Chapter 2: Overview of supervisory activities

2.1 Introduction

The Department monitors banks' compliance with the regulatory framework and specifically prudential requirements, as part of its risk-based supervisory approach. Understanding banks' risk profiles, their business models and the environment in which they operate is paramount to effective risk-based supervision by the Department. To this end the Department follows a structured, forward-looking supervisory review and evaluation process (SREP) that incorporates on- and off-site supervision, as well as quantitative and qualitative supervisory tools.

The SREP is designed to:

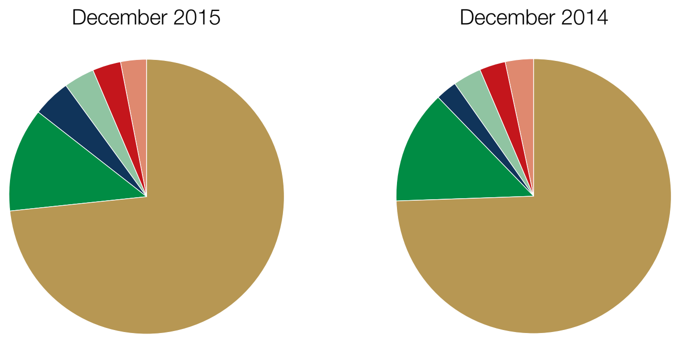
- identify key risk factors and the build-up of risks which could impact individual banks and the banking sector as a whole;
- assess the risk management policies, processes, practices and structures that are used to mitigate risks; and
- deploy resources accordingly to address the most critical risk areas and intervene early where required.

This chapter provides an overview of the operations of the Department during the period under review at an industry level and according to aspects of bank supervision that are common across banks. These operations include work undertaken with respect to thematic topics, risk-based reviews, consolidated supervision, and disclosure assessments.

Figure 2.1 gives an indication of the aggregated risk profile of the banking sector as at 31 December 2014 and 31 December 2015, reflecting Pillar 1 risks that are quantifiable in terms of the Regulations and for which the sector is required to hold regulatory capital. The banking sector is also exposed to other risks that are not quantified in terms of regulatory capital requirements, such as liquidity risk and interest rate risk in the banking book that are monitored specifically through the application of the Department's SREP and assessed under Pillar 2 supervisory activities.

Figure 2.1 Composition of risk-weighted exposure

(R billions)



December 2015		December 2014	
Credit risk	1 838	Credit risk	1 658
Operational risk	309	Operational risk	291
Counterparty credit risk	111	Counterparty credit risk	59
Market risk	85	Market risk	70
Other risks	83	Other risks	69
Equity risk	76	Equity risk	73

2.2 Thematic topics for 2015

2.2.1 Introduction

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

The Department identifies certain themes (or flavour-of-the-year topics) to be discussed with banks' Boards annually as part of its ongoing supervisory interventions. Guidance Note 2 of 2015[25] identified the following two topics for 2015:

- IFRS 9; and
- shadow banking.

Banks' Boards were requested to make presentations and engage with the Department on each topic. A review of the Department's interactions related to these topics is detailed in sections 2.2.2 and 2.2.3.

2.2.2 IFRS 9

In July 2014, the IASB issued the final version of IFRS 9 Financial Instruments, which will replace International Accounting Standard 39 (IAS 39). The most significant change in the standard was the change from an incurred loss impairment model to an expected loss impairment model. Effective from 1 January 2018, entities applying IFRS will have to account for loan loss impairments on the expected loss model.

In light of this development and to ensure that banks are on track to implement the standard by the effective date, the Department included IFRS 9 as a flavour-of-the-year discussion topic for meetings with the Boards of directors of banks and executive committees of local branches of international banks (collectively referred to as Boards). The discussions were positioned to gain insight into the processes that banks have embarked on and to instigate banks to gear up for the implementation of IFRS 9 by the due date, which is the reporting period that commences in 2018. The Department also needs to review the impact this new standard could have on the banks' financial statements, and therefore the investors' perspective.

The Department stressed that the priority at the planning stages was to ensure that a robust implementation process was followed and that the planning was comprehensive enough to ensure that the impairment figures to be produced through these processes are accurate and reflect, as far as possible, the behaviour of the accounts and the expected future cash flows therefrom. Discussions held with Boards revealed that the majority of the banks embarked on formal initiatives for the implementation of IFRS 9, evidenced by the establishment of project teams to oversee the implementation. The project teams focused on areas such as governance, modelling requirements, accounting and credit policies, as well as data requirements. However, certain aspects had to be addressed for most banks including staff training, internal and external audit involvement, and interpretation of key terms used in the standard, for example, significant increase in credit risk.

Meetings were also held with audit firms to discuss the Department's expectations with regard to implementation readiness, including the involvement of audit firms during banks' planning and implementation stages and the impact the new standard would have on the audit firms and their audit approaches.

In addition to the aforementioned meetings held during the year, the IFRS 9 Implementation Working Group was formed in June 2015, comprising representatives from the Department, banks, audit firms and regulatory or industry bodies such as IRBA and SAICA. The working group was established in an effort to facilitate a high-quality implementation of IFRS 9 across the industry and, where possible, promote consistent application. Meetings of the working group provide a platform where industry players can deliberate on policy modelling and disclosure issues related to the IFRS 9 standard and produce a set of principles and/or guidelines that promote consistent understanding and comparability across the banking industry. Where identified, additional guidance would be issued by the regulatory bodies to assist with interpretive or policy matters that would impact the application of the standard.

During December 2015, the Basel Committee issued the final version of its *Guidance on accounting for expected credit losses*,[26] which sets out the supervisory requirements on sound credit-risk practices associated with the implementation and ongoing application of ECL provisioning frameworks. The Department expects this guidance to be incorporated by banks as part of their processes for the implementation of IFRS 9. Discussions on IFRS 9 will continue as a topic for discussion during Board meetings in 2016, with the emphasis being on progress made, the results of an impact analysis and post-implementation maintenance procedures to be adopted by banks.

26. http://www.bis.org/bcbs/publ/d350.pdf

2.2.3 Shadow banking

Increased disintermediation, both globally and within the South African financial system remains a key focus area for regulators.[27] Non-bank channels can also become a source of systemic risk, especially when structured to perform bank-like functions and where there is strong interconnectedness with the banking system.

27. Refer to the Financial Stability Board's report called 2014 *Global Shadow Banking Monitoring Report*, available at http://www.fsb.org/wp-content/uploads/r_141030.pdf.

Banks' Boards were required to engage with the Department regarding their strategic perspective on shadow banking type activities. Presentations by banks addressed the associated risks and benefits of shadow banking type activities, the extent of each bank's activities within the realm of shadow banking, future strategic initiatives and the potential impact of shadow banking activities on each bank and its business model. Banks' presentations included a discussion of recent asset and liability disposals that may have been executed in pursuit of a shadow banking objective.

From the discussions, it was evident that the majority of banks understood shadow banking market activities as well as their associated risks and benefits. However, a potential area of improvement identified by the Department was that banks' Boards could apply increased business foresight in their assessment of the potential risks and benefits arising from shadow banking type activities and the conceivable impact on their business models.

2.3 Credit risk

2.3.1 Introduction

Consumers remained constrained against the backdrop of slow employment growth, declining disposable income and rising inflation. Combined with tighter affordability criteria, following the implementation of amendments to regulations of the NCR, this resulted in subdued growth in retail credit exposure. Credit extension to the corporate sector, by contrast, has been buoyant. However, several increases in the repurchase rate of the Bank during the past 24 months require renewed focus on the sector's management of credit risk. The Department continued to monitor the impact of market conditions on South African banks' credit risk profiles and portfolios through a number of initiatives.

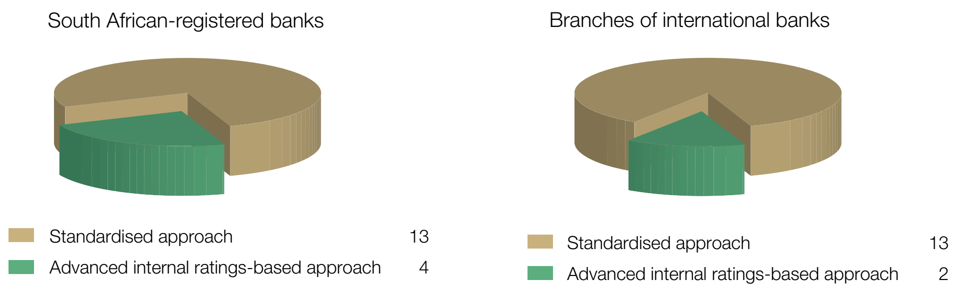
2.3.2 Methodologies to calculate minimum required regulatory capital relating to credit risk

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. the standardised approach (STA), including the simplified standardised approach;
2. the foundation IRB approach; and
3. the advanced IRB approach.

The number of banks using each of the aforementioned approaches is depicted in Figure 2.2.

Figure 2.2 Credit risk methodologies applied by banks as at 31 December 2015



As mentioned in Chapter 1 of this report, significant progress has been made in terms of the revision of the STA. In addition, the Basel Committee is continuing to review possible modifications to the IRB framework to narrow the modelling choices available to banks, particularly in areas for which the use of models might not be suitable for calculating regulatory capital. The Department continued to closely follow regulatory developments in this regard and to monitor any potential impact on the South African banking sector.

2.3.3 Thematic on-site reviews

During 2015 the Department's review team conducted on-site reviews of different credit portfolios, including unsecured personal loans, corporate, small and medium-sized enterprises (SMEs) and retail loans portfolios at four banks, focusing primarily on credit risk methodologies and impairment levels.

The reviews generally encompassed an assessment of the following:

- appropriateness of lending practices and adherence thereto;
- adequacy of the methodology applied in the process of determining the level of specific credit impairments, taking into account the requirements of IAS 39;
- efficiency of the credit risk methodologies or systems with regard to classification/ageing of loans and the valuation of collateral, and how such practices relate to regulation 24(5)(c) of the Regulations and the approved collections and recovery policies;
- appropriateness of write-off practices and policies, and procedures relating to the rescheduling/restructuring of loans and the correct application thereof;
- adequacy and the robustness of governance arrangements in respect of those loans in the legal, collections and recovery process; and
- risk weights assigned for the purpose of calculating regulatory capital required for the SME Corporate portfolio.

Shortcomings and areas of non-compliance were identified and discussed with the respective banks. The banks affected committed to remediate deficiencies identified during the reviews and, progress by these banks on remediating the deficiencies will be closely monitored by this Department.

2.3.4 On-site meetings relating to credit risk models

During 2015 the Department conducted on-site meetings related to credit risk models used by banks in order to gain an industry perspective on model-related topics, which covered model governance, scope and depth of validation performed, model usage with specific focus on overrides, treatment of unrated deals or delays in the re-rating of deals, model materiality definitions, discount rate used in loss given default (LGD) models, incorporation of multiple defaults in LGD models, and identifying the downturn period and methodologies used to determine the downturn LGD and downturn exposure at default estimates.

In addition to conducting these meetings at the banks, the Department obtained guidance from other international regulators on the above-mentioned topics. Bank-specific feedback was provided to the individual banks' senior management and once research embarked on by the Department on this matter is concluded, the Department will provide the industry with further guidance.

2.3.5 Changes to credit risk models

The Department continued to follow a robust review and approval process for changes to credit risk models used for the calculation of required capital and reserve funds for credit risk by banks that adopted the IRB approach as highlighted in the Department's 2013 *Annual Report*. During 2015 this Department received 18 notifications of non-material changes and 27 submissions of material changes to the IRB banks' rating systems.

2.3.6 Eligible External Credit Assessment Institutions

The Regulations stipulates that for the calculation of minimum required capital and reserve funds relating to credit risk in terms of the STA, and for the treatment of relevant securitisation and re-securitisation exposures, banks shall apply the ratings or assessments issued by eligible external credit assesment institutions (ECAIs).

During 2015, after a robust review process, the Department approved Global Credit Rating Co. (Pty) Limited (GCR) as an eligible ECAI. Directive 9 of 2015 was issued to inform banks and/or affected persons of the mapping of the international scale ratings of GCR to the prescribed risk weights specified in regulation 23 of the Regulations.

2.3.7 Directives and circular related to credit risk

The following directives and circular were issued during the period under review:

- Directive 4 of 2015: the directive specified areas of the legal framework requiring amendment in order to ensure that the legal framework appropriately reflects local and international market developments, and complies with the ever-evolving international regulatory and supervisory standards and best practices.
- Directive 7 of 2015: the directive provided clarity on how banks should identify restructured credit exposures and how to treat them for purposes of the definition of "default" as defined in regulation 67 of the Regulations. Furthermore, the directive also addressed the reporting of restructured credit exposures and the rehabilitation of non-performing loans using restructuring.
- Directive 9 of 2015: the directive informed banks and/or affected persons of the mapping of the international scale ratings of GCR to the prescribed risk weights specified in regulation 23 of the Regulations.
- Circular 5 of 2015: the circular informed banks that the use of credit risk support not specifically provided for in regulations 23(7), 23(9), 23(12) or 23(14) of the Regulations is prohibited in a bank's credit risk rating process and in the calculation of minimum required capital and reserve funds.

2.4 Market risk

2.4.1 Introduction

The global markets trading environment was particularly challenging for South African banks in 2015 due to a combination of market and regulatory factors. Most of these factors were discussed with banks in the scheduled supervisory meetings as discussed below.

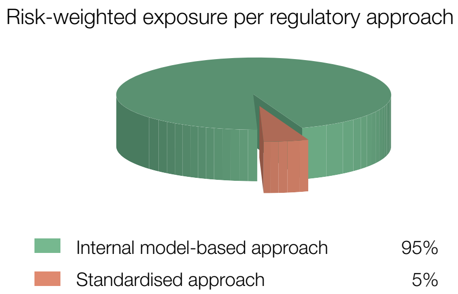
2.4.2 Methodologies to calculate minimum required regulatory capital relating to market risk

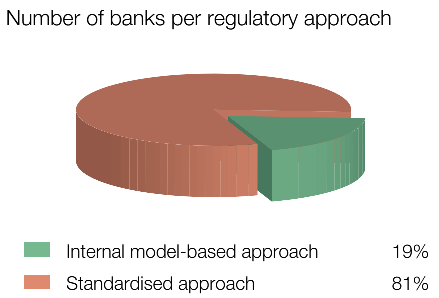
Under the regulatory framework employed in South Africa, banks can choose from the following two methodologies to calculate their minimum required regulatory capital relating to market risk:

1. the standardised approach; and
2. the IMA.

The risk-weighted exposure for the two approaches in comparison to the proportion of banks per approach is depicted in Figure 2.3.

Figure 2.3 Market risk methodologies applied by banks as at 31 December 2015





2.4.3 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 2015 focused on banks using the IMA for regulatory purposes. Reviews of certain banks' treasury and securities operations also took place. The Department also concluded one review on equity risk in the banking book, with further reviews scheduled for 2016. In addition, the Department conducted CCR reviews on selected banks.

2.4.4 Key findings

The following issues featured prominently in the discussions with the banking industry in 2015, to the extent that they impact the markets trading businesses:

- Commodity prices continued to decline sharply in 2015, with the oil price in particular slipping to its lowest level since 2004. The commodity price decline poses downside risks to the economic growth outlook in South Africa and many parts of Africa due to a high reliance on mining for employment, export growth and government revenue. Various South African banks have operations across Africa and are therefore exposed (directly and indirectly) to the downturn in the commodity super cycle.

- The availability of liquidity in the trading market has been declining during 2015 and the Department consistently engaged with banks to assess the impact of reduced liquidity on banks' ability to transfer risk in the market. Banks became more cautious with their trading risk assumptions.

- Conduct risk, a thematic topic of the Department in 2014, received a significant amount of attention by banks in their trading operations given the widespread and severe fines issued for misconduct globally during 2015. While there were no significant South African industry-wide concerns in this regard, banks have on a sporadic basis experienced some internal breaches of set policies and procedures. The emergence of this risk type has led to the FSB and the Bank's joint efforts to produce the foreign exchange review report as well as the draft code of conduct for the South African OTC markets. Both documents were published in October 2015, namely *Report of the Foreign Exchange Review Committee on the Operations of Authorised Dealers in the South African Foreign Exchange Market and Draft Code of Conduct for the South African Over-the-Counter Markets*.[28]
- Algorithmic trading also came to the fore during 2015 and has been cited as one of the contributors to the increased volatility in global markets.
- Concerns related to a possible change of the South African sovereign credit rating to sub-investment grade have been discussed with market participants for the past two to three years. The banking industry was urged to embark on stress testing exercises to determine the effects of a possible downgrade on their trading portfolios. South Africa's five-year credit derivative spreads approximately doubled over the 2015 calendar year, exceeding levels of spreads for Turkey and trending at the same level as Russia towards the end of 2015.

28. Both reports are available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6928

2.4.5 Counterparty credit risk thematic reviews

Central clearing will affect OTC trading activities world-wide. The banking industry is moving towards the use of central counterparties (CCPs) to clear OTC derivatives in order to reduce systemic risks associated with bilateral OTC derivatives markets. These risks include the long and legally cumbersome transaction close-out process in the event of a major default which CCPs can mitigate by establishing and enforcing close-out rules.

In terms of Core Principle 17, supervisors must be satisfied that banks have a CCR management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes appropriate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate this risk on a timely basis.

In order for the Department to discharge its duties relating to Core Principle 17, it therefore conducted CCR thematic reviews, based on a questionnaire that was sent to specific banks in the South African banking industry for completion. On-site supervisory meetings were subsequently held at the respective banks to discuss key issues emanating from the documents and any topics on which the Department may require clarity.

The thematic review process encompassed all areas required to be covered under Core Principle 17, as well as additional aspects related to the Basel III framework for risk measurement, standards and monitoring, together with pending regulatory reforms.

2.4.6 Equity risk in the banking book

During 2015 the Department continued with the thematic review that focused on exposures related to equity risk in the banking book. These exposures are generally held for long-term investment purposes and are included in the banking book for regulatory purposes, thus receiving a capital treatment that is independent of the market risk charge.

For supervisory purposes, equity risk in the banking book is regulated together with market risk, and the reviews are aimed at gaining insight into areas where this risk arises and management of the risk over the life cycle of these investments. This risk type has been diminishing over recent years as banks reduce this type of investment activity. Further assessments will continue during 2016, in this area, for selected banks.

2.4.7 Directive related to market risk

Directive 10 of 2014 was cancelled and Directive 5 of 2015 was issued with effect from 1 April 2015. The directive informs banks of the capital requirements for OTC derivatives not transacted through a CCP. Based on the relevant requirements specified in the Regulations, the full capital requirements for CVA risk emanating from a bank's exposure to ZAR-OTC and local-OTC derivatives[29] should be maintained.

29. For the purposes of Directive 5 of 2015, local-OTC derivatives mean OTC derivatives entered into bilaterally between South African counterparties. Locally registered branches of foreign banks are regarded as South African counterparties for this purpose. Local-OTC derivatives may include OTC-derivatives not denominated solely in ZAR.

2.5 Operational risk

2.5.1 Introduction

Operational risk and information technology (IT) risk have continued to occupy the risk landscape globally, from miss-selling, fines and penalties being levied against various institutions to the ever-increasing threat of cyber risk and other emerging technology risks. This happened despite the fact that, internationally, losses attributable to these risks seemed to have decreased year on year. Domestically the number of loss events increased slightly but the total gross loss amount decreased noticeably.

A turbulent 2016 has been predicted for the South African economy and this is normally associated with an increase in operational risk losses, albeit at a lag in terms of occurrence and impact. The Department expects a focus shift from the measurement of these types of risks to the management thereof based on the proposed amendments in terms of the operational risk approaches.

2.5.2 Methodologies to calculate minimum required regulatory capital relating to operational risk

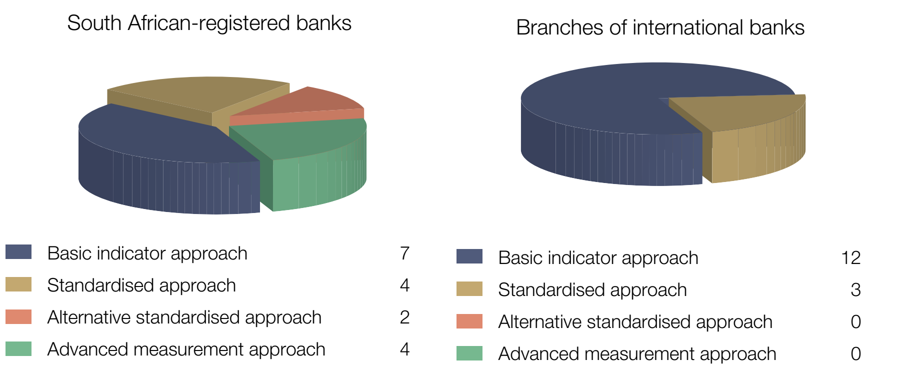
Under the regulatory framework employed in South Africa, banks can choose from the following four methodologies to calculate their minimum required regulatory capital relating to operational risk:

1. the basic indicator approach (BIA);
2. the standardised approach;
3. the alternative standardised approach; and
4. the advanced measurement approach (AMA).

During the period under review, one application for a local branch of an international bank licence was approved and the said branch opted for the default BIA in the measurement of operational risk (see Figure 2.4).

The number of banks using each of the aforementioned approaches is depicted in if Figure 2.4

Figure 2.4 Operational risk methodologies applied by banks as at 31 December 2015



2.5.3 Operational risk reviews

During the year under review, the Department continued its focused operational risk reviews at selected banks, with an emphasis on management, measurement, frameworks, processes, profiles and reporting of operational risks. The main findings of these reviews were:

- Governance and resourcing: banks generally have sound governance committee structures in place, which provide adequate operational risk management oversight. However, banks have been facing challenges in terms of scarcity of operational-risk skills, especially in cases where high staff turnover was prevalent.
- African footprint: local banks operating in the rest of Africa are still experiencing many risk, control and system issues. The Department is closely monitoring developments in this space.
- Risk control self-assessments (RCSAs), key risk indicators (KRIs) and control failures: the Department is concerned that RCSAs and KRIs are sometimes not completed appropriately. Moreover, control inefficiencies and failures remain prevalent in some institutions. A concerted effort by banks in reaching resolution on these matters is required.
- AMA: banks making use of internal models for calculating their operational risk-charge have maintained their efforts in refining, enhancing and in some instances researching and developing 'new-generation' models. Even though the Basel Committee has during the latter part of the year proposed the removal of the AMA, the Department is of the view that the use of models would still be critical for internal measurement purposes and that quantitative analytical skills will continue to play a pivotal role in the assessment of operational risk. Furthermore, these skills can also be applied in so far as data are concerned.
- Operational risk losses: in the midst of continuous challenging economic conditions, there has been a noticeable decrease in operational risk losses in 2015 compared to 2014. The losses emanated mainly from execution delivery and process management and external fraud event types.
- Audit reports related to operational risk management: during the reviews, closed sessions with banks' internal auditors were held to ascertain if a comprehensive review of operational risk was attained. In several instances the root cause analysis indicated that 'people' and 'negligence' were the main contributors to control breakdowns. The Department urged banks to address the matter urgently.

2.5.4 Operational risk long-form reviews

The long-form review process for operational risk was finalised late in 2013 after the finalised template was published on the Bank's website.[30]

The review has now been completed as two AMA banks in 2014 and two AMA banks in 2015 were subjected to this review. The results from these reviews were generally satisfactory with specific findings being highlighted. The Department will continue to monitor progress in closing the particular highlighted gaps. In addition, similar reviews could be considered in the foreseeable future.

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

2.5.5 Outsourcing

Outsourcing remained a focus area for the Department and there has been a marked increase in terms of either applications for approval by banks, notifications or merely requests for guidance and engagement. A return dealing with outsourcing was introduced during 2015 to better understand banks' outsourcing risk exposures, to ensure effectiveness and efficiency of managing these outsourcing exposures and to ascertain the level of concentration in the industry. The first submission in terms of Directive 8 of 2015 on the reporting of material outsourced service providers and critical third-party service providers was received, analysed and feedback was discussed with the relevant stakeholders. Some concerns were highlighted and ongoing monitoring and effort is required from both the Department and the respective banks, especially in terms of contingencies and dependence on providers that have a dominant presence in the market.

The team further provided input into several applications with regard to outsourcing of functions within banks in terms of Guidance Note 5 of 2014.

2.5.6 Information technology risk

Following the 2014 IT project governance flavour-of-the-year interactions, banks' investment in IT infrastructure was analysed to determine whether it was sufficient to ensure that IT systems were operationally 'fit'. The Department also engaged the banking industry to ensure that banks were adequately prepared for a worst-case scenario should a national blackout of the power grid or prolonged power disruptions occur.

Cyber security remains a concern and will continue to receive attention. The Department will also consider further regulatory interventions. The Department also benchmarked local IT risk practices against international best practices during international visits.

The Department continued to monitor global trends and noted changes with regard to central banks becoming more involved in dealing with financial technology innovation. South African banks have taken steps to prepare themselves for dealing with these technologies, including developing their position on adopting some of these technologies, such as cloud computing.

2.5.7 Information technology risk reviews

During 2015 focused IT risk on-site meetings continued. Topics covered included IT risk appetite, business continuity and disaster recovery, emerging technologies, project governance and maintenance, and information security, including cyber security. The key findings were as follows:

- Some instances of insufficient capacity of IT risk resources were noted and instances of governance structure changes that were still being embedded were identified.
- Banks had to deal with sizeable and complex projects while being faced with resource constraints. However, projects were receiving appropriate oversight and overall practices improved.
- Considerable effort has gone into information security controls and banks are exerting substantial time and resources to enhance their ability to detect and respond to security incidents, especially with a heightened focus on cyber security.
- IT governance in some of the rest of Africa countries was a concern.

The Department will continue to observe the maturity of processes within banks, specifically with regard to keeping its IT current and minimising control failures.

2.5.8 Risk data aggregation and risk reporting

The Basel Committee issued the *Principles for the effective risk data aggregation and risk reporting*[31] in January 2013, noting that the principles would initially only be applicable to systemically important banks. The Department has since issued Guidance Note 3 of 2014[32] informing the banking industry that the principles applied to all South African banks, including local branches of international banks. Subsequently, Directive 2 of 2015[33] was issued, advising domestic systemically important banks (D-SIBs) to comply with the requirements by 1 January 2017 and the implementation timelines for non-D-SIBs to be considered on a case-by-case basis.

The Department requested banks to compete self-assessments and continued interactions with banks on a bilateral basis, to inform and monitor progress made. This approach will endure

31. Available at http://www.bis.org/bcbs/publications.htm?a=1&mp=any&pi=title&page=4

32. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6114

33. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx? sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6629

and will be complemented with meetings with BASA. Banks, especially the larger organisations, have been making a concerted effort in progressing towards compliance.

2.5.9 Directives and guidance note related to operational risk

The following directives and guidance note were issued during the period under review:

- Directive 2 of 2015:[34] the purpose of this directive was to inform banks to implement robust risk management practices that include specified matters related to risk data aggregation and risk reporting.
- Directive 4 of 2015:[35] the purpose of this directive was to specify identified areas of the legal framework requiring amendments, including specified regulations, circulars, directives or guidance notes to ensure that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant and current.
- Directive 8 of 2015:[36] the purpose of this directive was to direct all banks to submit specified information in respect of their outsourcing arrangements within indicated timelines.
- Directive 10 of 2015:[37] this directive sets out the requirements for the approval and notification of changes to AMA banks' existing operational risk management and measurement systems.
- Guidance Note 3 of 2015:[38] the purpose of this guidance note was to inform all banks of the process to be followed and the information to be submitted when applying to adopt the AMA. This guidance note relates to all future applications to obtain the relevant approval from the Registrar and the fact that banks that received approval previously do not have to reapply.

2.6 Asset and liability management risk

2.6.1 Focused reviews

According to the Core Principles, a supervisor is required to determine that banks have in place certain minimum standards in respect of liquidity risk and interest rate risk in the banking book. During 2015 the Department conducted several reviews covering both major banks and smaller individual banks to evaluate their current practices. The Department sent out a questionnaire covering banks' policies, procedures and internal controls relating to liquidity risk and interest rate risk in the banking book.

Following an off-site review of the responses received, the Department conducted on-site meetings to discuss the responses and to probe any relevant additional information to ascertain the level and intensity of supervisory action required.

2.6.2 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 frameworks.

Representatives of the Department fulfilled an observer role during these exercises. These simulation exercises continued to be of great value both to the Department and participating banks by highlighting areas of improvement and by demonstrating the need for robust liquidity risk management.

34. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6629

35. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6664

36. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6786

37. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6995

38. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6617

2.6.3 Sovereign rating change scenario

In line with the continued risk of South Africa receiving a sub-investment grade sovereign credit rating and the subsequent impact it might have on the banking sector, the Department requested all banks to participate in a stress scenario to assess the potential impact.

2.6.4 Regulatory developments

The Department continues to monitor implementation of the NSFR standard by banks. This process commenced on 1 January 2013 and will continue until the NSFR becomes a regulatory requirement as from 1 January 2018.

Through its membership on the TFIR, the Department continued to participate in the development of the international framework to measure and potentially implement a regulatory capital requirement for interest rate risk in the banking book.

In 2015 the Department continued to engage with the South African banking sector through BASA to monitor and discuss international regulatory developments and the impact thereof on liquidity risk and interest rate risk in the banking book.

2.7 Capital management

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

The Department issued Guidance Note 4 of 2015 during August 2015 to provide guidance on expectations with respect to ICAAPs as well as the contents of ICAAP-documents of banks.

During 2015 the Department also continued with focused reviews on 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 2015 highlighted the following:

- Banks' capital planning was generally robust and regularly challenged by management. Forecasts for capital and leverage indicated that South African banks remained adequately capitalised.
- Risk appetite frameworks of smaller banking institutions required improvements.
- Large and complex banks use economic capital models to accurately measure risks and to relate the risks to capital requirements. The results of these models are used in decision-making; therefore, management should continue to ensure economic capital models are validated and are still appropriately calibrated post the financial crisis.
- In certain instances banks applied the STA to calculate capital requirements for credit risk, especially relating to exposures in foreign operations. The Department imposed additional capital requirements in such instances where the STA was found not to be a true reflection of the underlying risk.
- The identification, measurement, monitoring and mitigation of credit concentration risk, model risk and business risk required improvements at some banks.
- 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 within a short turnaround time.

2.7.2 Regulatory and economic capital data collection exercise

The Department continued to collect and monitor regulatory and economic capital forecasts from D-SIBs, biannually, in order to supplement the ICAAPs. During 2015 a data assessment template was standardised in order to automate and simplify the monitoring and analysis of regulatory versus economic capital data.

The data collected also included projected regulatory capital planning data. The aforementioned data continue to enhance the Department's assessment of risk coverage and capital planning at banks.

2.7.3 Domestic systemically important banks

The Department continuously applies its D-SIB methodology to assess which banks are regarded as systemically important and the extent to which they are systemically important. During November 2015, updated D-SIB loss absorbency capital buffer requirements were communicated to bank-controlling companies and banks that were classified as D-SIBs.

Since 2013 the Department kept D-SIBs informed of changes to the size of their D-SIB capital buffer requirements. This communication allowed banks and bank-controlling companies sufficient time to adequately plan and manage the aforementioned capital buffer requirements.

The phasing-in of the D-SIB loss absorbency capital requirement together with capital buffers forming part of the capital conservation range, that is, the capital conservation buffer and the countercyclical capital buffer commenced on 1 January 2016. During times of stress, CARs might fall below the aforementioned buffer requirements; however, restrictions on the level of distributions apply with effect from 1 January 2016.

2.8 Pillar 3: disclosure

2.8.1 Overview of key activities

During 2015 the Department reviewed disclosures by banks in terms of Pillar 3 requirements, with specific focus on the newly implemented Pillar 3 disclosure standards relating to the composition of capital, LCR and the leverage ratio. In some instances, although the banks disclosed some of the required information, mandatory disclosure templates were not always used and some banks failed to comply with all of the disclosure requirements. The Department will continue to monitor compliance with Pillar 3 disclosure requirements, with emphasis on areas where banks are still lacking.

2.8.2 Directives related to disclosure

Directive 3 of 2015 titled *Matters related to composition of Pillar 3 disclosure requirements*[39] was amended and reissued following the RCAP review. Amendments effected to the directive were, in the main, related to the frequency of the reconciliation of regulatory capital to the financial statements. The said reconciliation is now required semiannually instead of annually.

Directive 11 of 2015 titled *Matters related to revised Pillar 3 disclosures requirements*[40] was issued to ensure timeous implementation of the revised *Pillar 3 Standards: revised Pillar 3 disclosure requirements*, issued by the Basel Committee in January 2015. Banks are expected to publish their first Pillar 3 reports in accordance with the revised framework with their annual reports that relate to the 2016 financial year end.

39. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6660

40. Available at http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=7003

2.9 Consolidated supervision

2.9.1 Nedbank Group Limited's Supervisory College

The Department is committed to conducting effective consolidated supervision, as proposed by the Basel Committee. The Department's consolidated supervision framework includes the hosting of supervisory colleges. The overarching objective of a supervisory college is to assist the home- and host-country supervisors in gaining a better understanding of the banking group's risk profile.

In line with the Department's consolidated supervision framework and international best practices, the Department held a supervisory college for supervisors of Nedbank Group Limited's (NGL) African banking operations from 9 to 10 November 2015. NGL is involved in six countries in Africa, including South Africa, and a total of eight supervisors from four countries attended the supervisory college for the African operations of NGL.

The college afforded all an opportunity to gain knowledge and share information. Also, networks were built between home and host regulators, which will contribute to a more effective consolidated supervision. Information sharing and enhanced cooperation between supervisory authorities are key to strengthening cross-border supervision of banking groups.

2.9.2 Supervisory meetings with the FSB

Throughout the year the Department and the FSB maintained regular interactions. Conglomerates operating within the South African jurisdiction were discussed ensuring appropriate supervisory processes were in place. These meetings serve as a platform where valuable information is shared between the relevant supervisory authorities thereby enhancing supervision effectiveness of conglomerate groups.

2.9.3 Supervisory colleges hosted by the FSB

As mentioned in the Department's previous annual reports, the FSB and the Department have always enjoyed a close working relationship by virtue of the regular supervisory discussion meetings. This relationship has been further strengthened during the year under review by increasing cooperation, information sharing and communication between the two supervisory bodies in anticipation of the imminent establishment of the PA.

In August 2015 the FSB hosted supervisory colleges for all South African insurance groups with a presence in Africa. Representatives from the Department were also invited due to the interconnectedness between banking groups and insurance groups.

During the supervisory college sessions each country provided insights into the host entity's operations, including, but not limited to financial highlights, strategic objectives and pertinent risk areas.

The information and interactions obtained at the supervisory college sessions proved extremely valuable in the Department's continued risk assessment and analysis of the banking groups with insurance subsidiaries.

2.10 Anti-money laundering and combating the financing of terrorism

2.10.1 Thematic sanctions review

In 2014, the Department, with the assistance of a third party service provider, conducted a banking-wide off-site thematic review of the sanctions-screening controls employed by South African banks. The thematic review evaluated if banks' sanctions-screening systems were adequately configured to protect the South African banking industry against being used for the financing of terrorism and related activities and whether or not banks effectively comply with combating of terrorism legislation.

During the course of 2015, the AML team received quarterly progress reports from all 31 participant banks and worked closely with those banks that required additional support, re-testing and guidance. The deadline for remediation of deficiencies identified in the 2014 exercise was November 2015 when all banks were expected to have addressed their specific areas of concern.

2.10.2 On-site inspections

On an annual basis, the Department follows an AML/CFT risk-based approach to determine which banks to inspect during the year. A total of seven AML/CFT local on-site inspections in terms of section 45B of the FIC Act were conducted during 2015. All local inspections undertaken in 2015 were on average conducted over a period of three weeks.

The most pertinent findings arising from local on-site inspections conducted during 2015, indicated that banks required enhanced focus and strengthening of their controls in relation to compliance with the FIC Act in various areas, but in particular the following:

- documentation and implementation of client identification and verification as well as record-keeping procedures;
- implementation of effective working methods pertaining to the identification and reporting of cash transactions above the prescribed amount;
- implementation of effective working methods pertaining to the detection and investigation of suspicious and unusual transactions;
- implementation of effective controls relating to the identification and reporting of property associated with terrorism and related activities; and
- development and implementation of AML/CFT targeted training programmes on specialised business areas, that is, in line with employees' responsibilities, activities and skills.

In addition to testing banks' compliance with the FIC Act, the Department also assessed banks' adopted AML/CFT risk-based approaches, including their treatment of politically exposed persons in line with the FATF recommendations.

The most pertinent finding arising from these assessments indicated that banks required enhanced focus and strengthening of their controls in relation to the review and implementation of effective controls relating to management of transactions of high-risk clients (including politically exposed persons), products, services and channels.

In 2015 the Department visited two cross-border banking subsidiaries of South African registered banks in order to assess the operations level of compliance with:

- the global AML/CFT standards of the FATF 40 Recommendations;
- the Basel Committee's guidance on sound management of risks related to money laundering and financing of terrorism; and
- country-specific AML/CFT legislation.

Each visit took a week and was conducted in collaboration with the specific regulators of that country. The inspection findings revealed, among other things, that there was still a need for parent companies to enhance their efforts to assist, guide and perform adequate oversight of their cross-border operations' AML/CFT frameworks.

Table 2.1 reflects the details of the inspections conducted and also provides a comparison of the inspections conducted from 2012 to 2015.

Table 2.1 On-site inspections

Nature of inspection		2012*	2013	2014	2015
Routine........................	Large banks	2	3	0	1
	Small banks	6	2	8	6
	Cross-border (Africa)	0	0	1	2
Non-routine	Large banks	0	1	0	0
	Small banks	0	1	0	0
Total		8	7	9	9

* AML/CFT inspections commenced in April 2012

2.10.3 Off-site supervision

Throughout 2015 the Department conducted various workshops and prudential meetings with select locally registered banks. Topics discussed at such meetings included:

- challenges faced by banks to comply with the FIC Act;
- banks' readiness to implement the FIC Act Amendment Bill with regard to policies, procedures, systems and controls;
- issues emanating from international best practice standards, such as the FATF Recommendations;
- AML/CFT compliance resource staffing and capacity;
- compliance monitoring and oversight in respect of automated and/or manual monitoring systems and record-keeping processes;
- the use of alternative processes and/or technological advancements to identify and record customer identification and information verification;
- progress made by banks in remediating AML/CFT inspection findings;
- innovative ways to further financial inclusion, while still meeting AML/CFT requirements in the context of the risk-based approach relating to product offerings, customer due diligence and risk assessment and controls; and
- ways in which banks perceive and manage the AML/CFT risks of money value transfer service providers as clients and/or products.

This is an ongoing element of the Department's supervisory calendar that is continued on an annual basis.

2.11 Recovery planning

In the past the main objective of banking regulations was to reduce the risk of bank failures and the focus was on recovery planning. Currently, resolution planning has come to the fore with the main objective of reducing the negative impact and consequences of a bank failure. Banks are responsible for the development of their own recovery plans and supervisory authorities are responsible for the development of resolution plans.