2. Overview of supervisory activities

2.1 Introduction

As part of its risk-based supervisory approach, BSD monitors banks' compliance with the regulatory framework and specifically with prudential requirements. Understanding banks' risk profiles, their business models and the environment in which they operate is paramount to BSD's effective risk-based supervision. To this end, BSD 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:

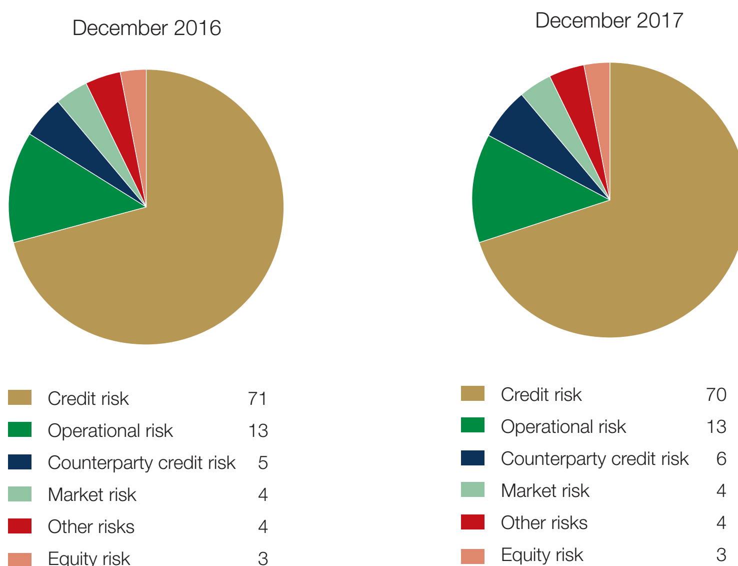
- identify the key risk factors and the build-up of risks which could impact on individual banks and the banking sector as a whole;
- assess the risk management policies, processes, practices and structures that are used to mitigate risks; and
- deploy resources accordingly to address the most critical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

This chapter provides an overview of BSD's operations 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 themes, risk-based reviews, consolidated supervision, and disclosure assessments.

Figure 2.1 gives an indication of the composition of risk-weighted exposure as at 31 December 2016 and 31 December 2017, reflecting Pillar 1 risks that are quantifiable in terms of the Regulations relating to Banks (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 SREP and assessed under Pillar 2 supervisory activities.

Figure 2.1 Composition of risk-weighted exposure

(Per cent)



2.2 Themes for 2017

2.2.1 Introduction

8. Available at http://www.resbank.co.za (refer to Prudential Authority link)

As part of its ongoing supervisory interventions, BSD identifies certain themes, or flavour-of-the-year topics, for an annual discussion with banks' boards of directors (boards). Guidance Note 2 of 2017[8] identified the following two topics for 2017:

- risk data aggregation and risk reporting; and
- the implementation of King IV requirements.

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

2.2.2 Risk data aggregation and risk reporting

The Principles for Effective Risk Data Aggregation and Risk Reporting (Principles) were issued by the BCBS in January 2013. The Principles aims to strengthen banks' risk management practices by improving their risk data aggregation and risk reporting.

BSD applied the Principles on a proportional basis to all banks in South Africa and adopted these principles as an integral part of its regulatory and supervisory framework.

Focus areas for the board presentations included:

- the awareness, knowledge and understanding of the board to provide oversight of the Principles;
- the board's awareness and assessment of the bank's data architecture, data adaptability, data capability and limitations, and risk reporting practices;
- the business impact associated with the Principles, including the quantification of benefits and the interdependency between the risk and finance disciplines;
- the bank's articulation of its risk data aggregation and risk reporting expectations in line with their risk appetite in both normal and stress periods;
- investment made by the bank associated with the Principles (e.g. headcount, spend and governance structures established);
- the bank's interpretation of key terminology used (e.g. scope, legal entities, materiality, metrics, full compliance, manual processes);
- the bank's progress (e.g. milestones reached and still to be achieved, gaps identified, challenges encountered and plans to overcome these, oversight and internal accountability);
- the involvement of internal and external audit/consultants pre- and post-implementation;
- the board's process(es) adopted to ensure the periodic assessment, continued application, monitoring, improvement and embedment of the Principles in ongoing risk management frameworks.

Through these discussions, it was evident that the Principles had received a high level of attention and traction in the banks, with adequate involvement from the respective boards. The banks now have a markedly better understanding of the requirements relating to the Principles and recognise the importance of these principles as they promote informed decision making up to senior management and board level.

BSD observed the extensive investments made by banks associated with the implementation of the Principles. The establishment of appropriate governance structures and, where necessary, the creation of new positions as well as the recruitment of specialists and engagements with

consultants has assisted banks immensely. The banks are currently focusing on measures to support the embedment of the Principles in their existing risk management frameworks.

Several banks indicated that, in many instances, implementing the Principles had enhanced risk reporting and improved transparency of data limitations and data architecture applicable across lines of business. Additionally, there seems to be an improved recognition of the importance of data quality across the industry, with various banks implementing data quality issue tracking and rectifying techniques.

The banks have demonstrated an adequate interpretation of the key terminology used in relation to the Principles, such as 'metrics', 'scope', 'legal entities' and 'manual processes'. BSD did, however, detect a challenge with regard to the interpretation of 'largely compliant', 'fully compliant' and 'materially compliant', with some banks confusing these terms.

BSD will continue to focus on the Principles during the 2018 supervisory year. As part of this focus area, 'use tests' will be introduced, in which business users at banks will be required to provide feedback on the progress and implementation of the Principles within their respective roles and areas.

2.2.3 The implementation of the King Committee's report on corporate governance

The King Committee is acknowledged to be the standard-setting body for corporate governance in South Africa. BSD monitors, on an ongoing basis, developments emanating from the committee and other similar international bodies.

The *King IV Report on Corporate Governance for South Africa 2016 (King IV)* was launched on 11 November 2016 and replaces *King III*, which came into effect in 2009. *King IV* became effective on 1 April 2017.

The objectives of *King IV* are to:[9]

- promote corporate governance as integral to running an organisation and delivering governance outcomes such as an ethical culture, good performance, effective control and legitimacy;
- broaden the acceptance of *King IV* by making it accessible and fit for implementation across a variety of sectors and organisational types;
- reinforce corporate governance as a holistic and interrelated set of arrangements to be understood and implemented in an integrated manner;
- encourage transparent and meaningful reporting to stakeholders; and
- present corporate governance as concerned with not only structure and process, but also with an ethical consciousness and conduct.

King IV focuses on an outcomes-based approach and makes clear distinctions between principles and practices. Governance outcomes are based on the categories of ethical culture, good performance, effective control, and legitimacy. Principles can be achieved by an organisation if it considers and applies recommended practices. *King IV* contains supplements which are intended to help organisations from different industry sectors and types of organisations to understand and apply the practices.

The 17 principles advocated by *King IV* are linked to governance outcomes. It was the intention of the King Committee to place greater emphasis on transparency and to ensure the principles and practices are qualitatively applied, and thus proposed an 'apply and explain approach' rather than the 'apply or explain philosophy' of *King III*.

King IV applies to all organisations and across different sectors, and can be applied on a proportional basis depending on the size, resources and business activities of the organisation.

9. The objectives were extracted from *King IV* (2016) published by The Institute of Directors in Southern African NPC (page 22). Available at: http://www.iodsa.co.za/?page=KingIV

Based on the value and the importance of the report, BSD identified *King IV* as a flavour-of-the-year topic. During the year under review, banks and their boards of directors demonstrated a commitment to understanding and applying the principles and practices espoused in *King IV*.

2.3 Credit risk

2.3.1 Introduction

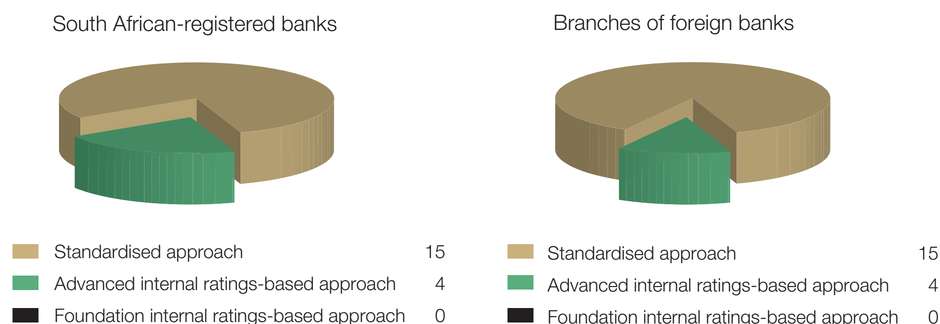
The macroeconomic environment continues to be unsupportive of meaningful and robust growth in credit extension, at least by historical standards. Although household debt metrics continue to show signs of improvement, household debt remains persistently high. Consequently, appetite for household credit remains rather sluggish. In comparison, credit extension to the corporate sector continues to grow modestly.

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 STA ;
2. the foundation internal ratings-based (FIRB) approach; and
3. the advanced internal ratings-based (AIRB) approach.

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

Figure 2.2 Credit risk methodologies applied by banks as at 31 December 2017



2.3.2 Regulatory developments

The BCBS published a high-level summary of the Basel III reforms in December 2017. The Basel III reforms seek to restore credibility in the calculation of risk-weighted assets and help facilitate the comparability of banks' capital ratios. The implementation date for the revised STA for credit risk and revised IRB framework is 1 January 2022, and the transitional arrangement for phasing in the aggregate output floor is between 1 January 2022 and 1 January 2027.

As reported in the 2016 *Bank Supervision Annual Report*, BSD, together with National Treasury and members of the banking industry, has started a process to amend the Securitisation Notice (Government Notice No. 2, published in *Government Gazette* No. 30628, dated 1 January 2008). In conjunction with the revisions to the Securitisation Notice, BSD embarked on a process to determine the required changes to the Commercial Paper Notice (Government Notice No. 2172, published in *Government Gazette* No. 16167, dated 14 December 1994). The purpose of the revision of both these notices is to ensure that legislation facilitates the development of a sustainable funding model for South Africa by allowing certain entities of substance to access capital markets, while still ensuring the protection of the general public.

2.3.3 Model changes

During 2017, BSD received 33 notifications of non-material changes and 22 submissions of material changes to the IRB banks' rating systems. BSD continued to follow a robust review and approval process.

2.3.4 PD/LGD benchmarking exercise

The attainment of a level playing field with regard to the implementation of the AIRB approach continues to be one of the key focus areas of BSD's supervisory efforts. In pursuit of this goal, a benchmarking exercise to assess the extent of the variability of risk-weighted assets among AIRB banks' large corporate portfolios was conducted. This was a follow-up exercise to the 2012/13 exercise, but with a narrow focus on the corporate asset class.

Several factors necessitated this exercise. First, BSD had observed an increasing reliance on external data sources, particularly with the low default nature of the corporate asset class, and the general lack of internal default and loss experience to support the development of robust rating systems. Moreover, the majority of available external data sources have limited representation of emerging market economies – South Africa in particular – which in turn raises the pertinent question of whether internal risk parameter estimates produced from these sources are representative of the South African credit risk environment in general and AIRB banks' internal risk characteristics more specifically. In this regard, this benchmarking exercise aimed to gather some industry insights in order to inform supervisory actions that may be warranted to ensure that the AIRB data reported to BSD are credible, reliable and consistent with the AIRB minimum requirements in the Regulations.

Second, risk-weighted asset variability among banks has over the years focused global attention on the use of internal models, specifically in relation to low default portfolios, and the practice-based differences driving this variability. The benchmarking exercise will also assist BSD in this regard in gaining a better understanding of the diverse industry practices and the drivers of risk-weighted asset variability.

An analysis of the results has been completed and feedback will be provided internally and to participants of the exercise during 2018.

2.4 Market risk

2.4.1 Market risk environment

The year under review was characterised by market uncertainty and rand volatility, which was mostly as a result of an unstable political environment.

The rand weakened over the period by 1.3%; bonds weakened with the depreciation of the rand, but the weakening of bonds was perceived to be temporary due to the global search for yield which was still present.

On the international front, central bank announcements were critical as they directly impacted emerging markets. South Africa and other emerging markets enjoyed the benefits of a global search for yield as investors allocated large amounts of money to emerging markets. The local market saw phenomenal inflows from international participants, particularly in the bonds space. This trajectory is expected to change as the United States Federal Reserve (Fed) hikes rates within a targeted range of 1.25–1.5%.

South Africa experienced a ratings downgrade to sub-investment grade by Standard & Poor's in November, while Moody's Investors Service placed South Africa on a downgrade review. The market reaction to the downgrade was fairly muted as a downgrade by at least one rating agency was largely priced in. The news resulted in a positive bias across asset classes, including a rally in bonds and an appreciation of the rand.

Following the delivery of the *Medium Term Budget Policy Statement* in October 2017, and the forecast for growth being revised downwards from 1.3% to 0.7%, the rand decreased by almost 4%, followed by decreasing bond prices and increasing yields.

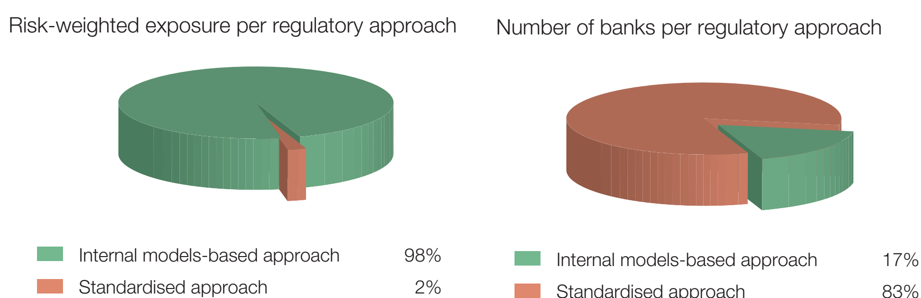
2.4.2 Methodologies to calculate the minimum required regulatory capital relating to market risk

Under the current 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:

- the standardised approach; and
- the internal models-based approach (IMA).

The risk-weighted exposure for these two approaches, in addition 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 2017



2.4.3 Market risk reviews

BSD performed both compliance-based and risk-focused supervision of market risk during the period under review. The market risk reviews conducted in 2017 focused on banks using the IMA for regulatory purposes.

2.4.4 Key findings

Market uncertainty was the key theme throughout the year, both at a global and a domestic level. Banks ran low levels of market risk due to this uncertainty and lack of confidence, mostly as a result of political upheaval.

Banks still performed relatively well on the trading side in a challenging market environment, and were able to take advantage of the volatility in the rand as well as the positive demand for South African assets as global investors sought out higher yields.

The JSE Limited volumes were low for the majority of the year, which affected banks' client-facing businesses, particularly on the equities side. This was also a factor of the uncertainty in the market where investors were taking a cautious approach towards investments. Compliance and changes in regulations, such as the fundamental review of the trading book, continue to promise a heavy regulatory cost. As a result, banks have started assessing whether it is feasible to keep certain business lines.

2.4.5 Counterparty credit risk

In terms of Core Principle 17 (CP 17) of the Core Principles published by the BCBS, supervisors must be satisfied that banks have a counterparty credit risk management process that takes

into account their risk appetite, risk profile as well as market and macroeconomic conditions. This includes appropriate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate this risk in a timely manner.

BSD continued to conduct thematic reviews for certain banks exposed to counterparty credit risk, derived from the requirements of CP 17 and encompassing its complete scope, as well as additional aspects related to the Basel III framework, pending regulatory reforms and industry best practices. A questionnaire was used to establish the fundamental drivers, controls and governance of counterparty credit risk management and to assess banks' incorporation of the Basel III framework into their business practices and risk management procedures.

The main outcomes of these reviews include insights into the practical implementation of banks' counterparty credit risk management frameworks, including areas of improvement, and assessing the banks' strategies in light of the relevant regulatory reforms and macroeconomic environment.

It is anticipated that the Standardised Approach for Counterparty Credit Risk (SA-CCR) will be implemented on 1 January 2019.

2.4.6 Equity risk in the banking book

Exposures arising from equity risk in the banking book (ERIBB) are generally held for long-term investment purposes and receive a capital treatment that is independent of the market risk capital charge. For supervisory purposes, ERIBB is regulated together with market risk, and the reviews are aimed at gaining in-depth insight into areas where this risk arises as well as the management of this risk over the life cycle of these investments. It is worth noting that this risk type continues to diminish as banks strategically reduce investment activity. BSD did not conduct any ERIBB thematic on-site reviews in 2017.

2.4.7 Securities thematic reviews

During 2017, BSD conducted two focused reviews on bank-associated entities that conduct stockbroking and other securities activities. The main objective was to assess how the risks affect the bank-specific risk profile. The review placed emphasis on the trading businesses, systems utilised, risk management processes as well as regulatory issues with respect to market risk. Further assessments will continue in 2018 for selected banking groups.

2.5 Operational risk

2.5.1 Introduction

Operational risk and IT risk continue to be of material focus, both locally and globally. Process execution and internal control breakdowns as well as fraud incidents were particularly notable during the year, largely driven by tough economic and socio-economic conditions. It was no surprise that cyber-risk once again remained a key focus area due to investments in digital products and services, rapid innovation and technology changes, and increased sophistication of cyberattacks in general. FinTech such as cryptocurrency, blockchain, artificial intelligence and robotics are no longer foreign terms. Outsourcing further remained relevant, with discussions relating to cloud computing and the offshoring of data becoming more frequent.

Even though the frequency and severity of industry-wide operational risk losses seemed relatively flat when compared to 2016, domestically it highlighted a sustained two-year uptick with the severity component once again driven by a handful of extraordinary sizeable events. A decrease in operational risk losses was, however, evidenced globally, with losses decreasing by more than half over the year under review. This decline was mainly attributable to a drop in the number of large fines and settlements imposed by regulators against banks, and were not a pure reflection of actual operational incidents and losses within institutions.

The leading gross operational risk losses in terms of severity that occurred locally related mostly to execution and process errors, whereas gross fraud losses made up the bulk of losses on the global stage – a correction from the previous year's category of clients, products and business practices, which was mostly due to conduct offenses.

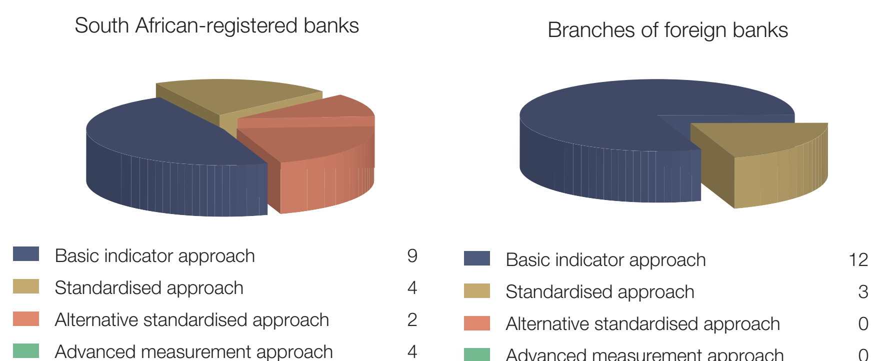
2.5.2 Methodologies to calculate the minimum required regulatory capital relating to operational risk

Under the current 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:

- the basic indicator approach (BIA);
- the standardised approach (TSA);
- the alternative standardised approach (ASA); and
- the advanced measurement approach (AMA).

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

Figure 2.4 Operational risk methodologies applied by banks as at 31 December 2017



2.5.3 Operational risk reviews

BSD performed focused operational risk reviews at selected banks during the period under review. Topics from an operational risk perspective included strategic objectives, governance structures, human resources, IT systems used, and frameworks and policies. Discussions extended to operations outside of South Africa and further incorporated material concerns. Outsourcing, top operational risks, risk and control self-assessments and key risk indicators within the corporate environment, and internal loss data were additional themes that received attention. Key findings included the following:

- Operational risk governance structures, human resources, frameworks and policies: Banks maintained sound governance structures, with many banks enhancing their existing frameworks and processes by promoting an explicitly defined ownership of roles and responsibilities. In addition, banks demonstrated an overall improvement with regard to the management of operational risk, with some banks incorporating the use of new operational risk and control systems. However, BSD cautioned banks against the dilution of operational risk management due to the integration of operational risk processes with other risk types.

- The African footprint: BSD observed a general improvement in banking operations outside of South Africa with regard to the management of operational risk, in which some local banks streamlined processes that are country-specific. Moreover, local banks made concerted efforts to improve control weaknesses, such as enhancing data quality and existing controls, as well as establishing operational risk frameworks that are fit for purpose.

- **Overview of risk and control self-assessments and key risk indicators:** Most banks continued to enhance their risk and control self-assessments and key risk indicators by ensuring the maintenance of frameworks and the reviewing of policies and procedures. Some banks did, however, experience challenges when it came to monitoring control weaknesses and designing appropriate key risk indicators.

- **Internal loss data:** Discussions encompassed items such as coverage, data collection thresholds, reconciliations, boundary events, material incidents and review as well as verification and validation. For the most part, banks were able to adequately evidence adequacy relating to internal loss data. Efficiency, quality and completeness should be monitored and examined internally on an ongoing basis via the three-lines-of-defence model as well as being scrutinised and challenged via BSD, where relevant and appropriate.

2.5.4 Guidance notes related to operational risk

Guidance Note 4 of 2017:[10] The purpose of this guidance note was to bring to the attention of banks the latest international best practices related to cyber-resilience, namely the Committee on Payments and Market Infrastructures (CPMI) and the Board of the International Organization of Securities Commissions' (IOSCO) guidance on cyber-resilience for financial market infrastructures issued on 29 June 2016.

10. Available at http://www.resbank.co.za (refer to Prudential Authority link)

2.5.5 Information technology risk

BSD continued to collaborate with the banking industry with regard to the possible establishment of a reporting process for material IT-related, including cyber-related, incidents. BSD contributed to the establishment of the SARB FinTech Steering Committee and collaborated and cooperated with the SARB FinTech Programme with regard to its engagement model, areas of interests and expectations. BSD participated in working groups dealing with aspects of virtual currencies and distributed ledger technologies, the offshoring of data and cloud computing, the Inter-governmental Fintech Working Group, as well as the regulatory work stream of the South African Financial Blockchain Consortium. BSD further contributed to the drafting of concept papers on blockchain and FinTech for SADC's Committee of Central Bank Governors (CCBG) Information and Communications Technology (ICT) Subcommittee. Membership to international bodies such as the ITSG and TFFT had assisted BSD to align its views with regard to global IT supervisory practices and experiences to the local environment.

BSD issued a proposed directive and its associated draft position paper that sets out the requirements and related considerations under which banks may offshore their data and/or make use of cloud computing.

The short- and medium-term IT supervisory programmes will include a focus on cybersecurity, FinTech and emerging technologies. In addition, BSD will remain involved in both local and international initiatives to supervise and provide guidance on IT risk in the industry.

2.5.6 Information technology risk reviews

The supervisory plan during the year under review included various on-site visits to banks. Areas covered comprised IT and IT risk in terms of strategic objectives, governance structures, human resources, frameworks and policies, and incidents. These discussions extended to African operations. Information security and cybercrime as well as emerging technologies were additional themes that received attention. The main findings from these reviews were as follows:

- Business disruptions and system failures were a concern at some banks.
- The maturity of IT risk at some banks, including operations outside of South Africa, required improvement. Most banks have adopted internationally recognised best practises and IT risk frameworks; however, these frameworks should still be tailored for banks' specific requirements.

- There is a lack of adequate cybersecurity skills, both locally and internationally. Owing to the increasing nature and complexities of cyberattacks, most banks have increased their resources, financially and/or otherwise, to counteract the onslaught of cybersecurity. In addition, industry collaborations and information sharing with other industry players was reiterated as being crucial.
- Several banks have adopted emerging technologies, including FinTech solutions, which are still maturing. Adequate risk assessments and governance processes applied as well as due consideration for the banks' risk appetite have been evaluated.
- Certain banks were reminded of the provisions of Guidance Note 5 of 2014 when outsourcing particular processes, functions or activities. To attempt alleviating misconceptions, BSD would consider separating requirements from guidance during future revisions.

2.5.7 Outsourcing

BSD continued to critically analyse submissions in terms of Directive 8 of 2015 on the reporting of material outsourced service providers and critical third-party service providers. A synopsis of the outcomes of the 2017 outsourcing submissions was presented to the industry. It was concluded that continued cooperation and collaboration with various stakeholders was essential to mitigate outsourcing risk. BSD received various submissions from banks, mostly IT in nature, relating to outsourcing arrangements, cloud computing and data offshoring during the period under review. Most banks pursued these forms of information processing, storage and retrieval to optimise economies of scales and reduce costs, improve flexibility and accessibility of critical IT resources, and enhance standardisation and/or utilisation of centralised centres of excellence.

2.6 Asset and liability management risk

2.6.1 Regulatory developments

BSD actively participated in the continued development and refinement of the two main standards relating to liquidity and funding, namely the LCR and NSFR through its participation in the WGL.

BSD continued to engage with the banking sector through BASA to monitor and discuss international regulatory developments, and the impact thereof in South Africa, relating to liquidity risk and interest rate risk in the banking book.

Within the SARB, the ALM team continued to collaborate with other relevant departments on the impact that regulatory developments have had on South Africa, and the potential future impacts of further regulatory developments on their SFAs.

2.6.2 Focused reviews

According to the Core Principles, a supervisor is required to determine that banks have certain minimum standards in place. During 2017, BSD conducted several reviews covering both major banks and small individual banks. To evaluate their current practices, BSD sent out a questionnaire covering banks' policies, procedures and internal controls relating to funding, liquidity risk and interest rate risk in the banking book.

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

2.6.3 Sovereign credit rating downgrade scenario

In line with the continued risk of a sub-investment grade sovereign credit rating downgrade and the subsequent impact it may have on the banking sector, BSD requested all banks to participate in a stress scenario to assess the potential impact thereof.

2.6.4 Participation in liquidity risk simulations

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

2.7 Capital management

2.7.1 Overview of ICAAP reviews and key findings

BSD continued to conduct focused reviews on the internal capital adequacy assessment process (ICAAP) in 2017, in particular to follow up on prior ICAAP recommendations, risk appetite, credit risk economic capital estimations, capital management, stress testing, the validation of economic capital and stress-testing models as well as the continued focus on the use test.

On-site reviews conducted in the year under review highlighted the following aspects:

- Banks' regulatory capital planning was robust and underwent regular challenges by management. The forecast regulatory capital and leverage ratios indicated that South African banks remained well capitalised. A number of banks, however, were encouraged to place more focus on economic capital planning and its stress testing.
- Banks continued to enhance their stress-testing methodologies and processes.
- The development of a model risk framework continued to be part of future ICAAP initiatives for most banks.
- Although the estimated impact of IFRS 9 was incorporated by most of the banks in their capital plans, ongoing improvements were still underway. Some banks phased in the impact of IFRS 9 over a period, whereas others included the full impact in their capital plans for 2018.

2.7.2 Amendments to directives and guidance notes

As a result of the amendment of the Regulations with effect from July 2016, the following two directives and one guidance note were replaced[11]:

- Directive 1 of 2017 in respect of matters related to qualifying capital instruments issued by subsidiaries of banks or controlling companies was issued in February 2017 and replaced Directive 1 of 2013.
- Directive 6 of 2017 in respect of the process in terms of specific capital issuances and redemptions was issued in November 2017 and replaced Directive 3 of 2014.
- Guidance Note 6 of 2017 in respect of loss absorbency requirements for additional tier 1 and tier 2 capital replaced Guidance Note 7 of 2013.

11. Available at http://www.resbank.co.za (refer to Prudential Authority link)

2.7.3 Data collection

In addition to the revised form BA 700 that was implemented with effect from July 2016, and as part of BSD's continued monitoring and collection of forecast regulatory and economic capital data from domestic systemically important banks (D-SIBs) on a biannual basis, Directive 7 of 2017 was issued in November 2017.

2.7.4 Domestic systemically important banks

On a quarterly basis, BSD applied its D-SIB methodology to assess which banks are regarded as systemically important and the extent to which they are systemically important. Such monitoring and assessment of banks and bank controlling companies was based on the latest available data.

The phase-in of the D-SIB loss absorbency capital requirement commenced on 1 January 2016, together with capital buffers forming part of the capital conservation range (i.e. the capital conservation buffer and the countercyclical capital buffer) and will end on 31 December 2018. During times of stress, CARs may fall below the aforementioned buffer requirements; however, certain restrictions on the level of distributions would apply. This was effective from 1 January 2016. With regard to the higher loss absorbency capital requirement imposed on D-SIBs, 50% had been phased in with effect from 1 January 2017.

2.8 Pillar 3: disclosure

2.8.1 Introduction

In accordance with Core Principle 28: Disclosure and Transparency of the Core Principles, the supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies, and corporate governance policies and processes.

2.8.2 Reviews

During the period under review, BSD continued its reviews of banks' compliance with the Pillar 3 disclosure requirements, with a focus on matters relating to compliance with the revised disclosure requirements. In general, banks have implemented the revised disclosure requirements. However, while most have reported the required information using the required formats, there are still some banks which have not adopted the new disclosure formats of using common templates and tables for publishing the Pillar 3 reports. BSD will continue to monitor bank's compliance and engage with banks on Pillar 3 matters (and schedule interactions through BASA) to ensure full compliance with the disclosure framework.

2.8.3 Directives issued in 2017

In March 2017 the BCBS issued 'Pillar 3 disclosure requirements – consolidated and enhanced framework'. The standard issued by the BCBS sets out the disclosure requirements arising from the second phase of the Pillar 3 framework. The enhanced framework consolidated different disclosure requirements into the Pillar 3 framework and introduced some adjustments to the timing and format of some disclosures. BSD issued a directive to implement the consolidated and enhanced disclosure framework.

2.9 Consolidated supervision

2.9.1 Supervisory colleges

BSD is committed to conducting effective consolidated supervision, as proposed by the BCBS. Supervisory colleges are an integral component of BSD's consolidated supervision framework. In addition to the collaborative supervisory on-site reviews conducted with many host regulators, BSD continued to arrange supervisory colleges.

Supervisory colleges make it possible for supervisors to share information on any material developments in risk profile, group structure, strategy as well as operations in home and host countries. They also enhance the development of a common understanding of risk in financial groups, promote a shared agenda for addressing risks and vulnerabilities, and provide a platform for communicating key supervisory messages among members.

During the year under review, supervisory colleges were held for the Standard Bank Group, the FirstRand Group and the Nedbank Group. These colleges were very successful and valuable information was shared, which contributed to more effective consolidated supervision. In addition to the above, two specific supervisory colleges were held for Barclays Africa Group Limited (BAGL), which focused on BAGL's sell-down process and separation from Barclays Plc.

2.9.2 Supervisory meetings with the Financial Services Board

BSD and the FSB maintained regular interactions throughout the year. The financial conglomerates operating in the South African jurisdiction were discussed, ensuring that appropriate regulatory and supervisory processes were in place.

2.10 Anti-money laundering and combating the financing of terrorism

2.10.1 On-site inspections

On an annual basis, BSD follows an AML/CFT risk-based approach to determine which banks to inspect during any particular year. During 2017, seven AML/CFT on-site inspections were conducted in terms of section 45B of the FIC Act, one of which was a joint inspection with the FIC. All the inspections undertaken in the year under review were concluded over an average period of three weeks.

The most pertinent findings that arose from the on-site inspections conducted in 2017 indicated that banks still required focus on strengthening their controls in relation to compliance with the FIC Act in various areas.

Besides testing banks' compliance with the FIC Act, BSD also assessed banks' adopted AML/CFT risk-based approaches, including their treatment of politically exposed persons in line with the FATF Recommendations.

During 2017, BSD also initiated and participated in the joint cross-border on-site inspections with the domestic banking regulators of two foreign banking subsidiaries of banks registered in South Africa in order to assess the operations' level of compliance with:

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

Each joint inspection took a week to be concluded. The inspection findings revealed, among other things, that there continues to be a need for parent companies to enhance their efforts to assist, guide and perform adequate oversight of their foreign operations' AML/CFT frameworks.

Table 2.1 On-site inspections

	2012*	2013	2014	2015	2016	2017
Large banks	2	4	0	1	0	0
Small banks	6	3	8	6	9	7
Cross-border (Africa)	0	0	1	2	2	2
Total	8	7	9	9	11	9

* AML/CFT inspections commenced in April 2012

2.10.2 Off-site supervision

Throughout 2017, BSD conducted various workshops and prudential meetings with select locally registered banks. Topics discussed at such meetings included:

- methods of identifying possible terrorist financing other than sanctions-list screening;
- banks' readiness to implement the FIC Act amendments with regard to policies, procedures, systems and controls;
- the management of records within a banking group when sharing client information between foreign branches and subsidiaries, local subsidiaries and financial intermediaries;
- observations related to the de-risking of correspondent banking relationships; and
- distinctive and overlapping AML/CFT roles, responsibilities and oversight.

This is an ongoing element of BSD's supervisory calendar that is executed on an annual basis.

2.10.3 Thematic sanctions review

BSD conducted a follow-up banking industry-wide thematic review of bank's sanctions-screening systems and systems-related controls. This was a follow-up to the review conducted in 2014 to assess banks' current sanctions-screening capabilities and to determine whether there were any improvements to the 2014 results.

The findings from this follow-up review showed a marked improvement in the effectiveness of banks' sanctions-screening systems.

2.11 Recovery planning

Following the publication of the *Key attributes of effective resolution regimes for financial institutions* by the Financial Stability Board in 2011, BSD requested banks to develop recovery plans. In 2015 BSD issued Directive 1 of 2015 on the minimum requirements for recovery plans against which banks could benchmark their recovery plans.

Since 2013, BSD and the SARB's Financial Stability Department's Resolution Planning Division (RPD) have jointly reviewed the recovery plans of D-SIBs on an annual basis. The format of this review is to have workshops with the D-SIBs to address the banks' compliance with Directive 1 of 2015 and their progress made in addressing the gaps identified during the previous year's review. Sector-wide comparisons between banks are done by BSD and the RPD, with best practices being shared at these workshops to ensure that the banks follow a consistent, yet bank-specific approach in the development of the various elements of their recovery plans.

In general, the quality of the recovery plans has improved. The continual refinement of these plans is expected as the recovery planning process matures further and becomes increasingly embedded in the banks' risk management processes.

During 2017, the RPD also initiated a project with BSD to review the recovery plans of non-systemically important locally controlled banks. Although the primary focus of the workshops with these banks is to assess compliance with Directive 1 of 2015, the workshops also provide an opportunity to create a better understanding among these banks of the purpose and elements of a recovery plan. The outcome of this project will be used to refine the guidance given to non-systemic banks on recovery plans.

2.12 Risk data aggregation and risk reporting

As indicated in the 2016 *Bank Supervision Annual Report*, none of the D-SIBs in South Africa were able to fully comply with the risk data aggregation by the directed date of 1 January 2017. Principle 2 in particular, relating to data architecture and IT infrastructure, continued to pose challenges for banks.

BSD had interactions with the majority of banks during the year under review and will continue to monitor their progress in 2018.

The final compliance dates for the implementation of the Principles with all banks was determined on a case-by-case basis, and these date have been spread over the next two to four years. Furthermore, BSD indicated that there is no appetite to postpone the compliance dates agreed upon with the banks.

In addition, the audit reports from the D-SIBs in relation to Directive 5 of 2016 that requested an independent party (either internal or external audit, or a combination of the two parties) to complete a granular review and verification of the evidence and artefacts motivating the state of compliance with the Principles have been received. The key themes will be shared within BSD and with the banks in 2018.

Finally, the industry has demonstrated a greater understanding of the Principles and the requirements thereof. The interactions with banks as well as the quarterly BASA meetings assisted with this. Moreover, this was further evidenced in the flavour-of-the-year presentations provided by the boards of banks (refer 2.2.2).

2.13 Thematic on-site reviews

BSD's review team conducted on-site reviews during the 2017 calendar year, which focused primarily on enhancing the understanding of some of the branches of foreign banks' extent of compliance with corporate governance principles as well as risk management and compliance functions as related to the Banks Act, the Regulations and best practices.

The reviews encompassed the assessment of the under-mentioned:

- the risk management function and whether there are policies, practices and procedures to identify, measure, monitor, control, mitigate and report risks applicable to the branch;
- the level of involvement and awareness of the executive committee and senior management in the governance and risk management of the branch;
- the risk appetite statement and the risk tolerance levels set and approved by the executive committee;
- the compliance function, including its roles and responsibilities in ensuring that the branch manages its regulatory and supervisory risks adequately; and
- the independence of the compliance function, including the adequacy of skills and resources within the compliance function.

The most pertinent findings that arose from the aforementioned reviews are as follows:

- The roles and responsibilities assigned to the Chief Risk Officer (CRO) were found not to be entirely in line with the requirements of the BCBS: Corporate Governance Principles for Banks, and internal policies and/or frameworks.
- A dual-hatting of roles by a Chief Operating Officer (COO) who also acted as a CRO was found to be in contravention with paragraph 110 of the BCBS guidelines on Corporate Governance Principles for Banks (July 2015).
- Shortcomings were noted regarding risk appetite statements (RAS) which were incomplete and not properly approved and signed off. RAS also did not include all risks deemed as material and some risks rather formed part of global RAS instead of being branch specific.
- Findings with regard to the outsourcing of services related mostly to poor internal controls, the absence of recovery plans in respect of outsourced activities, and service level agreements (SLAs) not appropriately approved.

In general, the branches reviewed during 2017 committed to remediate deficiencies identified during the on-site reviews.