to meet regularly with the Financial Services Board.

2.9 Review team

2.9.1 Thematic on-site reviews

The Department's review team conducted credit risk management on-site reviews in 2013, focusing on two different products types, namely residential mortgages and unsecured personal loans.

During the first half of 2013 the key focus entailed obtaining an understanding of banks' risk management processes relating to the residential mortgage portfolios within the collections, and legal and recoveries units.

The reviews were conducted at two South African major banks and encompassed the assessment of the following:

- The adequacy and effectiveness of banks' collections and recovery policies, procedures and processes
- The adequacy of the processes employed for determining whether the level of specific impairments which had been raised, based on a granular segmentation of the said book, was reasonable taking into account historical loss experience
- The reasonableness of loan classifications and the valuation of collateral, and how such practices related to the relevant bank's approved policies
- The accuracy of the reporting of defaulted exposures in the collections and recovery process
- The adequacy of the management information in facilitating effective monitoring and risk management of the portfolio
- The adequacy and robustness of governance provided by the board and senior management, including the processes in respect of loans in the collections, and legal and recovery processes.

During the second half of 2013 a new cycle of reviews relating to banks' unsecured personal loans portfolios commenced. The request to conduct these reviews emanated from the high growth rate in the unsecured lending market and the Department considered it prudent to gain an in-depth understanding of the banks' effectiveness, sufficiency and efficiency of specific provisioning, write-off, collections and recovery, restructuring and rescheduling policies, processes and practices.

Further to the focus of the review on residential mortgages, the evaluation in this regard encompassed the following:

- The appropriateness of banks' lending practices and their adherence thereto
- The appropriateness of banks' write-off practices and the rationale behind their write-off policies
- The appropriateness of banks' policies and procedures relating to the restructuring of loans and the correct application thereof.

2.10 Anti-money laundering and countering the financing of terrorism

2.10.1 On-site inspections

The Department conducted six AML/CFT on-site inspections in terms of section 45B of the FIC Act for the year ending December 2013. Table 2.1 below reflects the details of the inspections conducted and also provides a comparison of the inspections conducted in 2012.

Table 2.1 On-site inspections

Nature of inspection	Size	2012*	2013
Routine..	Large banks	2	3
	Small banks	6	1
Non-routine	Large banks	0	1
	Small banks	0	1
Total		6	6

* AML/CFT inspections commenced in April 2012

The inspections were conducted on average over a period of seven weeks for each of the large banks and three weeks for each of the smaller banks. The banks co-operated fully during the inspections and acknowledged the deficiencies identified by the Department pertaining to their AML/CFT frameworks. In this regard, the banks committed to remediate identified deficiencies within an agreed period of time.

The most pertinent findings arising from inspections conducted in 2013 include the following:

Customer identification and verification

- AML/CFT risk frameworks were not duly documented or adequate to reflect acceptable risk-rating criteria for clients and the appropriate enhanced or reduced due diligence levels linked thereto.
- Processes to maintain the correctness of client particulars susceptible to change were inadequate.

Record-keeping

- Client identification and verification (CIV) documentation in respect of terminated relationships were not always kept for the prescribed period of five years.
- Record-keeping measures in place to ensure the safety and integrity of CIV documentation were ineffective.

Reporting duties

- Cash threshold reporting (CTR) processes were generally automated in which responsibilities mainly vested with the IT departments, thus resulting in limited or no oversight performed by bank's compliance functions.
- System constraints resulted in banks' not detecting and filing all reportable transactions with the FIC.

Suspicious and unusual transaction reporting

- Backlogs in respect of the investigation of suspicious transaction alerts existed due to AML/CFT compliance teams not being sufficiently resourced to investigate all suspicious and unusual transaction alerts.
- The banks interpretation of the 15-day reporting period for suspicious and unusual transaction reporting (STR) was incorrect, therefore resulting to late submission of STRs.

Reporting property associated with terrorism and related activities

- Clients were not continually screened against updated sanction and embargo lists.

Training

- In some instances AML/CFT training material was outdated and not aligned to the FIC Act amendments promulgated in 2010.
- Employees of the banks provided client-facing services without having received appropriate AML/CFT training.

AML/CFT Compliance Officer

- The money-laundering control office did not properly oversee the implementation of AML/CFT measures by business units.

In general, most banks inspected during the period under review demonstrated a high level of commitment to improving their AML/CFT system in preventing criminals abusing the banking system for money-laundering and terrorist financing purposes.

Stemming from the findings of the above-mentioned AML/CFT inspections, the Bank imposed administrative sanctions on certain commercial banks.[40]

40. The press release issued by the Bank in this regard is available at http://www.resbank.co.za/Publications/Media/MediaReleases/Pages/MediaReleases-Home.aspx.

2.10.2 Interactions with the Financial Intelligence Centre

In a continued effort to stay abreast of material money-laundering and terrorist financing matters facing the South African banking industry, representatives of the Department and the FIC met on a quarterly basis in 2013 to discuss imminent risks, banking-sector challenges and matters relating to the implementation of the FIC Act. This forum provided the Department with further insight into matters of non-compliance by banks, which, in turn, prompted some non-routine inspections which took place during the year under review.

In addition, attendance at the FIC Act Enforcement Forum provided a platform for supervisory interaction with other regulatory bodies tasked with the responsibility of AML/CFT supervision and on-site work, where valuable information related to the challenges encountered in enforcing compliance with the provisions of the FIC Act was shared.

2.10.3 Co-operation and interaction with law-enforcement agencies

The FATF recommendations relating to national co-operation encourage all national stakeholders in the fight against ML and TF to have an effective mechanism in place which will enable them to co-operate, and where appropriate co-ordinate domestically, with each other concerning the activities of combating ML, TF and proliferation of weapons of mass destruction.

In this regard, the Department established a co-operative relationship with the Directorate for Priority Crime Investigations (commonly known as the Hawks) to encourage better co-operation between law-enforcement agencies, regulatory authorities and the banking industry. The co-operation resulted in the establishment of a forum between the Department, banks, the Hawks, the National Prosecuting Authority and the FIC. The forum managed to resolve some frustrations experienced by banks and law enforcement agencies when information is shared during investigations.

2.11 Co-operative banks

In view of the fact that all data and relevant information pertaining to co-operative banks are contained the *Combined Annual Report of the Supervisors of the Co-operative Banks Development Agency and the South African Reserve Bank*,[41] this data and information will not be repeated in this report.

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