Cooperative Banks Annual Report 2016/17

South African Reserve Bank

Mission

Promote the soundness of the cooperative banking sector through the effective regulation and supervision of cooperative banks in the interests of their members and the economy.

Regulatory philosophy

The Supervisor of Cooperative Banks (Supervisor) follows a coordinated approach with all stakeholders to ensure the consistent and fair application of the Cooperative Banks Act 40 of 2007.

The Supervisor's objective is to apply international regulatory and supervisory standards, where necessary, to cater for the unique needs of the domestic cooperative banking sector.

The Supervisor operates through a relationship of mutual trust and cooperation with all role players in an effort to promote and enhance the accessibility of sound financial services to all South Africans.

Cooperative Banks Annual Report 2016/17 for the financial year ended 31 March 2017 in terms of section 52 of the Cooperative Banks Act 40 of 2007

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South African Reserve Bank

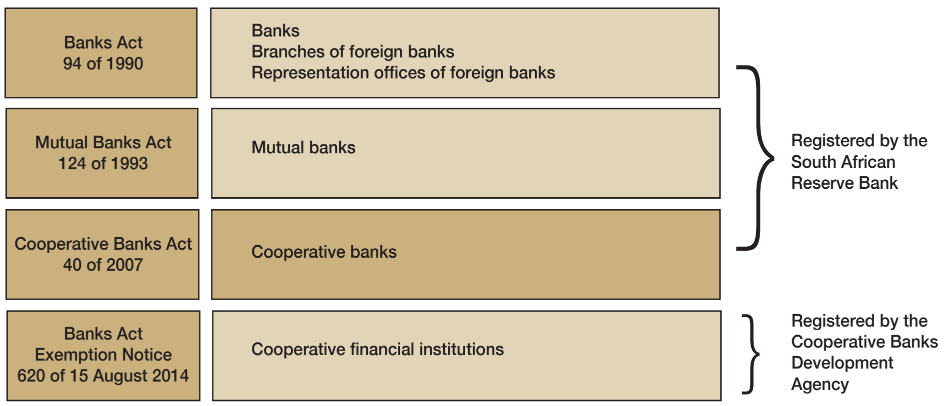
Chapter 1: Introduction and Supervisor's overview

1.1 Introduction

The *Cooperative Banks Annual Report 2016/17* (Annual Report) begins with an overview of the organisational developments at the South African Reserve Bank (SARB). Chapter 2 provides data and an analysis of the aggregated information of cooperative banks, while Chapter 3 outlines the regulatory developments during the past financial year and an overview of interactions with stakeholders.

Cooperative banks are registered in terms of the Cooperative Banks Act 40 of 2007 by the SARB, whereas cooperative financial institutions (CFIs) are registered by the Cooperative Banks Development Agency (CBDA) in accordance with the Banks Act Exemption Notice 620 of 15 August 2014, issued by the Registrar of Banks (See Figure 1).

Figure 1 Registration of some deposit-taking institutions



The total assets of cooperative banks reached R121 million in the year under review. The performance of the combined results of the two registered cooperative banks has improved year on year.

The total income of the cooperative banking sector increased by 22.2%, from R11.7 million at the end of February 2016 to R14.3 million at the end of February 2017. Total assets increased by 12.9%, from R107 million to R121 million, which was mainly driven by growth in loans. Total capital also increased by 27%, from R12.6 million at 29 February 2016 to R16.1 million at 28 February 2017, which is attributed to increased retained earnings and reserves. The cooperative banking sector's capital adequacy ratio increased from 9.5% at the end of February 2016 to 11.9% at the end of February 2017, which is well above the required 6%.

1.2 Organisational developments

1.2.1 Introduction

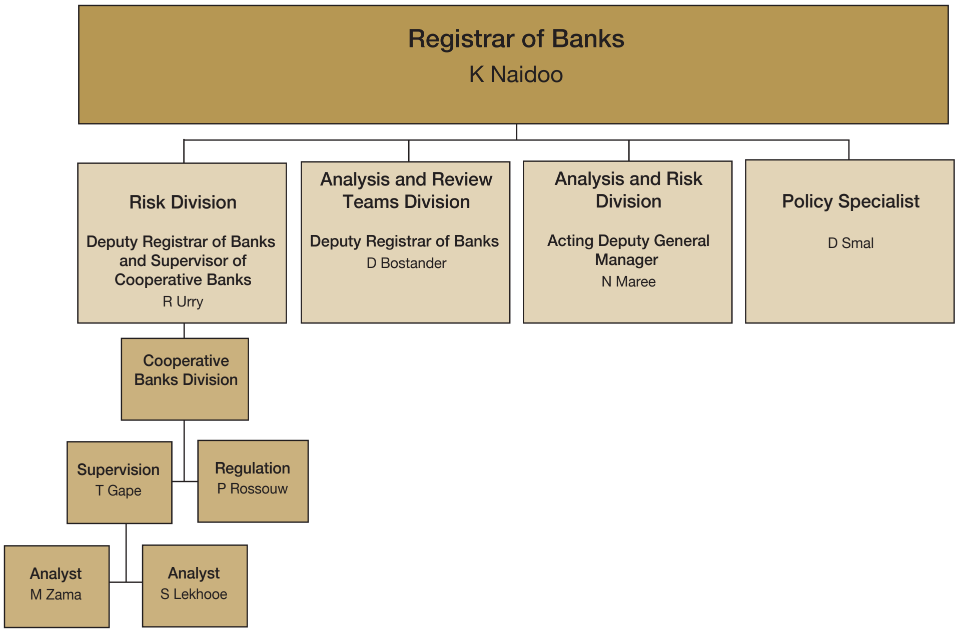
Apart from one additional staff member being transferred temporarily to the Cooperative Banks Division of the Bank Supervision Department, the organisational structure remained the same.

1.2.2 Structure of the Bank Supervision Department

The Supervisor of Cooperative Banks (Supervisor) has the authority to exercise the powers and perform the functions afforded by the Cooperative Banks Act 40 of 2007. Mr R Urry is the Deputy Registrar of Banks and Supervisor of Cooperative Banks in terms of the Banks Act 94 of 1990 (Banks Act). During the period under review, Mr Urry was assisted by Mr P Rossouw, and Dr T Gape and Mr M Zama, who were responsible for regulatory and supervisory responsibilities respectively. Mr S Lekhooe was temporarily transferred to the Cooperative Banks Division as an analyst in 2016.

It is anticipated that there will be changes to the structure of the SARB's Cooperative Banks Division once the Twin Peaks model of financial regulation in South Africa is implemented. Suitable arrangements will be made to cater for the relevant duties and responsibilities necessary to execute the SARB's responsibilities in terms of the applicable laws.

Figure 2 Structure of the Bank Supervision Department



Chapter 2: Cooperative banking sector overview

2.1 Introduction

This chapter provides an overview of the financial performance of the two cooperative banks in the cooperative banking sector for the financial year ended 28 February 2017. Increases and decreases indicate year-on-year fluctuations for the period under review, unless explicitly stated otherwise.

During the year under review, the cooperative banking sector experienced solid growth in its asset base, which was largely supported by growth in deposits, the injection of capital and the retention of profits. On a year-on-year basis, the cooperative banking sector's total assets increased by 12.9%, driven by an increase in loans, whereas liabilities increased by 10.9%, mainly driven by the increase in members' deposits. Profit before tax increased by 101.3%, primarily due to an increase of 29.2% in total net financial income, while operating expenses increased by 25.7%.

2.2 Membership and shareholding

In order to transact with a cooperative bank, customers must first become members by meeting the cooperative bank's eligibility criteria and purchasing membership shares in the cooperative bank. This results in members becoming both customers and owners of the cooperative bank.[1]

Membership in the cooperative banking sector increased by 5.9%, from 2 258 at the end of February 2016 to 2 392 members at the end of February 2017.

Share capital amounted to R777 577 at the end of February 2017, which is an increase of 5.6% from R736 567 at the end of February 2016.

Table 1 Membership and share capital in 2015/16 and 2016/17

	2015/16	2016/17	Percentage change (%)
Number of members	2 258	2 392	5.9
Share capital	R736 567	R777 577	5.6

2.3 Balance sheet analysis

Year on year the cooperative banking sector recorded total assets growth of 12.9%, from R107.4 million to R121.2 million, mainly driven by growth in loans. Growth in liabilities was primarily due to increased member deposits, which accounted for 99% of total liabilities. Equity increased by 27.3% year on year, which was primarily comprised of retained earnings, reserves and year to date income. Table 2 provides further detail on the cooperative banking sector's balance sheet at 28 February 2017.

1 It should be noted that members of cooperative banks do not have a right to the cooperative bank's accumulated retained earnings and reserves, but each member's share value is paid back at nominal value when membership is terminated. It is also important to note that section 24(1) of the Cooperatives Act 14 of 2005 determines that, despite any provisions contained in its constitution, if a cooperative bank determines that the repayment of shares would adversely affect its financial well-being, it may direct that the repayment be deferred for a period not exceeding two years after the effective date of the notice of withdrawal.

Table 2 Balance sheet growth during the period under review

	29 February 2016 (R)	28 February 2017 (R)	Percentage change (%)
Assets			
Loans	71 300 137	84 552 050	18.6
Liquid assets	31 020 969	30 334 804	-2.2
Fixed assets	1 401 861	2 158 652	54.0
Investments	1 924 772	2 094 258	8.8
Other assets	1 792 005	2 106 788	17.6
Total assets	107 439 744	121 246 552	12.9
Liabilities and capital			
Liabilities			
Deposits	94 455 907	103 994 839	10.1
Other liabilities	347 597	1 166 830	235.7
Total liabilities	94 803 504	105 161 669	10.9
Capital			
Members' shares	736 567	777 577	5.6
Retained income	6 779 321	10 966 267	61.8
Reserves	5 120 350	4 341 039	-15.2
Total capital	12 636 238	16 084 883	27.3
Total liabilities and capital	107 439 742	121 246 552	12.9

At the end of February 2017, 69.7% of total assets were comprised of loans, of which 84.3% were long-term loans, and 98.1% were secured by collateral in the form of deposits, mortgage bonds or guarantees.

Figure 3 Composition of gross loans at 28 February 2017

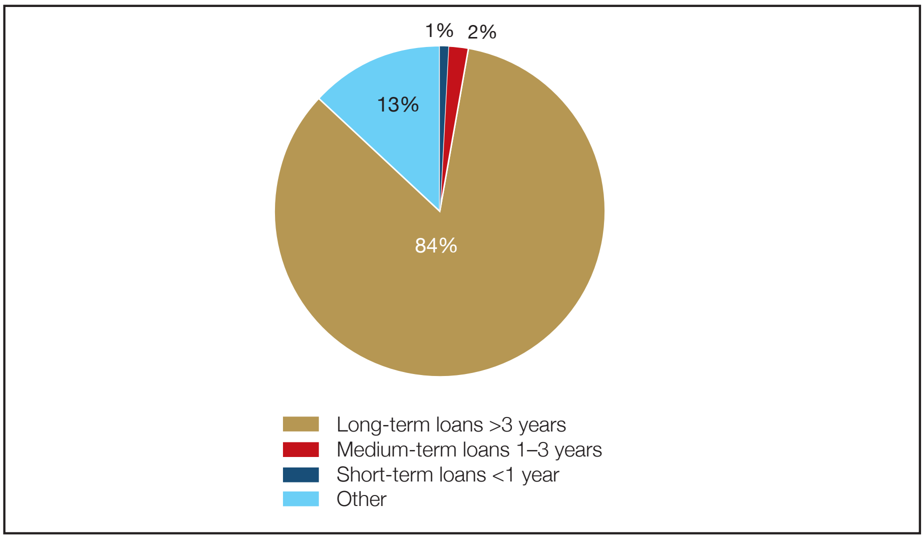
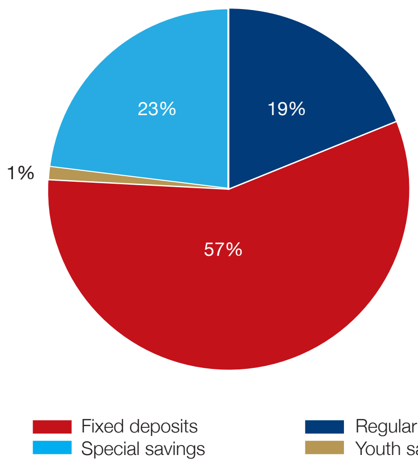


Figure 4 reflects the composition of the cooperative banking sector's deposits at 28 February 2017. Fixed deposits, which are deposits with maturity dates of up to six years, constituted 57.6% of members' deposits. Special savings, which are funds that are accumulated during the year for a particular purpose, such as school fees or seasonal expenses, accounted for 23.1%, and regular savings accounted for 18.7% of deposits. Youth savings, which are savings of people under the age of 21, made up only a small fraction of the total savings in the cooperative banking sector.

Figure 4 Composition of deposits at 28 February 2017



2.4 Capital and capital adequacy

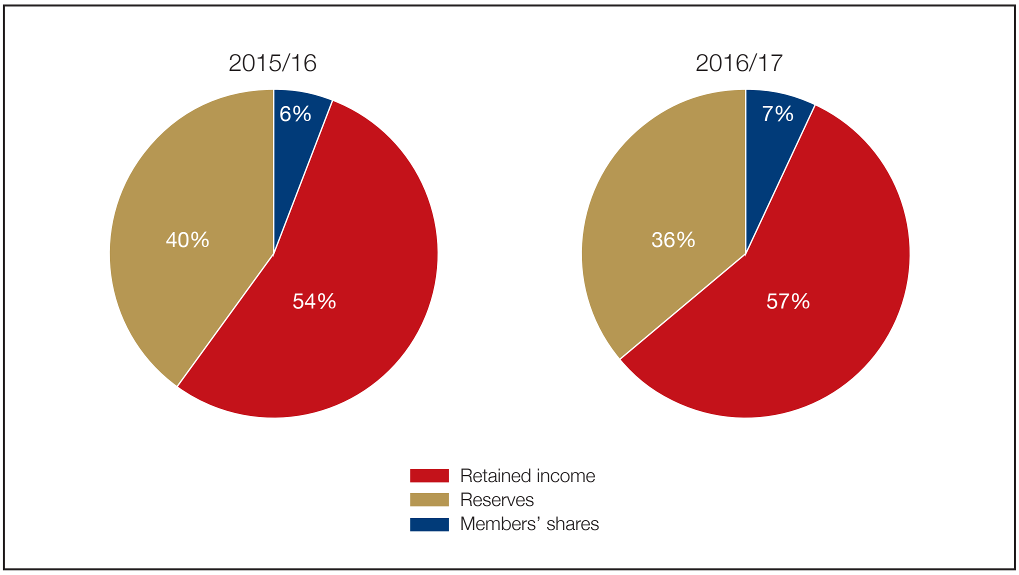
Total capital comprises member share capital, retained earnings, and year-to-date income and reserves. Total capital increased by 27.3%, from R12.6 million at 29 February 2016 to R16.1 million at 28 February 2017. Growth is attributable to increased year-to-date income and a significant increase in retained earnings. The cooperative banking sector's capital adequacy ratio[2] increased from 9.5% at the end of February 2016 to 11.9% at the end of February 2017.

Table 3 Change in the capital adequacy ratio during the period under review

	29 February 2016 (%)	28 February 2017 (%)	Percentage change (%)
Minimum required capital adequacy ratio	6.0	6.0	0.0
Actual capital adequacy ratio.........................	9.5	11.9	2.4

2 The capital adequacy ratio is calculated by subtracting the amount of provision made for delinquent accounts from the total capital and expressing it as a percentage of total assets. Regulation 4(2) of the Regulations relating to Cooperative Banks only allows members' shares, reserves held in terms of section (3)(1)(e) of the Cooperative Banks Act 40 of 2007, retained income (non-distributable reserves created or increased by appropriations of surpluses, but excluding loan-loss provisioning), and non-distributable reserves of a permanent nature, as approved by the Supervisor of Cooperative Banks in writing, to qualify as capital for purposes of calculating the capital adequacy ratio.

Figure 5 Composition of capital in 2015/16 and 2016/17



2.5 Liquidity

Liquidity is measured by the cash and other liquid financial assets that cooperative banks hold to meet their short-term commitments as and when they fall due. Effective liquidity management, which includes both quantitative and qualitative elements, is crucial for the continued viability of cooperative banks. The average liquidity ratio of the cooperative banking sector exceeded the minimum regulatory requirement of 10.0% of total deposits, amounting to 26.3% at the end of February 2017 (2016: 30.0%).

2.6 Asset quality

Delinquent loans accounted for 3.7% of the cooperative banking sector's gross loans at the end of February 2017 – a decrease from 5.6% in the previous financial year. During the year under review, delinquent loan repayments increased due to a greater effort by the cooperative banks to recover unpaid amounts. The sector continued to provide sufficiently for potential losses in accordance with regulatory requirements during the review period.

Table 4 Risk classification of loans for the years ended 29 February 2016 and 28 February 2017

	29 February 2016		28 February 2017	
	Amount (R)	Percentage (%)	Amount (R)	Percentage (%)
Non-delinquent loans	67 277 672	94.4	81 438 660	96.4
Delinquent loans between 1 and 6 months	1 910 109	2.7	2 637 694	3.1
Delinquent loans between 6 and 12 months	718 572	1.0	116 591	0.1
Delinquent loans >12 months	1 393 784	1.9	359 106	0.4
Total loans	71 300 137	100.0	84 552 050	100.0

Figure 6 Composition of delinquent loans at 29 February 2016 and 28 February 2017

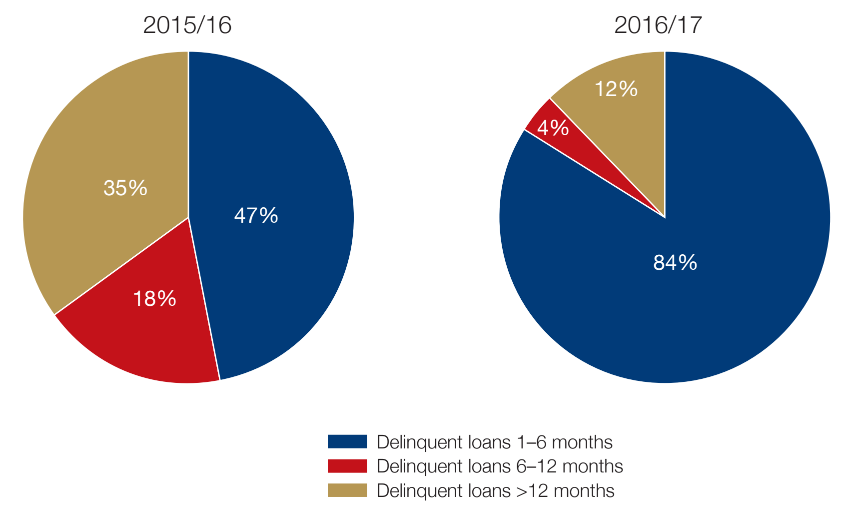


Table 5 Provisions for total loans and delinquent loans at 28 February 2017

	Loans (R)	Regulatory requirement (%)	Provision required (R)	Actual provision (R)
Total loans	84 552 050	2	1 691 041	1 691 041
Delinquent loans between 1 and 6 months	2 637 694	35	923 193	923 193
Delinquent loans between 6 and 12 months	116 591	50	58 296	58 296
Delinquent loans >12 months	359 106	100	359 106	359 106
Total provisioning			3 031 636	3 031 636

2.7 Income statement analysis

2.7.1 Profitability

The cooperative banking sector remained profitable in the year under review, with income before taxation increasing by 101.3%, from R2.1 million at the end of February 2016 to R4.2 million at the end of February 2017, which was driven significantly by increased interest income on loans.

The cooperative banking sector's return on assets was 3.5% at the end of February 2017 compared to 1.9% at the end of February 2016, and return on equity was 26.1% at the end of February 2017 compared to 16.5% at the end of February 2016. The cost-to-income ratio decreased to 39.5% at the end of February 2017 from 45.9% at the end of February 2016.

2.7.2 Income

The total income of the cooperative banking sector increased by 22.2% from R11.7 million at the end of February 2016 to R14.3 million at the end of February 2017. Income growth was driven primarily by an 18.4% increase in interest income, which accounted for 88.6% of the cooperative banking sector's total income for the 2016/17 financial year, down by 3.2% from the 91.6% recorded in 2015/16.

2.7.3 Expenses

Total expenses increased by 5.1% from R9.6 million at the end of February 2016 to R10.1 million at the end of February 2017.

Table 6 Income and expenditure in 2015/16 and 2016/17

	2015/16		2016/17	
	Rand (R)	Percentage of total income (%)	Rand (R)	Percentage of total income (%)
Interest income	10 733 685	91.6	12 703 732	88.6
Non-interest revenue	997 865	8.4	1 635 191	11.4
Total income	**11 731 550**		**14 338 923**	
Interest expenses	5 998 612	51.1	6 932 887	48.4
Operating income	**5 732 938**		**7 406 036**	
Provision for loans	**1 010 333**	**8.6**	**278 380**	**1.9**
Operating expenses	**2 633 449**	**22.4**	**2 922 363**	**20.4**
Personnel	1 544 344	13.2	1 747 422	12.2
Governance	331 392	2.8	404 203	2.8
Marketing	476	0.0	7 065	0.1
Administration	609 198	5.2	596 532	4.2
Auditing	132 434	1.1	143 989	1.0
Depreciation	15 605	0.1	23 152	0.2
Total expenses	**9 642 394**	**82.2**	**10 133 630**	**70.7**
Operating profit/income before taxation	**2 089 157**	**17.8**	**4 205 292**	**29.3**

2.8 Performance rating

The Supervisor applies the capital adequacy, asset quality, management quality, earnings and liquidity (CAMEL) rating system to assess the soundness of cooperative banks. At 28 February 2017, one bank was assigned an overall rating of '3', denoting 'fair', while the other bank was assigned a rating of '2', denoting 'satisfactory'.

2.9 Inherent risks

The inherent risks to the cooperative banking sector include credit risk, liquidity risk, interest rate risk, operational risk, legal and compliance risk, strategic risk and reputational risk. During the year under review, cooperative banks continued to improve in all risk areas, with adequate risk management policies and strategies in place to meet regulatory and reporting requirements.

Chapter 3: Regulatory developments and interactions with stakeholders

3.1 Introduction

This section of the Annual Report covers regulatory developments and interactions with stakeholders.

3.2 Regulatory developments

CFIs currently operate in terms of the Banks Act Exemption Notice 620 of 15 August 2014, and are subject to the supervision and regulation of the CBDA. In terms of the Financial Sector Regulation Bill, the registration, regulation and supervision of CFIs will become the function of the Prudential Authority (PA), once the Bill is promulgated. On the date that section 40(A)(1) of Chapter VIIA of the Financial Sector Regulation Bill comes into operation, a CFI that meets the requirements for registration must apply to the PA for registration within 12 months from the date on which the above-mentioned section comes into operation. These registration requirements will be determined by the PA, taking into account the number of members, the value of membership shares and the total value of members' deposits held by the institution. Furthermore, the PA will also determine the general limit for holdings of members' deposits by any registered CFI.

Once the prescribed amount of members' deposits has been reached, registered CFIs are obliged to apply for registration as cooperative banks. In the event that the application by a CFI to register as a cooperative bank is declined, the PA may determine that the CFI concerned is not allowed to hold members' deposits exceeding an amount specified by the PA, which will be based on the nature and size of the CFI, and may not exceed the general maximum limit of members' deposits that may be held by any registered CFI as prescribed by the PA.

3.3 Interaction

Apart from formal on-site visits to cooperative banks, the Supervisor is expected to participate in the activities of international bodies and authorities whose main purpose is to develop, advance and promote the sustainability of cooperative banks, and to cooperate with these international bodies and authorities in respect of matters relating to cooperative banks.[3]

A total of five on-site visits to the cooperative banks were undertaken during the period under review. The visits focused on ensuring compliance with regulatory standards. The reviews undertook to ensure that systems, processes and relevant risk frameworks were in place and functioning as they should be. Other areas focused on during the visits included the Board of Directors and its effectiveness, the composition and functioning of subcommittees, and ensuring that policies were applied and up to date.

Between 14 and 16 September 2016, Dr Gape, a member of the supervisory team, attended the International Credit Union Regulators' Network (ICURN) Conference in Washington DC. The annual conference aims at addressing the challenges that exist in the regulation of CFIs across the globe. Emerging risks from different regions and ICURN guiding principles were explored. The regulators and supervisors of CFIs also dealt with topics such as cybersecurity; credit risk and the impact of external events, balancing anti-money laundering and financial inclusion objectives; deposit insurance and dealing with firm failures; assessing governance and risk frameworks; and supervising small CFIs and the regulatory burden.

3 As prescribed by section 55(2) of the Cooperative Banks Act 40 of 2007.

Abbreviations

Banks Act	Banks Act 94 of 1990
CAMEL	capital adequacy, asset quality, management, earnings and liquidity
CBDA	Cooperative Banks Development Agency
CFI	cooperative financial institution
ICURN	International Credit Union Regulators' Network
PA	Prudential Authority
SARB	South African Reserve Bank