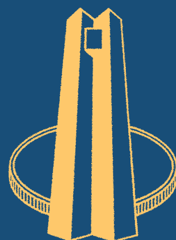
Annual Report 2009

Bank Supervision Department



South African Reserve Bank

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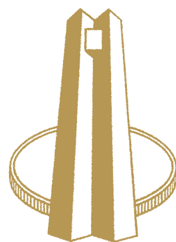

South African Reserve Bank

Mission

To promote the soundness of the banking system through the effective and efficient application of international regulatory and supervisory standards.

Business philosophy

Market principles underlie all our activities and decisions, and we strive to act with professionalism, integrity, credibility and impartiality at all times. We liaise with each individual bank through a single point of entry – a relationship manager, assisted by a team with diverse competencies. We follow a risk-based supervisory approach, not one of inspection, and our objective is to add value. Consequently, our role is that of a 'watchdog', not that of a 'bloodhound'. We place emphasis on empowering our staff to ensure that all interaction and service delivery is characterised by professionalism, and a high premium is placed on ethical behaviour at all levels of activity. A relationship of mutual trust between the Bank Supervision Department and all other key players is regarded as essential and is built up through regular open communication.

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ISSN 1811-4431
Obtainable from:
Bank Supervision Department
South African Reserve Bank
P O Box 8432, Pretoria, 0001
Tel. 27-12-313 3218

Also available on the Internet at: http://www.reservebank.co.za

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Annual Report for the calendar year ended 31 December 2009 in terms of section 10 of the Banks Act, 1990 (Act No. 94 of 1990) and section 8 of the Mutual Banks Act, 1993 (Act No. 124 of 1993).

This report presents an overview of the objectives and activities of the Bank Supervision Department of the South African Reserve Bank, with particular reference to the period 1 January 2009 to 31 December 2009.

Chapter 1: Registrar of Banks' review

1.1 Introduction

During 2009 the South African banking sector continued to experience a challenging operating environment, characterised by a cyclical downturn in domestic economic conditions and worsened by the aftermath of the 2007/08 international financial market crisis. Consumer spending remained subdued, the level of impaired advances in existing asset portfolios of banks continued to increase and lending criteria applied by banks were tightly controlled. However, notwithstanding these difficult circumstances, the banking system remained stable and profitable, and capital levels were adequate throughout 2009.

banking system remained stable and profitable, and capital levels were adequate

From an international perspective, regulatory and supervisory standard-setting bodies, such as the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (the Basel Committee), continued their respective processes of developing and issuing guidance and standards to strengthen the resilience of the financial sector in general and the banking sector in particular. The Bank Supervision Department (the Department) of the South African Reserve Bank (the Bank), as always, closely monitored and considered developments on the international regulatory and supervisory fronts in an ongoing effort to promote the soundness of the domestic banking sector through the effective and efficient application of international regulatory and supervisory standards.

This chapter will cover in more detail the key responses of standard-setting bodies to the international financial market turmoil and provides a high-level overview of key banking-sector trends, including the level of concentration in the banking sector. It also contains details of the steps taken by the Department to address the main findings of the International Monetary Fund (IMF) *2009 Article IV Consultation: Staff Report* (the Staff Report). Furthermore, this chapter reviews the Department's role in facilitating the optimisation of banks' compliance with anti-money laundering (AML) and the combating of the financing of terrorism (CFT) measures and it provides an overview of the Financial Stability Institute high-level meeting on developments in financial markets and supervisory responses. In addition, it covers topics such as the Department's thematic review of incentive schemes of banking institutions, its participation in international regulatory and supervisory fora, and skills development-related issues.

1.2 High-level overview of the banking sector

1.2.1 Key banking-sector trends

As at the end of December 2009 there were 31 banking institutions reporting data to the Department (excluding 2 mutual banks, but including 1 institution conducting banking business in terms of an exemption from the provisions of the Banks Act, 1990 (Act No. 94 of 1990) (the Banks Act, 1990), namely Ithala Limited) and 42 international banks with authorised representative offices in South Africa.

31 banking institutions and 42 representative offices

Of the nominal value of the total South African banking-sector's shares in issue at the end of December 2009, foreign shareholders held 47,5 per cent, domestic shareholders held 30,4 per cent and minority shareholders held 22,1 per cent.

Total banking-sector assets amounted to R2 967 billion at the end of December 2009, compared with R3 177 billion at the end of December 2008, representing negative year-on-year growth of 6,6 per cent. Total assets of the four largest banks accounted for

banking-sector assets amounted to R2 967 billion

gross loans and advances declined by 2,6 per cent

84,6 per cent of total banking-sector assets (December 2008: 84,4 per cent). Gross loans and advances declined by 2,6 per cent from R2 316 billion at the end of December 2008 to R2 257 billion at the end of December 2009 (December 2008: 9 per cent increase). Homeloans and term loans remained the largest component of gross loans and advances, representing approximately 50 per cent thereof, followed by lease and instalment debtors at 10,5 per cent and commercial mortgages at 9,7 per cent.

At the end of December 2009 banking-sector total equity and liabilities amounted to R2 967 billion. Total deposits, amounting to R2 366 billion, represented 85,4 per cent of banking-sector liabilities of R2 769 billion at the end of December 2009 (December 2008: 79,6 per cent). Fixed and notice deposits accounted for 27,4 per cent of total banking-sector deposits at the end of December 2009 (December 2008: 24,9 per cent), while call deposits represented 18,0 per cent, negotiable certificates of deposit 18,0 per cent, current accounts 16,8 per cent and other deposits 10,5 per cent of total banking-sector deposits (December 2008: 22,0 per cent, 16,2 per cent, 17,4 per cent and 10,2 per cent respectively). Deposits from corporate customers constituted the largest portion of total banking-sector deposits, namely 42,6 per cent at the end of December 2009, followed by retail customers and bank deposits, which accounted for 22,3 per cent and 13,7 per cent respectively.

Tier 1 capital-adequacy ratio improved to 11,0 per cent

The total capital-adequacy ratio of the banking sector improved during 2009, increasing from 13 per cent at the end of December 2008 to 14,1 per cent at the end of December 2009. The Tier 1 capital-adequacy ratio also improved from 10,2 per cent at the end of December 2008 to 11,0 per cent at the end of December 2009. Total banking-sector equity increased by 9,5 per cent during the 12 months to December 2009 and amounted to R198,2 billion at the end of December 2009. Share capital and retained earnings cumulatively represented approximately 91 per cent of total equity throughout 2009 (share capital 44,3 per cent and retained earnings 46,8 per cent). The financial leverage ratio for the South African banking sector reduced from 17,9 times at the end of December 2008 to 15,7 times at the end of December 2009.

Off-balance-sheet items expressed as a percentage of banking-sector total assets increased from 11,5 per cent at the end of December 2008 to 13,4 per cent at the end of December 2009, mainly due to a slowdown in the growth of banking-sector assets during the period.

banking sector remained profitable throughout 2009

The banking sector remained profitable throughout 2009. However, profitability levels were negatively impacted, mainly by an increase in credit losses and operating expenses. Gross operating income amounting to R149,7 billion for the year ending December 2009, remained at a level similar to that recorded in December 2008, namely R149,2 billion, while operating profit amounted to R 35,2 billion (December 2008: R44 billion). The banking sector's return on equity (ROE) and return on assets (ROA) ratios, calculated on a smoothed basis (i.e., utilising a 12-month moving average), deteriorated during 2009 to 15,9 per cent and 0,94 per cent respectively at the end of December 2009 (January 2009: 20,7 per cent and 1,2 per cent respectively). For the year ending December 2009, credit losses and operating expenses rose to R35,5 billion and R76,5 billion respectively (December 2008: R29,7 billion and R73,4 billion respectively).

statutory liquid asset holdings exceeded the prescribed requirement

The liquid assets held by the banking sector increased by 20 per cent during 2009 and the statutory liquid asset holdings of the sector exceeded the minimum prescribed requirement by 46,3 per cent (December 2008: 15,5 per cent). Liquid assets held by the banking sector exceeded the statutory liquid asset requirement throughout 2009.

credit ratios continued to deteriorate during 2009

Credit ratios continued to deteriorate during 2009, but at a slower rate compared with 2008. Impaired advances (i.e., advances in respect of which a specific credit impairment

has been raised) increased by 47,5 per cent between December 2008 and December 2009, and amounted to R134,0 billion at the end of December 2009 (December 2008: R90,8 billion). Impaired advances to gross loans and advances deteriorated to 5,9 per cent at the end of December 2009 compared with 3,9 per cent at the end of December 2008. The deterioration in this ratio was exacerbated by the impact of negative annual growth of 2,6 per cent in gross loans and advances at the end of December 2009. However, the banking sector reported a slight decline of 0,5 per cent (month on month) in impaired advances in December 2009, the first decline since the commencement of the credit down-cycle.

1.2.2 Concentration in the South African banking system

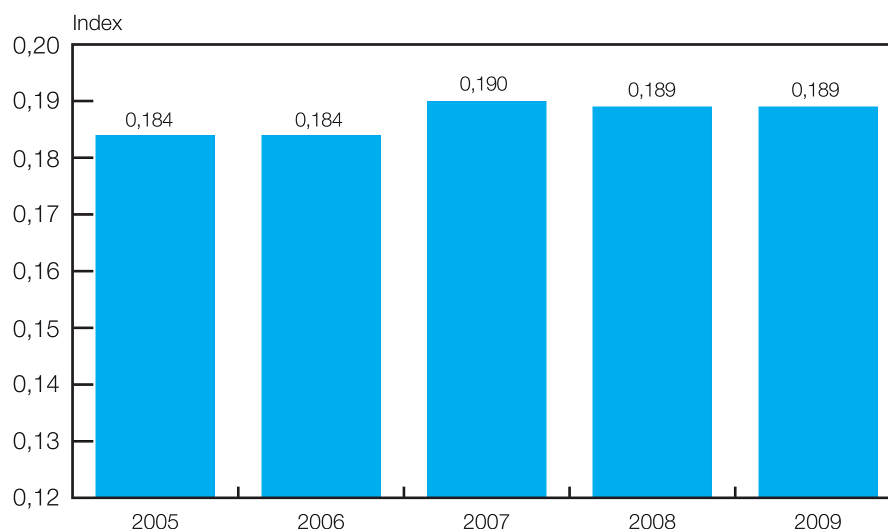
The Herfindahl–Hirschman Index (H-index) is a commonly accepted measure of market concentration in a banking system. The index is calculated by squaring the market share, in terms of total assets, of each bank in the system and subsequently summing the squares. It takes into account the relative size and distribution of the firms in a market, and approaches zero when a market consists of a large number of firms of relatively equal size.

The index increases as the number of firms in the market decreases and as the disparity in size between those firms increases. The higher the index, the less competition exists in the market and vice versa. An H-index below 0,1 indicates that there is no concentration in an industry, while an H-index between 0,1 and 0,18 is an indication of moderate concentration. An H-index above 0,18 represents a highly concentrated industry that indicates the presence of an oligopoly. An 'oligopoly' can be defined as an imperfectly competitive market structure in which a few institutions dominate the industry.

The level of concentration in the South African banking sector, measured using the H-index, is presented in Figure 1.1. The index amounted to 0,189 at the end of December 2009 (December 2008: 0,189). The index has remained high due to the continued dominance in terms of market share by the four largest banks. The total balance sheet of the four largest banks amounted to R2 510 billion and accounted for 84,6 per cent of banking-sector assets at the end of December 2009 (December 2008: 84,4 per cent).

the four largest banks accounted for 84,6 per cent of banking-sector assets

Figure 1.1 H-index for the South African banking system (2005–2009)



1.3 International Monetary Fund Article IV Consultation 2009

1.3.1 Staff Report for the 2009 Article IV Consultation

Staff Report for 2009 Article IV Consultation completed on 20 July 2009

The IMF's annual bilateral discussions (under Article IV of the IMF Articles of Agreement) with South African officials were held during June and July 2009. The Staff Report in respect of South Africa was completed on 20 July 2009 and published on the IMF website.[1] A Public Information Notice (PIN) (No. 09/114), summarising the views of the IMF's Executive Board as expressed during its discussion of the Staff Report, is also available on the website.

An extract from the above-mentioned PIN, relating specifically to the banking sector, states the following:

> Directors found reassuring the authorities' assessment that the banking sector remains well capitalised and adequately provisioned. Nonetheless, to meet increasing risks, they recommended that the authorities continue engaging with banks to ensure that provisions and capital buffers remain adequate. Directors welcomed efforts to follow up on the 2008 Financial Sector Assessment Program Update recommendations, and encouraged further strengthening consolidated supervision and exploring ways to reduce banks' reliance on short-term wholesale funding.

banking system remained liquid and well capitalised

The Staff Report broadly described the financial sector as "remaining vigilant" and indicated that the banking system remained liquid and well capitalised. This was as a result of South African banks' low leverage ratios, sound profitability and limited exposure to foreign assets and foreign funding. Therefore, during the global financial crisis South African banks required no liquidity support from either the central bank or the government, in contrast with the experience of banks in many other countries. Impaired advances rose as the economy weakened, household debt remained near historic highs, and borrowers were subjected to the unfolding recession and rising interest rates during the period 2006 to 2008. Nevertheless, the IMF's analysis of macrofinancial linkages suggests that the overall assessment of solvency risks to South African banks, as well as feedback effects from the real sector, remains small; likely reflecting the South African banks' strong capital position and generally high profitability.

1.3.2 Key findings

banking-sector risks identified in Staff Report

The banking-sector risks identified in the Staff Report, in addition to the above-mentioned risks are summarised below, followed by comments on the progress made by the Department in addressing the recommendations from the 2008 Financial Sector Assessment Program (FSAP) Update, in square brackets.

- The IMF stated that the credit risks to the banking system were mitigated by supportive macroeconomic policies, coupled with features of the South African financial system. Significant monetary policy easing had lowered lending rates, while more stringent bank loan origination standards and a decline in the demand for credit had moderated credit growth. In addition, and in the light of the intricacies of the recent global crisis, it was highlighted that South African banks held most of the mortgages they originated, which encouraged them to engage in negotiations with distressed homeowners to put in place alternative repayment arrangements. Also of

1 www.imf.org.

significance to the IMF was the fact that the South African legislative framework enabled banks to claim other assets of defaulting borrowers, thereby mitigating incentives to default, including on foreclosed properties with negative equity.

- South African banks' reliance on short-term wholesale corporate deposit funding was again highlighted and described as a long-standing structural risk. The 2008 FSAP Update recommended the implementation of a deposit insurance system to counter such risks and to induce household savings to migrate from unguaranteed liquid financial instruments to competing bank deposits, thereby strengthening the banks' retail base. An analysis of the extent to which deposit insurance could provide incentives for increasing the scale of retail bank deposits was also advised. The Staff Report further recommended that it would be useful for the Bank and the Financial Services Board jointly to explore ways to reduce the risks associated with banks' reliance on short-term wholesale deposits.

reliance on short-term wholesale corporate deposit funding highlighted

[The Department has engaged National Treasury and the Financial Services Board on the structural make-up of the financial sector. Discussions are ongoing. Furthermore, liquidity risk management formed the basis of the Department's discussions during 2009 with the boards of directors of banks and liquidity risk thematic reviews were conducted at various banks. In addition, liquidity simulation exercises were performed at two of the large South African banks. More simulation exercises are planned for execution during 2010. The Department also continues to monitor and consider developments in liquidity risk issued by the FSB and the Basel Committee.]

- In line with the 2008 FSAP Update recommendations, it was highlighted that the dominance of the financial system by a few large financial conglomerates with cross-border share holdings and cross-sector activities also posed structural risk. These conglomerates combine banking, securities trading and insurance in a single organisation. It was stated that, as the recent global crisis had illustrated, even when banks are well managed, as is the case in South Africa, there is a risk that the sectoral supervisory arrangements could miss potentially systemic linkages. Therefore, it was again recommended that the authorities should seek to identify potential information and regulatory gaps relating to conglomerate activity by enhancing the work of the existing high-level Bank–Financial Services Board Committee, and the already-established working-level joint Bank–Financial Services Board Committee to help guide the work of supervisory colleges covering individual financial conglomerates. The Staff Report suggested regular reporting on the work of these committees to senior policy-makers in order to assess whether further action, including possible changes to legislation, would be required to minimise regulatory gaps and strengthen consolidated supervision. It also suggested that a formal analysis of systemic linkages based on a matrix of exposures within and across financial conglomerates be considered.

minimise regulatory gaps and strengthen consolidated supervision

[During 2009 the Department reviewed and strengthened its working relationship with the cross-sectoral regulatory authorities to enhance the supervision of banking groups further. Regular supervisory meetings between the Department and the Financial Services Board were instituted for the three largest South African banking and insurance groups. The main purpose of the supervisory meetings was to enhance information sharing, identify issues of mutual relevance and to work together towards greater consistency in the supervisory approach of the two supervisory bodies, where appropriate. The Department is also planning to host a supervisory college in 2010 with African supervisors where South African banking groups have a presence.]

- The IMF estimates suggested that, on balance, markets had a positive outlook with regard to South African banks' credit risk. A staff paper estimated probabilities of

default for the four largest banks and macrofinancial linkages for the period 2000 to 2009, based on equity price data. The paper found that although South African banks' probabilities of default had recently increased, they were significantly lower than those of several large international banks based in mature economies. Furthermore, feedback from the real economy-to-solvency risk in the banking sector was limited, but shocks from the banking sector had significant effects on the exchange rate and gross domestic product (GDP) growth.

supervision of banks had generally intensified since late 2008

- The Staff Report further indicated that the supervision of banks had generally been intensified since late 2008 in response to rising financial sector risks. On-site supervision, including the assessment of banks' stress-testing practices, risk models and risk management practices, was intensified. Off-site stress-testing utilising supervisory data, in line with the recommendations of the 2008 FSAP Update, was carried out biannually. The stress-testing exercise in the last quarter of 2008 showed that even under a severely unfavourable macroeconomic scenario the capital-adequacy ratios of none of the systemically important banks would fall below the regulatory minimum. Overall, the Staff Report stated that authorities were of the view that banks were provisioning adequately for the increase in impaired loans and that banks' capital, which comprised predominantly Tier 1 capital, remained at comfortable levels to meet the increasing risks.

  [The Department continued to focus on the above-mentioned issues raised as part of its ongoing supervisory review and assessment process.]

1.4 Compliance with anti-money laundering and the combating of the financing of terrorism standards

The Department acknowledges its role and remains committed to facilitating the optimisation of banks' compliance with AML and CFT measures.

1.4.1 Mutual evaluation of South Africa

final report on the evaluation of South Africa's AML/CFT measures

During March 2009 the Financial Action Task Force (FATF), an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and the financing of terrorism, published a final report on the evaluation of South Africa's AML/CFT measures. The evaluation was done mutually by the FATF and the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). The full mutual evaluation report (MER) was debated and adopted on 26 February 2009 at a plenary meeting of the FATF and was made available publicly on 27 March 2009.[2]

The MER presents an overview of the key findings on South Africa's AML/CFT framework aimed at combating money laundering and the financing of terrorism. It also provides details of the measures required to criminalise money laundering and the financing of terrorism, and to provide for the forfeiture of the proceeds of crime in accordance with international standards. It is noted in the MER that South African authorities have established comprehensive mechanisms to co-operate on operational matters relating to the implementation of these measures.

South African AML/CFT framework could be enhanced further

A number of general areas are identified in the MER where the South African AML/CFT framework could be enhanced further, namely

2 A copy of the report can be viewed at http://www.fic.gov.za.

- customer due diligence conducted by financial and other institutions, including the identification of certain types of customers, such as the beneficial owners of legal persons and politically exposed persons;
- customers' particulars should accompany electronic funds transfers;
- the disclosure of cross-border cash transfers;
- the supervision of compliance by financial and other institutions with obligations flowing from AML legislation;
- improving the transparency of the ownership and control structures of legal persons and trusts; and
- protecting non-profit organisations from abuse for the purpose of laundering money and financing terrorism.

1.4.2 Key findings

The key findings of the MER included the following:

- Good progress had been made in developing a system to combat money laundering and the financing of terrorism since the previous FATF mutual evaluation in 2003.
- Money-laundering offences are in line with the Vienna and Palermo Conventions.
- Provisions for criminalisation of the financing of terrorism were comprehensive.
- The Financial Intelligence Centre (FIC) appeared to be operating effectively.
- The scheme for confiscating the proceeds of crime is comprehensive.
- The Financial Intelligence Centre Act, 2008 (Act No. 11 of 2008) (FICA) imposes customer due diligence record keeping.
- Suspicious transaction reporting and internal control requirements are in place.
- FICA covers the majority of financial institutions, and non-financial businesses and professions.
- The mechanisms for co-operation among South African authorities on operational matters to combat money laundering and the financing of terrorism are effective.
- South Africa can provide a wide range of mutual legal assistance, including the possibility of extraditing its own nationals.

recommendations for follow-up actions

Recommendations for follow-up actions that will impact on the private sector, included the following:

- Improving provisions on customer due diligence.
- Improving powers for supervisors to supervise and enforce compliance, and increased action by supervisors to ascertain compliance levels and sanction non-compliance among financial and non-financial institutions.
- Introducing measures to regulate people who provide a domestic money remittance service.

Recommendations in the MER for follow-up actions by the public sector included the following:

- Increasing the priority to be given to money-laundering investigations and prosecutions relative to underlying profit-generating offences.
- Improving legislation (e.g., amendments to FICA to improve customer due diligence provisions in line with new standards).
- Introducing measures for the regulation of people who provide a domestic money remittance service.
- Improving transparency of the ownership and control structures of legal persons and trusts.

- Requiring the assessment of potential risks of the financing of terrorism posed within the non-profit organisation sector.
- Developing and maintaining comprehensive statistics on actions taken against money laundering.
- Developing unique South African trend and typology reports, case studies and best practices.

South Africa is required to provide the FATF (as part of the normal processes following the adoption of an MER) with a progress report during 2011 reflecting on the steps that have been taken to improve in the areas mentioned above.

In July 2009 the FIC and the Department held discussions to determine the various tasks to be completed and the two offices' respective responsibilities to ensure that the relevant areas highlighted in the MER were addressed to enhance South Africa's overall level of compliance with the FATF Recommendations further.

1.4.3 Financial Action Task Force mutual evaluation stakeholder feedback sessions

FIC hosted two FATF mutual evaluation stakeholder feedback sessions

In July 2009 the Director of the FIC hosted two FATF mutual evaluation stakeholder feedback sessions to provide feedback to the industry on the process followed by, and the findings of, the MER. The first session was held with private-sector stakeholders in Sandton, Johannesburg, on 14 July 2009. The second session with public-sector stakeholders was held in Pretoria on 16 July 2009.

1.4.4 A workshop with the President of the Financial Action Task Force

On 25 August 2009 the FIC hosted a workshop which was also attended by the President of the FATF, Mr Paul Vlaanderen. The workshop, which was attended by the Department, focused on the following:

- The relationship of the FATF with the Group of Twenty Finance Ministers and Central Bank Governors (G-20) and the dynamics and processes of the G-20 to consider financial regulatory reform measures.
- The matter of "tax havens", the Organisation for Economic Co-operation and Development (OECD) processes and the listing of certain jurisdictions that did not comply with FATF Recommendations.
- The relationship between taxation and money-laundering issues, including trade-based laundering.
- Recent developments in the FATF, including the consideration of procedures in the International Co-operation Review Group to identify non-co-operative jurisdictions and the implications thereof.

1.4.5 Financial Intelligence Centre Act, 2008 (Act No. 11 of 2008), as amended

proposal made to amend Schedule 2 to FICA

In 2009 the proposal was made that Schedule 2 to FICA, which designated the Bank as one of the supervisory authorities, be amended to confer supervisory powers relating to AML/CFT to specific departments in the Bank, that is, the Bank Supervision and Exchange Control departments. The President of the Republic of South Africa assented to the amendments to other sections of FICA on 27 August 2009. The amendments will come into effect on a date to be determined by the Minister of Finance by notice in a *Government Gazette*.

1.5 Financial Stability Institute: High-level Meeting on Recent Developments in Financial Markets and Supervisory Responses

1.5.1 Background

The Financial Stability Institute (FSI) was created in 1999 by the Bank for International Settlements (BIS) and the Basel Committee in order to assist financial sector supervisors globally in improving and strengthening their financial systems.

key objectives of the FSI

The key objectives of the FSI are to

- promote sound supervisory standards and practices, and to assist in the implementation of such standards globally;
- disseminate to supervisors across the globe the latest information on market products, practices and techniques to assist them in adapting to ongoing change and innovation in the financial sector;
- help supervisors develop solutions to their respective challenges by sharing experiences during seminars, discussion forums and conferences; and
- assist supervisors in employing the practices and tools that will allow them to meet everyday demands and tackle more ambitious goals.

The attainment of these objectives is facilitated by means of conferences, high-level meetings, discussion forums and seminars that are hosted by the FSI globally. During these sessions participating supervisory bodies focus on and discuss various relevant topics.

1.5.2 High-level meeting in Cape Town

recent developments in financial markets and supervisory responses

In this regard the FSI, jointly with the Department, hosted a high-level meeting in Cape Town on 29 and 30 January 2009. The focus of this meeting was on recent developments in financial markets and supervisory responses thereto. The high-level meeting was organised as a joint forum for heads of supervisory authorities from the Africa continent, and a limited number of representatives of Basel Committee member countries and the private sector. The key objective of the meeting was to share participants' views on the latest international developments, including Basel II and the international financial market crisis and its impact.

Core Principles remained the basis of supervision

The meeting was chaired by Mr Josef Tošovský, Chairperson of the FSI, who commenced the proceedings with introductory remarks, followed by a keynote address by Mr Nout Wellink, Chairperson of the Basel Committee and President of the Netherlands Bank, on the future of supervision in view of the developments flowing from the international financial market crisis. Mr Wellink stated that, in essence, the future of supervision was to "go back to basics". The Core Principles for Effective Banking Supervision (the Core Principles), first issued by the Basel Committee in September 1997 and revised in 2006, remained the basis of supervision and full compliance with these principles should remain a core focus of supervisors across the globe. Mr Wellink noted that many of the problems identified during the financial crisis were the result of the failure to adhere to core governance and risk management principles, and a lack of proper knowledge and understanding of the core business, sophistication and risk exposure of banking institutions and groups by members of the board of directors of those institutions. From a supervisory perspective, the Core Principles specifically highlight all of the aforementioned as focus areas for supervisors. For example, Core Principle 7 requires supervisors to be satisfied that banks have comprehensive risk management processes

in place, which includes board and senior management oversight, to identify, evaluate, monitor and control or mitigate all material risks, and to assess banks' overall capital adequacy in relation to their risk profile.

broadened scope to include a macroeconomic perspective

Mr Wellink stated that the financial architecture was changing and supervisors should ensure that they broadened their scope to include a macroeconomic perspective of the risks impacting on the banking industry. It was also important to focus on and further enhance the interaction between supervisors, banking groups and other non-bank financial institutions, thereby identifying and addressing any possible regulatory gaps. Mr Wellink added that the Basel Committee had begun drafting comprehensive guidelines for co-operation between the various supervisory bodies. Other key focus areas included cross-border supervision and regulation in order to deal with cross-border crisis issues appropriately, and further Pillar 2 guidance and methods that could reduce the impact of procyclicality on regulatory capital of financial institutions.

lessons learnt from the international financial market crisis

Mr Roger Cole, the then Director of Banking Supervision and Regulation of the Board of Governors of the United States (US) Federal Reserve System (the Fed), provided a high-level synopsis of the Fed's response to the crisis which focused on stabilising systemically important financial institutions, providing additional liquidity assistance to the market, and stronger supervisory and regulatory systems. Mr Cole provided some insight into lessons learnt from the international financial market crisis, including the importance of prudent valuation practices, stress testing and contingency planning, and the role of the board and senior management in ensuring proper governance and controls within financial institutions.

CEBS' stance on future institutional setting and actions

Ms Kerstin af Jochnick, Head of Prudential Supervision of the Finansinspektionen, Sweden and Chair of the Committee of European Banking Supervisors (CEBS), provided an overview of the role of CEBS, with particular focus on its role during the financial crisis, which revolved mainly around co-operation and co-ordination among CEBS members, analysis of supervisory implications of national rescue plans implemented and crisis events surrounding individual institutions. Ms Jochnick also touched on CEBS' stance on future institutional setting and actions to contribute to the restoration of confidence in the financial markets, which included the following:

- The establishment of colleges for supervisors for all cross-border banks in the European Union (EU).
- The establishment of networks of national experts.
- Reinforced institutional arrangements between CEBS, the Banking Supervision Committee of the European System of Central Banks and the European Central Bank (in particular in the context of risk assessment).
- Issuance of further guidance and recommendations.
- CEBS guidance and recommendations to be implemented timely and adequately at a national level.

key strategic responses of the Basel Committee to developments in financial markets

Mr William Coen, Deputy Secretary General of the the Basel Committee provided a high-level overview of the key strategic responses of the Basel Committee to the developments in financial markets subsequent to the international financial market crisis. The responses of the Basel Committee were focused on the following areas:

- Capital adequacy (e.g., risk coverage, quality and composition, procyclicality and supplementary measures).
- Risk management and supervisory review (e.g., supplementary Pillar 2 guidance and counterparty credit risk).

- Liquidity risk management and supervision (e.g., principles and guidance issued in respect of sound liquidity risk management and supervision, sound stress-testing practices and the assessment of banks' financial instrument fair value practices).
- Cross-border co-operation.
- System-wide (macroprudential) approach to supervision.

Mr Coen proceeded to provide brief comments in respect of a Basel II consultative package released on 16 January 2009 which included the following:

- Revisions to the Basel II market risk framework.
- Guidelines for computing capital for incremental risk in the trading book.
- Proposed enhancements to the Basel II framework.

Mr Coen also provided a high-level overview of the supervisory expectations in respect of liquidity risk, referring mainly to the Principles for Sound Liquidity Risk Management and Supervision issued by the Basel Committee in September 2008.

Mr Arthur Murton, Director, Division of Insurance and Research, Federal Deposit Insurance Corporation (FDIC), US, provided some introductory remarks on the main events leading up to the international financial market crisis, and discussed the efforts and initiatives of the US Treasury and the FDIC in response to the crisis. He also discussed the responses of deposit insurers globally, including the increases in insurance coverage limits and the future of deposit insurers. He concluded by providing a high-level overview of the Core Principles for Effective Deposit Insurance Systems,[3] which were issued in June 2009.

consistent regulatory approach towards credit-rating agencies

Mr Greg Tanzer, Secretary General, International Organisation of Securities Commission (IOSCO), Spain, provided some thoughts on a consistent regulatory approach towards credit-rating agencies (CRAs). Mr Tanzer provided a high-level overview of the CRA Code of Conduct issued by IOSCO in 2004, which covered the quality and integrity of the rating process; the independence of CRAs and the avoidance of conflict of interest; the responsibilities of CRAs towards investors and issuers; and the disclosure of the CRA code. Mr Tanzer also discussed the revisions that were made to the CRA Code of Conduct during 2008 and the declaration by the G-20 on 15 November 2008 to exercise strong oversight over CRAs, consistent with the agreed and strengthened international code of conduct. Mr Tanzer concluded by providing insight into the IOSCO priorities for 2009, which included the following:

- Greater collective CRA discussions with IOSCO.
- The development of a cross-border framework for co-operation with regard to the assessment of CRAs using a consistent global regulatory approach based on the IOSCO CRA Code of Conduct.

role of CRAs in providing independent opinions on creditworthiness

Ms Vickie Tillman, Executive Vice-President, Standard & Poor's Rating Services (S&P) discussed the role of CRAs in providing the market with independent opinions on creditworthiness. Ms Tillman highlighted the fact that ratings by CRAs had to be regarded as only one of many tools that market participants should use. She stated that the recent credit market dislocation raised concerns about credit ratings and their use, and resulted in a loss of confidence in credit ratings by market participants. Restoring confidence would require greater emphasis on

3 A copy of the report can be viewed at http://www.bis.org/publ/bcbs156.htm.

- transparency at all stages of the capital-raising and investment process;
- the use of investor tools beyond credit ratings and the prospectus attached to new securities; and
- accountability, that is, a clear delineation of responsibilities at each stage of the capital-raising and investment process.

Further steps to be taken in order to restore confidence in CRAs included the following:

- Strengthening the integrity of the ratings process.
- Enhancing ratings models and processes, and staff training.
- Greater transparency with regard to the ratings process and the risks that would lead to CRAs reviewing ratings assumptions.
- Enhancing the outreach programme to help market participants consider ratings appropriately.

In closing, Ms Tillman highlighted some of the actions that S&P had implemented including the following:

- An Ombudsman for S&P was appointed in February 2009.
- S&P revised its ratings criteria to incorporate a measure of stability into its investment grade ratings, in order to mitigate severe downgrades in highly leveraged securities.
- S&P held regular meetings with the Audit Committee of the McGraw-Hill board of directors to review S&P's compliance and governance structures.
- S&P implemented "look-back" reviews for analysts who leave the firm to work for other financial institutions.
- An analyst rotating programme was implemented in terms of which analysts are only allowed to rate a particular client for a maximum of five years.
- S&P was conducting reviews of all the models it used.
- S&P developed a ratings user manual which was publicly available online.

IFRSs accepted as basis from a prudential regulation perspective

Mr Karl-Heinz Hillen, Head of Division Accounting, Deutsche Bundesbank, Germany, made some comments on the similarities and differences between International Financial Reporting Standards (IFRSs) and prudential regulation. He highlighted the fact that IFRSs were accepted as a basis from a prudential regulation perspective with certain prudential filters and supervisory fair value guidance being applied. He also discussed the role of IFRSs during the financial market turmoil, with particular reference to the following:

- The impact of the requirements of International Accounting Standard (IAS) 39 (categories of assets and liabilities, and the valuation hierarchy).
- The impact of changing from mark-to-market to mark-to-model valuations.
- Reclassification.
- Incurred loss versus expected loss.
- Procyclicality.
- Transparency.

Mr Mike Brown, the then Financial Director, Nedbank Limited, South Africa, discussed the relationship between IFRSs and prudential regulation with specific reference to the concept of fair value, which was regarded as a controversial topic and the different objectives of IFRSs compared to the objectives of Basel II. He noted support for recommendations made by international standard-setting bodies to converge international accounting standards to a single global standard and to move towards standardisation of derivative instruments, but without hindering innovation.

He also made some comments on the transformation of the nature of liquidity risk due to financial innovation and global market developments. He listed the following factors that contributed positively to liquidity risk management by domestic banks:

transformation of the nature of liquidity risk

- Domestic banks had low levels of securitised funding.
- The relative size of the domestic conduit business was small.
- South Africa had a strong and well-functioning interbank market.
- There was limited global credit contagion in the South African money market.
- South Africa maintained a robust macroeconomic policy framework.

However, Mr Brown stated that factors that negatively impacted liquidity risk management in South Africa included the following:

- Banks increasingly relied on professional funding sources. South Africa had a high degree of liquidity mismatching.
- Low levels of retail deposits.

Mr David Scott, Adviser at the World Bank, discussed the World Bank's response to the international financial market crisis, including the implications for risk-based supervision. He highlighted the fact that some concerns existed regarding the long-term impact of the international financial market crisis, in particular the impact of government actions during the crisis period from a prudential regulation perspective.

Mr Errol Kruger, Head of the Department provided a brief overview of the events leading up to the international financial market crisis and the impact of the crisis from a South African perspective. He provided some insight into the supervisory actions taken in South Africa that had mitigated the severity of the impact of the crisis on the domestic banking industry. He stated that the supervisory focus going forward would be to

supervisory focus going forward

- continue to monitor international developments and their potential impact on the domestic markets;
- continue to interact with South African banks and monitor them closely;
- ensure regular supervisory communication with banks' management and boards;
- ensure regular communication with other appropriate supervisors (domestically and globally); and
- remain in regular contact with the press and media to avoid misunderstandings in the market.

Mr Kruger also stated that the international financial market crisis highlighted important governance issues, including the following:

important governance issues highlighted by financial crisis

- The quality of board members and the effectiveness of boards.
- The effectiveness of board subcommittees.
- Senior management oversight.
- The appropriateness of incentive schemes.
- The appropriateness of new product approval processes.
- The effectiveness of risk management processes.

Mr Kruger described some of the key experiences of the Department during and after the implementation of Basel II. He stated that the overarching goals of Basel II were to promote greater financial stability through greater risk sensitivity and better risk management, and better governance and capital management. He described the stages of the Basel II implementation, which process commenced during 2001. Post-Basel II implementation challenges included the refinement of the Department's

organisational structure, the risk-based supervisory process applied, and its information technology systems to cope with the increased complexity and volume of information submitted by banks. He highlighted the fact that ongoing industry interaction and guidance were key to the successful implementation of Basel II. The key challenges for supervisors with regard to the implementation of Basel II included the following:

- The attraction and retention of suitably skilled staff.
- Staff training.
- Ongoing development of the risk-based supervisory process.
- The optimisation of operational structures.
- Change management.
- Maintenance of an appropriate information technology and data infrastructure.
- Development and maintenance of appropriate management reporting and disclosure processes.

key challenges faced by banks

Mr Kruger briefly discussed some of the key challenges faced by banks, namely
- ensuring proper planning with regard to, and implementation of, Basel II;
- attracting and retaining appropriately skilled and experienced staff;
- ensuring the availability and quality of data;
- developing and maintaining appropriate information technology systems; and
- change management.

“pitfalls” to the successful implementation of Basel II

He concluded by listing possible “pitfalls” to the successful implementation of Basel II that needed careful consideration, namely
- avoiding an “adopt-at-all-cost” strategy;
- ensuring that financial sector safety and soundness were priorities;
- ensuring compliance with Basel I, the Core Principles and IASs;
- ensuring the achievement of Basel II preconditions for implementation;
- guarding against leaving too little time for parallel runs and field testing; and
- ensuring that appropriate resources were in place prior to commencing with the implementation of Basel II.

Ms Gill Marcus, the then Chairperson of the Board of Directors of Absa Group Limited, South Africa, provided some thoughts and led an active debate on the following issues:

- The appropriateness of the size of boards of directors and the effectiveness of boards.
- The need for more competition in concentrated banking industries.
- The responsibilities of non-executive members of the boards of directors of banks.
- The importance of the independence of mind of non-executive directors.
- The need for non-executive board members to have an appropriate level of understanding of banking and the risks to which banks were exposed.
- The importance of a good relationship between banks and their supervisors.
- The management of concentration risk in banking systems, with particular focus on the so-called too-big-to-fail concept and whether the concept still applied.

Mr Alvir Alberto Hoffmann, Deputy Governor, Central Bank of Brazil, provided a high-level overview of certain aspects of the Basel II implementation process in Brazil. He described the three phases of the Basel II implementation project, which was launched by Brazil in 2001. It was highlighted that the initial focus during Phase 1 was on the implementation of

the simpler approaches in terms of Basel II, whereas the application and validation of the more advanced approaches would be the focus during Phases 2 and 3 of the project.

comments on the implementation of Basel II from a regional perspective

Mr Ousman Sowe, Chairperson of the Committee of Bank Supervisors in West and Central Africa (CBSWCA), The Gambia, also shared some comments on the implementation of Basel II from a regional perspective. He stated that the member countries of CBSWCA were committed to the implementation of Basel II, but that implementation would be at the discretion of each of the individual countries, guided by country-specific circumstances. Owing to the small size and limited level of sophistication of the various CBSWCA member countries' financial systems, it was expected that most would initially adopt only the standardised approaches available in respect of credit and market risk, and the basic indicator approach for operational risk. Mr Sowe highlighted the fact that the priority in most CBSWCA member countries remained the implementation of the Core Principles and full compliance with these principles. Key challenges to the CBSWCA member countries' successful implementation of Basel II included the lack of appropriate comprehension of Basel II due to its complexity, the costs involved in its implementation, a lack of resources in terms of both staff numbers and appropriate skills, and a lack of rating agencies in some member countries.

success factors in respect of the implementation of Basel II

Mr Paul Smith, Chief Risk Officer of the Standard Bank of South Africa Limited, provided brief comments on the success factors in respect of the implementation of Basel II from a commercial bank's perspective. The following key factors were mentioned:

- The importance of early planning and preparation.
- Implementation should be a "team effort" between the bank and the regulator.
- There should be active involvement from line managers and not only from risk management and finance functions.
- There should be strong oversight by the board of directors.
- Basel II implementation should be a national commitment.

Mr Smith stated that the key post-implementation benefits for his institution were a better understanding of the risks to which they were exposed, improved decision-making, improved management performance measures and a better understanding of the capital impact of risk exposures.

1.6 Incentive schemes of banking institutions

1.6.1 Background

In its 2007 *Annual Report* the Department highlighted the following:

> There are usually two key concerns raised about banks' incentive schemes. First, the schemes are misaligned, that is, they are linked to short-term performance, rather than the long-run interests and objectives of the institution. Second, these schemes have significant upside with no or limited downside and therefore may influence behaviour that could encourage excessive risk-taking.
>
> Misalignment between incentive schemes and the long-run objectives of banking institutions include mismatches between the timing of employees' bonus payments and the actual realisation of profits from their activities; inadequate recognition and remuneration of risk

management professionals, that is, their 'exclusion' from incentive schemes; and the provision of funding to business units based on income potential, without considering the level of risk these units undertake.

thematic review of South African banks' incentive schemes during 2008

The above discussion was a precursor to the Department's thematic review of South African banks' incentive schemes during 2008.

Internationally, several initiatives were undertaken in respect of incentive schemes during 2009, the most important of which follow.

1.6.2 Financial Stability Board guidance on compensation

It has been widely accepted that the structure of incentive schemes at financial institutions was one of the contributing factors to the financial crisis that began in 2007. As a result, in April 2009 the FSB issued FSB Principles for Sound Compensation Practices (the Compensation Principles) which are intended to apply to significant financial institutions. It is intended that these principles should be implemented by banking institutions and be reinforced through the supervisory process at national level.

In September 2009 the FSB published FSB Principles for Sound Compensation Practices: Implementation Standards (the Compensation Standards) to its Compensation Principles. The Compensation Standards were a response to a request by the G-20 to submit to the Pittsburgh Summit detailed specific proposals on corporate governance reforms, global standards on pay structure, and greater disclosure and transparency in order to enhance adherence to the Compensation Principles. The Compensation Standards do not fully cover all aspects of the Compensation Principles. However, they prioritise areas that should be addressed by banking institutions and supervisors to achieve effective global implementation of the Compensation Principles.

The Compensation Standards broadly cover the following key areas:

Compensation Standards cover key areas

- *Governance*: It is required of significant financial institutions to have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors. Furthermore, they prescribe the composition and objectives of the remuneration committee, while addressing the remuneration and performance measurement of risk and compliance staff.
- *Compensation and capital*: The total variable compensation of significant financial institutions should not limit their ability to strengthen their capital base. Supervisors should limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.
- *Pay structure and risk alignment*: The full range of current and potential risks should be taken into account in determining the size and allocation of variable compensation. Deterioration in the financial performance of an institution should generally lead to a contraction of the institution's total variable compensation, with such contraction reflecting the degree of deterioration. Senior management and employees responsible for the risk exposure of the institution should have a larger variable component as part of their total compensation. In addition, it is prescribed that a deferral system should be in place in respect of variable compensation, that is, variable compensation should not be paid once off, but rather staggered over a number of years.

- *Disclosure*: It is prescribed that an annual report on compensation should be disclosed to the public on a timely basis. Such disclosure should include areas such as the decision-making process related to the compensation policy; the key features of the compensation system and aggregate quantitative information.
- *Supervisory oversight*: Supervisors are required to ensure the effective implementation of the Compensation Principles and Compensation Standards in their respective jurisdictions. In the event of non-compliance, supervisors are required to act promptly.

participation in a thematic review conducted by the FSB

The Department commenced participation in a thematic review conducted by the FSB on the implementation of the Compensation Principles and Compensation Standards, which will form part of the areas of focus during 2010. Furthermore, in order to support implementation efforts, the Basel Committee published the consultative paper, *Compensation Principles and Standards Assessment Methodology* (the Methodology) in October 2009. The Methodology, a final version of which was released in January 2010, is a guide that enables supervisors to review banking institutions' compensation practices and assesses their compliance with the Compensation Principles and Compensation Standards.

1.6.3 The Department's review of South African banks' incentive schemes

In view of the risk posed by inappropriately structured incentive schemes, the Department conducted a thematic review of all South African banks' incentive schemes during 2008. The salient issues that emerged from the reviews are discussed below and, as a range of banks were reviewed, only the general high-level outcomes are discussed. Some of the statements made and views expressed may not reflect the practices of certain banks.

main purpose of banks' incentive schemes

- *Main purpose of incentive schemes*: The main purpose of banks' incentive schemes was to attract, motivate, reward and retain talented and exceptionally performing employees and leaders. It was highlighted that a shortage of skilled employees in the banking and broader financial sector led to banks competing for a limited pool of talent. Furthermore, incentive schemes were viewed as an important component of the total compensation package of employees, with cash incentives highlighted as having become increasingly more important for the retention of staff.

alignment of incentive schemes with performance and risk management of institution

- *Design, range and functioning of incentive schemes*: As incentive schemes change the behaviour of staff, the effective functioning of these schemes is critical.
  - *Alignment with the objectives of the institution*: Banks aligned their incentive schemes with the performance and risk management of the institution. Performance measures included ROE, growth in earnings and activity and cost-to-income levels. These various performance measures had hurdle rates that needed to be attained by business units and the bank as a whole, prior to any incentives being considered. In this way, the success of the organisation and business units determined the bonus of individuals. Risk management was both implicitly and explicitly built into incentive schemes. Some institutions were of the view that their general risk management framework ensured that employees would not 'chase' excessive bonuses by way of inappropriate risk-taking, as internal controls and exposure limits would prevent such behaviour. Other

institutions incorporated an explicit risk management component in assessing individuals and in awarding bonuses. Notwithstanding this approach, all institutions believed that failure to comply with organisational controls, values and culture resulted in a reduced bonus payment, both at individual and business unit level.

– *Range of incentive schemes*: Various schemes were identified during the review. However, they could broadly be grouped into two categories, namely cash-based schemes and share-based schemes.
  - o Cash-based schemes were predominantly short term, while share-based schemes were longer term in nature. In certain instances where cash-based payments were very large, these payments were staggered over a few years. Generally, it was observed that cash-based payments were skewed to the short term, that is, in excess of 80 per cent of the payments were made in the short term. In addition, it was observed that there was significant differentiation in respect of cash-based schemes, that is, a very large proportion of the pool allocated to individuals who performed exceptionally.
  - o In the case of share-based payments, these shares vested after three to four years only and therefore participants received no payments in terms of the scheme in the event of their leaving the organisation before the three- to four-year period. Share-based schemes were, in the main, reserved for more senior employees of the organisation. Furthermore, it was highlighted that these schemes were not backdated and therefore the benefits were based on the future performance of the organisation only.

functioning of incentive schemes found to be relatively transparent

– *Functioning and controls*: The functioning of incentive schemes was found to be relatively transparent. Banking organisations allocated a total bonus pool based on the performance of the consolidated institution, while business unit allocations were determined by performance contribution at business unit level. However, cognisance was taken of the risk and allocated capital. Individual employee incentives were a function of the bonus pool allocated to the business unit, the performance of the individual and the individual's team as a whole. Furthermore, adherence to the business unit and organisational value system, culture and risk appetite was also considered.

  Banks highlighted that they were comfortable with the functioning of their incentive schemes since they conducted regular industry benchmarking exercises, while one institution advised that its internal and external audit functions were tasked with identifying control weaknesses and breakdowns as a result of the bank's incentive schemes.

banks' boards of directors managed the highest level of approvals

- *Role of board remuneration subcommittee (Remco)*: It was noted that banks' boards of directors managed the highest level of approvals. However, Remcos were mandated to perform the following functions:

  – Shape the organisation's remuneration policy.
  – Determine the remuneration for executives.
  – Determine the structure of compensation packages for staff.
  – Determine incentive pools at organisational and business unit level.
  – Design incentive schemes.
  – Review top individual bonus awards.

  Following from the above, Remcos were ultimately responsible for creating work environments that stimulated performance and aligning employees' interest with that

of the organisation. This process had to take place while preserving the value and culture of the institution.

- *Monetary value of incentive payouts*: Annual total incentive pools were found to exceed 10 per cent of organisations' net profit before tax. Investment banking and trading business units received the highest relative proportion of bonus pools. Banks highlighted that these business units had the highest number of highly skilled staff, produced a large contribution to the overall performance of the institution and were the business units that were most exposed to competition from the South African branches of foreign financial institutions. In addition, certain banks highlighted that they were losing staff to international banks that were engaged in investment banking and trading.

investment banking and trading business units received the highest relative proportion of bonus pools

- *Conclusion*: South African banking organisations have generally sound principles embedded in their incentive schemes, including
  - alignment with the objectives of the organisation as a whole;
  - business unit bonus pools determined by overall performance of the organisation;
  - consideration of risk management in the performance assessment process; and
  - incorporation of team and business unit performance in individual assessments.

banking organisations have generally sound principles embedded in incentive schemes

However, the following issues that require banks' further attention were identified:

issues that require banks' further attention were identified

- Cash-based incentive schemes were very skewed towards the short term. This phenomenon may result in employees being rewarded for activities that appear positive in the short term. However, such activities may result in large losses before maturity.
- Short-term bonus awards exhibited large-scale differentiation. This may result in excessive individualism, to the detriment of the team, the business unit and the organisation.

During 2009, the Department closely followed international developments regarding financial institutions' compensation schemes by way of its participation in the activities of the Basel Committee and other international fora, such as the FSB, while continuing discussions with banks where required.

1.6.4 Initiatives planned for 2010

Initiatives planned for 2010 include engagement with all South African banks on the Compensation Principles and Compensation Standards in order to assess their levels of compliance. In addition, the aforementioned documents will be considered for incorporation into the amended bank regulatory framework that is anticipated to become effective in 2011. Furthermore, a review of the Department's supervisory review and evaluation process relating to compensation principles and standards applied by banks will be conducted.

1.7 The international financial market turmoil: Responses by standard-setting bodies

1.7.1 Introduction

comprehensive package of measures to strengthen trading-book capital and enhance the Basel II framework

The sub-prime and international financial market crisis that started in 2007 revealed fundamental weaknesses in international financial markets. In response to these weaknesses, international standard-setting bodies such as the G-20, the FSB and the

Basel Committee announced various initiatives, strategies, and new or amended requirements and standards covering a wide range of areas. In its *Annual Reports* of 2007 and 2008, the Department comprehensively covered matters such as the background to, and causes of, the crisis and the weaknesses that were identified that required specific attention or correction.

During July 2009, the newly expanded Basel Committee[4] approved a comprehensive package of measures to strengthen the 1996 rules governing trading-book capital for banks and banking groups, and to enhance the three pillars of the Basel II framework. The aforementioned package forms part of the Basel Committee's broader programme to strengthen the regulatory capital framework. The key aims of the broader programme are to introduce new standards to

- promote the build-up of capital buffers that can be drawn down in periods of stress;
- strengthen the quality of bank capital;
- introduce a leverage ratio as a backstop to the Basel II risk-sensitive measures;
- introduce measures to mitigate any excess cyclicality of the minimum capital requirement; and
- promote a more forward-looking approach to provisioning.

As part of the aforementioned comprehensive packages of measures the Basel Committee issued the following three documents in July 2009:

i *Enhancements to the Basel II framework*.
ii *Revisions to the Basel II market risk framework*.
iii *Guidelines for computing capital for incremental risk in the trading book*.

The measures contained in the above-mentioned documents materially impact on the regulation and supervision of banks and banking groups. The amended trading-book rules, which are scheduled to take effect at the end of 2010, include a stressed value-at-risk (VaR) requirement and the introduction of higher capital requirements for banks and banking groups to capture the credit risk associated with complex trading activities.

Basel II enhancements

The Basel II enhancements referred to above include the following:

- Measures to strengthen the treatment for certain securitisations in Pillar 1 of the Basel II framework, which deals with minimum capital requirements.
- The introduction of higher risk weights for resecuritisation exposures, often referred to as 'collateralised debt obligations' (CDOs) of asset-backed securities (ABSs), to better reflect the risks inherent in these products.
- Measures to raise the credit conversion factor (CCF) for short-term liquidity facilities granted to certain off-balance-sheet conduits.
- Requirements for banks to conduct more rigorous credit analyses of externally rated securitisation exposures.
- Supplemental guidance under Pillar 2 of the Basel II framework, which deals with the supervisory review process. This guidance also incorporates the Compensation Principles, issued by the FSB in April 2009 and addresses the flaws in risk management practices revealed by the crisis and raises the standards for
  - managing bank-wide governance and risk;
  - capturing the risk of off-balance-sheet exposures and securitisation activities;
  - managing risk concentrations; and

4 At its March 2009 meeting, the Basel Committee took a decision to expand its membership by inviting representatives of Australia, Brazil, China, India, Korea, Mexico and Russia. At its meeting in June 2009 the Basel Committee further expanded its membership with the addition of representatives of Argentina, Indonesia, Saudi Arabia, South Africa, Turkey, Hong Kong SAR and Singapore.

  – providing incentives for banks to better manage risk and returns over the long term.
- Pillar 3 of the Basel II framework, which deals with market discipline or public disclosure, was enhanced to strengthen disclosure requirements for securitisations, off-balance-sheet exposures and trading activities. The purpose of the additional disclosure requirements is to help reduce market uncertainties pertaining to the strength of banks' balance sheets related to capital market activities.

It is envisaged that the amended Pillar 1 capital requirements and Pillar 3 disclosure requirements will be implemented in South Africa with effect from 1 January 2011, while the further Pillar 2 supplemental guidance either already forms part of the Department's regulatory and supervisory framework or is in the process of being incorporated.

1.7.2 Responses by the G-20

During 2009, the G-20 held various summits to discuss the effects of the international financial market and economic crisis, and to take concerted and decisive actions in that regard. On 25 September 2009, following the Pittsburgh Summit, the G-20 issued a leaders' statement[5] and a progress report on the actions taken or to be taken to promote financial regulatory reform.

the G-20 held various summits to discuss the effects of the international financial market and economic crisis

According to the leaders' statement, the G-20, among other things, pledged the following:

- Confirmed the commitment of countries to doing everything necessary to ensure recovery, to repair the financial systems and to maintain the global flow of capital.
- Agreed to ensure that the regulatory system for banks and other financial firms reins in excessive risk-taking that led to the crisis.
- Agreed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter (OTC) derivatives market and to create more powerful tools to hold large global firms to account for the risks they took. Standards for large global financial firms should be commensurate with the cost of their failure. For all these reforms, the G-20 has set strict timetables.
- The establishment of the FSB to include major emerging economies and welcomed its efforts to co-ordinate and monitor progress in strengthening financial regulation.
- Substantial progress in strengthening prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges and reinforcing international co-operation.
- Enhanced and expanded the scope of regulation and oversight, with tougher regulation of OTC derivatives, securitisation markets, CRAs and hedge funds.
- Committed to taking action at national and international levels to raise standards together so that national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage.
- Committed to conducting robust and transparent stress tests as needed.
- Strike an adequate balance between macroprudential and microprudential regulation to control risks.
- Called on the G-20 members to reach agreement on an international framework of reform in the following critical areas:

agreement on an international framework of reform

5 The complete leaders' statement and progress report are available from the G-20 website at http://www.g20.org/pub_communiques.aspx.

– *Building high-quality capital and mitigate procyclicality*: The G-20 committed to developing by the end of 2010 internationally agreed rules to improve both the quantity and quality of bank capital, and to discourage excessive leverage. The rules will be phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by the end of 2012. The national implementation of higher levels and better quality of capital requirements, countercyclical capital buffers, higher capital requirements for risky products and off-balance-sheet activities, as elements of the Basel II capital framework, together with strengthened liquidity risk requirements and forward-looking provisioning, will reduce incentives for banks to take excessive risks and create a financial system better prepared to withstand adverse shocks.

The G-20 supports the introduction of a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting.

aligning compensation with long-term value creation

– *Reforming compensation practices to support financial stability*: Excessive compensation in the financial sector has both reflected and encouraged excessive risk-taking. Reforming compensation policies and practices is an essential part of the efforts to increase financial stability. The G-20 fully endorsed the implementation standards of the FSB aimed at aligning compensation with long-term value creation and not with excessive risk-taking. These standards include the following:

o Avoiding multi-year guaranteed bonuses.
o Requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback, and to be vested in the form of stock or stock-like instruments, as long as the created incentives aligned with long-term value creation and the time horizon of risk.
o Ensuring that compensation for senior executives and other employees that have a material impact on the firm's risk exposure align with performance and risk.
o Making firms' compensation policies and structures transparent through disclosure requirements.
o Limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base.
o Ensuring that compensation committees overseeing compensation policies are able to act independently.

Supervisors are expected to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary, to offset additional risks, apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices.

OTC derivative contracts should be traded on exchanges

– *Improving OTC derivatives markets*: All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest. Furthermore, OTC derivative contracts should be reported to trade repositories and non-centrally cleared contracts should be subject to higher capital requirements.

prudential standards for systemically important institutions

– *Addressing cross-border resolutions and systemically important financial institutions by the end of 2010*: Systemically important financial firms should develop internationally consistent firm-specific contingency and resolution plans. Furthermore, authorities should establish crisis management groups for the major cross-border firms and a legal framework for crisis intervention, as well as improve

information sharing in times of stress. Resolution tools and frameworks should be developed for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future. Prudential standards for systemically important institutions should be commensurate with the costs of their failure. The FSB is expected to propose by the end of October 2010 possible measures, including more intensive supervision and specific additional capital, liquidity, and other prudential requirements.

- Called on international accounting bodies to redouble their efforts to achieve a single set of high-quality, global accounting standards within the context of their independent standard-setting process and completing their convergence project by June 2011.

- Committed to maintaining the momentum in dealing with tax havens, money laundering, proceeds of corruption, terrorist financing and prudential standards. In this regard the G-20
  – stands ready to use countermeasures against tax havens from March 2010; and
  – welcomes the progress made by the FATF in the fight against money laundering and the financing of terrorism, and calls on the FATF to issue a public list of high-risk jurisdictions by February 2010.

The G-20's progress report on the actions taken or to be taken to promote financial regulatory reform was also issued on 25 September 2009 and covered a wide spectrum of key focus areas, including matters related to the following:

expanded membership and a broadened mandate to promote financial stability

- *The establishment of the FSB*: The G-20 Leaders at the London Summit, held in April 2009, transformed the Financial Stability Forum (FSF) into the FSB, with an expanded membership and a broadened mandate to promote financial stability. The FSB held its inaugural meeting in June 2009 and has established the internal structures needed to address its mandate.

  These new structures include a Steering Committee and three Standing Committees for the assessment of vulnerabilities; supervisory and regulatory co-operation and standards implementation. The FSB also established a Cross-border Crisis Management Working Group and an Expert Group on Non-co-operative Jurisdictions. These groups have all commenced with their work programmes.

- *International co-operation*: Systemically important financial firms are required to develop internationally consistent firm-specific contingency and resolution plans. Authorities are required to establish crisis management groups for the major cross-border firms and a legal framework for crisis intervention, as well as to improve information sharing in times of stress.

  firm-specific cross-border contingency planning discussions

  Work on the implementation of the FSB Principles for Cross-border Co-operation on Crisis Management is ongoing. Schedules for firm-specific cross-border contingency planning discussions have been set out to take place in 2009 and the first half of 2010. The FSB Cross-border Crisis Management Working Group is preparing a list of the main elements to be included in contingency planning discussions, including a template for "de-risking" plans to be prepared by the firms. De-risking plans will cover options the firms would need to consider to exit risky positions and scale back their activities, in an orderly fashion and without government intervention.

  Supervisory colleges have been established for more than 30 large and complex financial institutions identified by the FSB as needing college arrangements.

Progress has been made in the two major international initiatives under way on bank resolution frameworks, namely the Cross-Border Bank Resolution Group (CBRG) of the Basel Committee and the initiative by the IMF and the World Bank on the legal, institutional and regulatory framework for national bank insolvency regimes.

In September 2009 the CBRG published, for consultation, a report that included recommendations for authorities on effective crisis management and resolution processes for large cross-border institutions. The IMF is producing papers on a Framework for the Cross-Border Resolution of Insolvent Financial Institutions. The first paper examines key legal and policy issues.

Following Executive Board discussion, a second paper to be published by the IMF will set out recommendations for the resolution of these issues, which is scheduled for completion in 2010.

- *Prudential regulation*: The G-20 reached agreement in respect of various matters relating to prudential regulation, including the following:

predominant form of Tier 1 capital must be common shares and retained earnings

– *To raise the quality, consistency and transparency of the Tier 1 capital base*: The predominant form of Tier 1 capital must be common shares and retained earnings. Deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity or its equivalent. The definition of capital will be harmonised across jurisdictions and all components of the capital base will be fully disclosed so as to allow for comparisons across institutions to be made easily.

address any excessive cyclicality of minimum capital requirements

– *To introduce a framework for countercyclical capital buffers above the minimum requirement*: The framework will include capital conservation measures such as constraints on capital distributions. The Basel Committee will review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build-up and release of capital buffers. The Basel Committee continues to work on approaches to address any excessive cyclicality of minimum capital requirements.

The Basel Committee also actively engaged with accounting standard setters to promote more forward-looking provisions based on expected losses. The International Accounting Standards Board (IASB) is working to enhance its provisioning standards and guidance on an accelerated basis, including by considering a proposed impairment standard based on an expected loss approach to loan loss provisioning.

stressed liquidity coverage ratio requirement

– To introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.

– To introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting. The main elements of how a leverage ratio would work in practice have been formulated, and development work is taking place on important practical details. Calibration of a leverage ratio will be part of an impact assessment to be conducted in 2010.

At the end of 2009, the Basel Committee issued concrete proposals in respect of various components of the aforesaid matters, including the quality, consistency and transparency of the capital base, capital buffers and capital conservation measures, and minimum global standards for liquidity. These proposals are discussed in more detail elsewhere in this report.

- *The scope of regulation*: Prudential standards for systemically important institutions should be commensurate with the costs of their failure. In this regard, the FSB in the 12 months to September 2010 will be developing proposals to reduce the systemic risks posed by large and complex financial institutions.

  In addition, the Basel Committee has established a working group on macroprudential supervision that will cover, among other things, supervisory tools to address the externalities of systemically important banks.

  working group on macroprudential supervision

  Aside from the work on addressing procyclicality, the FSB and its members are developing quantitative tools to monitor and assess the build-up of macroprudential risks in the financial system. These tools aim to improve the identification and assessment of systemically important components of the financial sector and the assessment of how risks evolve over time.

  Initiatives are under way to promote the establishment of central clearing counterparties for credit default swap (CDS) contracts, with an initial focus on CDS indices. The Basel Committee is also considering revisions to ensure that capital requirements for OTC derivatives adequately reflect the risks of derivatives, taking into account the benefits of central clearing, the impact of collateralisation and other counterparty credit risks. In this regard, new standards will be issued during 2010.

  promote establishment of central clearing counterparties for credit default swap contracts

- *The transparent assessment of regulatory regimes*: All FSB members have undertaken, or are about to undertake, a review of adherence to international regulatory and supervisory standards through the FSAP and Reports on the Observance of Standards and Codes (ROSC).

- *Compensation*: Many national initiatives are under way to implement the FSB's Compensation Principles. A number of supervisory actions have also been taken to assess compliance by the industry with the FSB's Compensation Principles, through requests for self-assessment, assessments by the supervisors themselves, or both. These initiatives are broadly consistent in substance and have affected both regulatory frameworks and supervisory actions and practices.

  national initiatives under way to implement FSB Principles

  The Basel Committee, the International Association of Insurance Supervisors (IAIS) and the IOSCO are working to support consistent implementation of the FSB's Compensation Principles across jurisdictions. IOSCO is considering incorporating the FSB's Compensation Principles into its Principles for Periodic Disclosure.

  The IAIS has initiated work on the development of a standard and guidance paper on remuneration that will take into account the FSB's Compensation Principles for cross-sectoral consistency purposes. The Basel Committee incorporated the aforesaid principles in Pillar 2 of Basel II in July 2009, with the expectation that banks and supervisors begin implementing the new Pillar 2 guidance immediately.

The FSB has developed specific standards for implementing its Compensation Principles, which could be incorporated into supervisory measures and will complete a review of actions by national authorities to implement the principles by the end of March 2010. Supervisors are expected to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary, to offset additional risks, and to apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices.

adherence to co-operation and information-sharing standards

- *Tax havens and non-co-operative jurisdictions*: The G-20 committed itself to fighting non-co-operative jurisdictions and to maintaining the momentum in dealing with tax havens, money laundering and prudential standards. Furthermore, the G-20 welcomed the establishment by the FSB of an Experts Group under the Standing Committee for Standards Implementation that will develop criteria for identifying jurisdictions of concern due to a combination of their weakness and systemic importance; develop an approach and a toolkit of progressive and proportionate measures to engage non-compliant jurisdictions; identify jurisdictions of concern based on the criteria approved by the committee; develop an evaluation process to complement FSAP and ROSC assessments; assess compliance for jurisdictions of concern, using FSAP and ROSC information and mutual evaluations; and engage non-compliant jurisdictions as appropriate. Progress is also being made towards promoting adherence to co-operation and information-sharing standards in the financial regulatory and supervisory area.

  Furthermore, the G-20 agreed that the FATF should revise and reinvigorate the review process for assessing compliance by jurisdictions with AML/CFT standards, using agreed evaluation reports where available. The G-20 also welcomed the progress made by the FATF in the fight against money laundering and terrorist financing, and called on the FATF to issue a public list of high-risk jurisdictions by February 2010.

various discussion documents, exposure drafts and/or proposed new accounting standards

- *Accounting standards*: To date, the IASB has published various discussion documents, exposure drafts and/or proposed new accounting standards or guidance, among other things, to improve standards for the valuation of financial instruments, reduce the complexity associated with some accounting standards for financial instruments, strengthen accounting standards for loan-loss provisioning, enhance certain disclosure standards, and to improve accounting standards for off-balance-sheet exposure and valuation uncertainty. The IASB is working with supervisors and the Basel Committee in key areas to resolve matters of mutual interest.

national and regional initiatives ongoing to strengthen oversight of CRAs

- *Credit-rating agencies*: In March 2009, IOSCO published a report assessing the degree to which CRAs have adopted codes of conduct that reflect the updated provisions of the IOSCO Code of Conduct Fundamentals for CRAs. The report found that a larger proportion of the CRAs reviewed had taken steps to incorporate the provisions of the IOSCO CRA Code into their codes of conduct than when they were previously surveyed for IOSCO's first implementation review in 2007. National and regional initiatives are ongoing to strengthen oversight of CRAs.

  The Basel Committee is also reviewing proposals to address a number of inappropriate incentives arising from the use of external ratings in the regulatory capital framework, such as insufficient independent risk assessment by banks and "cliff" effects.

1.7.3 Responses by the Basel Committee: Proposals to strengthen global capital and liquidity regulations

At its December 2009 meeting, the Basel Committee approved for consultation a package of proposals to further strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector.

Along with the measures taken by the Basel Committee in July 2009 to strengthen the Basel II framework, the proposals announced on 17 December 2009[6] form part of the Basel Committee's comprehensive response to address the lessons learned from the crisis related to the regulation, supervision and risk management of global banks.

proposals announced on 17 December 2009 form part of the Basel Committee's comprehensive response

Through its reform package, the Basel Committee aims to strengthen, among other things, banks' risk management and governance, transparency and disclosures, and the resolution of systemically significant cross-border banks.

The Basel Committee's reforms form part of the global initiatives to strengthen the financial regulatory system that have been endorsed by the FSB and the G-20 at their Pittsburgh Summit.[7]

One of the main reasons the economic and financial crisis became so severe was that the banking sectors of many countries had built up excessive on-balance-sheet and off-balance-sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the re-intermediation of large off-balance-sheet exposures that had built up in the shadow banking system.

The crisis was further exacerbated by a procyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability.

crisis further exacerbated by a procyclical deleveraging process and interconnectedness of systemic institutions

To address the market failures revealed by the crisis, the Basel Committee is proposing to introduce a number of fundamental reforms to the international regulatory framework. The reforms strengthen bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions during periods of stress. The reforms also have a macroprudential focus, addressing system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.

fundamental reforms to the international regulatory framework

The micro- and macroprudential approaches to supervision are interrelated, as greater resilience at the individual bank level reduces the risk of system-wide shocks. It is expected that the capital and liquidity proposals issued for consultation by the Basel Committee will

- result in more resilient banks, and a sounder banking and financial system; and
- promote a better balance between financial innovation and sustainable growth.

6 The complete documents containing the Basel Committee's proposals to further strengthen global capital and liquidity regulations with a view to promoting a more resilient banking sector are available at https://www.bis.org/list/bcbs/from_01012008/index.htm.

7 http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

consultative documents to further strengthen global capital and liquidity regulations

The Basel Committee's consultative documents to further strengthen global capital and liquidity regulations cover the following key focus areas:

- *Raising the quality, consistency and transparency of the capital base*: It is critical that banks' risk exposures are backed by a high-quality capital base. The proposed amendments will ensure that the banking system is in a better position to absorb losses on both a going concern and a gone concern basis. For example, under the current Basel Committee standard, banks could hold as little as 2 per cent common equity to risk-based assets, before the application of key regulatory adjustments.

  predominant form of Tier 1 capital must be common shares

  The proposal is to strengthen the component of the Tier 1 capital base that is fully available to absorb losses on a going concern basis, thus contributing to a reduction of systemic risk emanating from the banking sector. In this regard, the predominant form of Tier 1 capital must be common shares and retained earnings.

  The remainder of the Tier 1 capital base must comprise instruments that are subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.

  innovative hybrid capital instruments phased out

  Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses, currently limited to 15 per cent of the Tier 1 capital base, will be phased out.

  The Basel Committee will calibrate the minimum requirements for the overall level of capital, Tier 1 capital, and the predominant form of Tier 1 capital as part of the impact assessment to be conducted.

  In addition, Tier 2 capital instruments will be harmonised and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated.

  Finally, to improve market discipline, the transparency of the capital base will be improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the reported accounts.

strengthen the risk coverage of the capital framework

- *Strengthening the risk coverage of the capital framework*: One of the key lessons of the crisis has been the need to strengthen the risk coverage of the capital framework. Failure to capture major on-balance-sheet and off-balance-sheet risks, and derivative-related exposures duly was a key destabilising factor during the financial market and economic crisis that started in 2007.

  enhanced treatment introduces a stressed VaR capital requirement

  In July 2009 in response to these shortcomings, the Basel Committee issued substantial reforms to the Basel II framework that will raise capital requirements for the trading book and complex securitisation exposures, a major source of losses for many internationally active banks since 2007. The enhanced treatment introduces a stressed VaR capital requirement based on a 12-month period of significant financial stress. In addition, the Basel Committee has introduced higher capital requirements for so-called resecuritisations held in both the banking book and the trading book of banks. The reforms also raise the standards of the Pillar 2 supervisory review process and strengthen Pillar 3 disclosure requirements. The Pillar 1 and Pillar 3 enhancements must be implemented by the end of 2010, while the Pillar 2 risk management standards became effective immediately.

In addition to the aforesaid trading-book and securitisation reforms announced in July 2009, on 17 December 2009 the Basel Committee issued for consultation proposals to strengthen the capital requirements for counterparty credit risk exposures arising from derivatives, repurchase and resale transactions, and securities financing activities.

strengthen capital requirements for counterparty credit risk exposures

The proposed enhancements will strengthen the resilience of individual banking institutions and reduce the risk that shocks are transmitted from one institution to the next through the derivatives and financing channel.

The proposed strengthened counterparty capital requirements will also increase incentives to move OTC derivative exposures to central counterparties and exchanges.

- *Introducing a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration*: As mentioned earlier, one of the underlying features of the crisis was the build-up of excessive on-balance-sheet and off-balance-sheet leverage in the banking system. The build-up of leverage was also a feature of previous financial crises, for example, leading up to September 1998. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and the contraction in credit availability.

  The introduction of a leverage ratio requirement will assist in containing the build-up of excessive leverage in the banking system, and introduce additional safeguards against model risk and measurement error. To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for any remaining differences in accounting.

introduction of a leverage ratio requirement

- *Introducing a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress*: The tendency of market participants to behave in a procyclical manner has been amplified through a variety of channels and through the build-up and release of leverage among financial institutions and consumers.

  The Basel Committee proposes to introduce a series of measures to address procyclicality and raise the resilience of the banking sector. The proposed measures have the following key objectives:

measures to address procyclicality

  – Dampen any excess cyclicality of the minimum capital requirement.
  – Promote more forward-looking provisions.
  – Conserve capital to build buffers at individual banks and the banking sector that can be used in stress.
  – Achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth.

  A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks. While procyclicality amplified shocks over the time dimension, the interconnectedness of many large banks and other financial institutions transmitted negative shocks across the financial system and economy. The Basel Committee is therefore also developing

developing practical approaches to assist supervisors in measuring the importance of banks

practical approaches to assist supervisors in measuring the importance of banks to the stability of the financial system and the real economy, and reviewing policy options to reduce the probability and impact of failure of systemically important banks.

minimum liquidity standard for internationally active banks

- *Introducing a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio*: Strong capital requirements are a necessary condition for banking-sector stability, but by themselves are not sufficient. A strong liquidity base reinforced through robust supervisory standards is of equal importance. As with the global capital standards, the proposed liquidity standards will establish minimum requirements and will promote an international level playing field.

  The framework therefore also includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank- and system-wide level. These standards and monitoring metrics complement the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision, issued in September 2008.

The Basel Committee and international regulatory and supervisory authorities, including the Department, are mindful of the need to introduce the aforesaid measures in a manner that raises the resilience of the banking sector over the longer term, while avoiding negative effects on bank lending activity that could impair the economic recovery.

comprehensive impact assessment of the capital and liquidity standards

In this regard, the Basel Committee is initiating a comprehensive impact assessment of the capital and liquidity standards proposed in the consultative documents. In a number of proposals, the committee is still considering different options, which will be included in the impact assessment. Decisions on the final proposals and their calibration will be made only after a thorough analysis of the impact assessment and the comments received on the consultative documents. The impact assessment will be carried out in the first half of 2010. On the basis of the impact assessment, the Basel Committee is expected to review the regulatory minimum level of capital and the proposed reforms to arrive at an appropriately calibrated total level and quality of capital.

fully calibrated set of standards will be developed by the end of 2010

It is expected that the fully calibrated set of standards will be developed by the end of 2010 to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by the end of 2012. The impact or potential impact of the aforesaid initiatives and strategies undertaken, and of the various new or amended requirements or standards issued by international standard-setting bodies such as the G-20 Forum, FSB and the Basel Committee to comprehensively address the fundamental weaknesses revealed by the international financial market and economic crisis, on the regulatory and supervisory framework of the Department is discussed in more detail in Chapter 3 of this report.

1.8 Participation in international regulatory or supervisory forums

1.8.1 Southern African Development Community Subcommittee of Banking Supervisors

the Department is represented on the SADC Subcommittee of Banking Supervisors

The Department is represented on the Southern African Development Community (SADC) Subcommittee of Banking Supervisors (SSBS), a subcommittee of the Committee of Central Bank Governors (CCBG) in SADC. The key focus areas of the SSBS are the following:

- The effective implementation of the Core Principles by supervisors in the SADC region.
- Training of supervisors and the effective implementation and ongoing enhancement of risk-based supervision.

- The effective implementation and ongoing review of AML and CFT measures.
- Implementation of IASs across the SADC region.
- Harmonisation of banking supervision and legal and regulatory reforms.

During 2009 the SSBS devoted most of its attention and time to the development of a template to enable member countries to perform self-assessments in respect of their compliance with the Core Principles and to the bank supervision information technology application project to enable the electronic submission of statutory returns. In addition, the SSBS identified areas to be focused on during 2010 namely:

- The regulation of electronic money in the SADC jurisdiction due to the increased usage of cellphone banking.
- Further development of off-site monitoring of banks.

During 2009 the SSBS also identified certain training initiatives to be initiated during 2010, namely

- the SADC Training and Development Forum is in the process of developing a course on financial soundness indicators; and
- risk-based supervision.

1.8.2 Standards Implementation Group – Validation Subgroup

The Department is represented on the Validation Subgroup (SIGV) of the Standards Implementation Group (SIG), an expert subcommittee of the Basel Committee focusing on issues related to the validation of systems used by banks to generate the ratings and parameters that serve as inputs into the internal ratings-based (IRB) approaches to credit risk. Members of the SIGV meet three times annually to share their experiences in respect of the IRB approach to credit risk. The work plan of the SIGV is continuously adjusted to the outcomes of the deliberations at the Basel Committee and, since 2004, when first established, has covered a wide range of issues such as

the Department is represented on the Validation Subgroup of the Standards Implementation Group

- definitional issues;
- minimum standards in respect of supervisory data requirements;
- challenges with the accuracy of standards for estimates of probability of default (PD), loss given default (LGD) and exposure at default (EAD);
- the interpretation of minimum standards for organisational processes;
- rating systems inputs;
- the robustness of validating tools for PDs, LGDs and EADs;
- validation issues unique to retail banking portfolios;
- the criteria considered for accepting PDs in order to take into account through-the-cycle effects; and
- consideration of the design and application of supervisory benchmarking techniques.

During 2009 the SIGV focused on the following topics:

- The cyclicality of capital.
- Validation techniques including backtesting.
- The impact of rating migrations.
- The impact of increased collateralisation and the subsequent impact on risk-weighted assets.
- The impact of calibration differences and changes in the actual underlying risk of exposures on the average risk weighting of exposures.

It is envisaged that during 2010 the SIGV will continue its analysis of the impact of the global financial market crisis, and the data flowing from it, on IRB parameters.

1.8.3 Standards Implementation Group Operational Risk

SIGOR focuses on operational risk implementation issues

The Standards Implementation Group Operational Risk (SIGOR) is a permanent working group of the SIG that focuses on operational risk implementation issues.

The principal focus of SIGOR is the practical challenges associated with the successful development, implementation and maintenance of an operational risk framework that addresses the requirements and expectations of the Basel Committee's advanced measurement approach (AMA). Subgroup members share identified operational risk implementation issues within their respective jurisdictions and actively participate in developing resolution plans. Another important element of SIGOR's mandate is to facilitate the resolution of issues associated with the cross-border supervision of international banking groups under Basel II, especially in relation to operational risk.

The sharing of information and experiences among SIGOR members on the practical challenges associated with the implementation and maintenance of an operational risk framework under the AMA continued during the period under review. The following two reports were finalised during 2009:

i *Results from the 2008 Loss Data Collection Exercise for Operational Risk*.
ii *Observed Range of Practice in Key Elements of AMA*.

The above-mentioned reports were published by the Basel Committee in July 2009. South Africa's contribution to these reports and the main findings of the reports are discussed in more detail on pages 57–61 of this report. In 2009 SIGOR members continued to work with supervisors, banks, insurance brokers and insurance providers to clarify SIGOR's expectations with respect to the recognition of insurance mitigation in AMAs.

Activities planned by SIGOR for 2010 include the following:

- Developing a comprehensive response to address the significant issues identified in the above-mentioned reports and national implementation efforts.
- Continuing work to explore improvements to the standardised and basic indicator approaches.
- Assessing whether the risk management standards set forth in the paper *Sound Practices for the Management and Supervision of Operational Risk*, issued in February 2003, warrant updating and enhancements. The standards in the 2003 paper establish general supervisory expectations for the management of operational risk for banks.

1.8.4 Trading Book Group

In 2007 South Africa was invited to participate in a technical group under the Basel Committee focused on implementation guidelines of the Basel II Accord related to the trading book, named the Accord Implementation Group–Trading Book (AIG–TB). Following completion of the implementation phase of the accord the AIG structure was disbanded. However, the issues associated with the trading book remained and in 2008 the group continued functioning under the Policy Development Group, as the Trading Book Group (TBG).

ascertaining the interaction between credit and market risk

Having dealt with a number of trading-book-related issues in the past, the recent work of the group was concentrated on ascertaining appropriate and practical ways for banks

to apply internal models in the calculation of capital for the risk of obligor default and other credit-related risks, and gain approval therefore in an approach that could be broadly consistent across jurisdictions. The proposed capital charge was then called the 'incremental default risk charge' (IDRC). Financial market events that unfolded during the latter months of 2007, peaking with the collapse of Lehman Brothers in late 2008, focused the importance of the group's work on ascertaining the interaction between credit and market risk. In particular, the discrepancy between capital charges for the same products held in the banking and trading books came under the spotlight. Structured products at the heart of the losses made by banks, such as synthetic CDOs, drew attention to the complexity of their pricing in both liquid and illiquid markets, and the indirect effect of credit events on their pricing.

Greater inspection of the sources of risk revealed the need to distinguish between obligor default risk, rating migration risk, the effect of market liquidity on market risk, and the effect of events such as jumps to default and mergers. This directed the work of the group. A trading strategy, known as 'correlation trading', also required careful consideration. Several alternatives were developed for banks to report these risks under standardised and modelled approaches.

In 2009 the TBG consolidated results of an impact study on the effects of implementing the IDRC that had commenced in 2008. Of the 26 banks participating in the survey, 5 were South African. The survey highlighted the effect of different standards in calculating capital requirements and the scarcity of sophisticated modelling techniques among banks.

survey highlighted the effect of different standards in calculating capital requirements

The events of late 2008 led the TBG to formulate a more wide-reaching response to the perceived insufficiency of capital for market risk, including the introduction of a stressed VaR component for banks with approval to report capital according to a VaR approach.

A further impact study was undertaken in 2009 to ascertain the effects of refined regulations for traded credit and stressed VaR. Again, the Department facilitated the participation of 5 South African banks in the study. The results of this study, which were published in October 2009, highlighted the significant effect of the proposed regulations for market risk on banks' overall capital requirements. Excluding correlation trading, the study concluded that the proposed changes to the market risk framework increase average trading-book capital requirements by two to three times. Based on the results of the study, the Basel Committee decided to retain the principles and capital calculations originally proposed in its January 2009 consultative package, as published in July 2009 in two documents, namely *Revisions to the Basel II Market Risk Framework* and *Guidelines for Computing Capital for Incremental Risk in the Trading Book*.

the Department facilitated the participation of 5 South African banks in the study

During debate around trading capital, discrepancies between capital treatment in the trading and banking books became increasingly apparent and demanding of the group's attention. Consequently, five work streams were initiated to address a fundamental review of the trading book. The Department, in co-operation with several South African banks, has contributed to studies in one of the work streams and will be a major participant in two others in 2010.

1.8.5 Regulation and supervision of microfinance activities

In 2009 South Africa participated as a member of a work stream of the Basel Committee on microfinance, the objectives of which were to identify the existing Basel Committee standards that are relevant to microfinance and to develop additional guidance or a

range of practice papers for supervisors responsible for microfinance activities, with a specific focus on micro deposit-taking. This would assist countries in developing coherent approaches to regulating and supervising microfinance, and for applying the Core Principles to microfinance activities conducted by depository institutions in their jurisdictions.

applying the Core Principles to microfinance activities

In April 2009 a survey was conducted by means of a questionnaire to draw on the collective experience of supervisors globally, identify supervisory issues and to illustrate accepted practices for the regulation and supervision of microfinance activities. The definition of 'microfinance', for the purposes of the project, was couched in general terms to cover the diversity of interpretations. It encompassed the provision of limited financial services to lower income persons and smaller, often informal, businesses. The intention is to present a draft report, "Microfinance Activities and the Core Principles for Effective Banking Supervision", to the Basel Committee in 2010. The draft report will consist of the range of practices on regulating and supervising microfinance activities, and the guidance for the application of the Core Principles to microfinance activities.

1.8.6 Capital Monitoring Group

The Basel Committee has established a Basel II Capital Monitoring Group that shares national experiences in monitoring capital requirements. Issues considered include measures to ensure that banks maintain a solid capital base throughout the economic cycle.

South Africa is a member of the Capital Monitoring Group

South Africa is a member of the Capital Monitoring Group and submits regulatory data to it for further analysis. The regulatory data submitted consist of credit risk, market risk, operational risk and net qualifying capital in respect of the industry. A detailed analysis is performed by the Capital Monitoring Group, and issued to the members for discussion.

The following areas, among others, are analysed:

- The overall results for the current period.
- The relative increase in the Basel II requirements compared to the Basel I requirements.
- The impact of transitional floors.
- The share of exposures subject to the standardised approach.
- The relative impact of risk types.
- Data at portfolio level, such as portfolio sizes, average minimum required capital per exposure and risk parameters.

The results of the analysis are then fed back to the Policy Development Group, a subgroup of the Basel Committee, to support the committee in identifying and reviewing emerging supervisory issues and, where appropriate, proposing and developing policies that promote a sound banking system and high supervisory standards.

1.9 Skills development

1.9.1 Introduction

During 2009 the Department spent R887 000 on the training of approximately 107 employees. Various training interventions were arranged, such as technical and managerial courses, risk management seminars and supervisory workshops. The main purpose of the training was to

- assist staff in implementing sound supervisory standards and practices;
- keep staff abreast of the latest information on market products, practices and techniques;
- keep staff abreast of the latest developments in international financial markets and supervisory responses to the financial market crisis; and
- ensure that staff were equipped with the necessary tools and techniques in order to meet their everyday supervisory tasks.

the Department spent R887 000 on training

1.9.2 Key training interventions

Table 1.1 on page 36 depicts a list of some of the key local and international training interventions that were attended by staff members during 2009, followed by brief details regarding certain of these training interventions.

Table 1.1 Key local and international training interventions

Local	
Training intervention	Date
South African Institute of Chartered Accountants updates	10 February 2009
	27 February 2009
	30 June – 1 July 2009
	26–27 October 2009
	27 November 2009
Induction programmes (for new staff)	16 February 2009
	14 April 2009
	5 May 2009
	12–13 August 2009
Foundation courses (for new staff)	18–20 February 2009
	15–21 April 2009
	6–8, 11 May 2009
	14–19 August 2009
Moody's KMV credit portfolio engineering course	24–26 February 2009
Basel II Operational risk training programmes	25–27 February 2009
	2–4 March 2009
Global risk management presentation (by KPMG Australia)	10 March 2009
Course on treasury basics	24–25 March 2009
Advanced credit risk measurement and management course	20–21 April 2009
Institute of Internal Auditors International Conference 2009	10–13 May 2009
National Credit Act course	28 May 2009
Corporate governance and King III seminar	22 June 2009
Financial sector distress and risk analysis	27–28 July 2009
Fighting fraud seminar	24–26 August 2009
POLS management course	14–17 September 2009
KPMG IFRSs update	17 September 2009
Pillar 3 and IFRS 7 training workshop	6–9 October 2009
Business statistics and data analysis	7–9 October 2009
Credit risk portfolio models	15–16 October 2009
Companies Act and King Report update	5 November 2009
Validating and auditing internal rating systems	9–12 November 2009
Credit derivatives	11–12 November 2009
Bank risk in emerging markets	16–17 November 2009
Financial-sector distress and financial analysis	18 November 2009
Latest developments in financial instruments accounting	24 November 2009
Basel II and corporate governance	26 November 2009

International	
Training intervention	Date
FSI high-level meeting on the recent developments in financial markets and supervisory responses (Cape Town)	28–29 February 2009
Banking regulation and supervision (Gerzenzee, Switzerland)	3–22 May 2009
Advanced techniques in stress-testing seminar (Frankfurt, Germany)	17–21 May 2009
FDIC examination management course (Blantyre, Malawi)	31 May – 6 June 2009
Toronto Centre crisis preparedness programme (Stockholm, Sweden)	16–21 August 2009
Advanced bank supervision seminar (Frankfurt, Germany)	31 August – 4 September 2009
26th International Banking Supervision Seminar (Beatenberg, Switzerland)	6–11 September 2009
Financial regulation and supervision seminar (Cambridge, UK)	14–18 September 2009
MEFMI regional workshop (Dar es Salaam, Tanzania)	21–24 September 2009
FSI seminar on operational risk management and the recent financial crisis (Basel, Switzerland)	13–15 October 2009
Consolidated supervision seminar (Lusaka, Zambia)	18–22 October 2009
FSI seminar on supervisory standards and select financial stability issues (Basel, Switzerland)	3–5 November 2009
FSI seminar on practical techniques to implement Basel II (Basel, Switzerland)	10–12 November 2009

1.9.3 Local training interventions

1.9.3.1 Foundation courses

Four foundation courses were presented during the year, one of which was a week-long course presented to all graduate staff members who had recently joined the Department. These courses covered the following topics:

- An overview of the South African banking system.
- South Africa's banking regulatory framework.
- The principles of a risk-based supervisory approach.
- The specialised software programs used for analysis.

1.9.3.2 Basel II operational risk training programmes

key aspects covered during the programmes

In February 2009 and March 2009 Professor Duc Pham-Hi, from the Ecole Centrale d'Electronique Graduate School of Engineering in Paris, France, conducted two operational risk training programmes of two-and-a-half days each for approximately 40 employees of the Department. The overarching objective of the specialised operational risk training was to enable participants to challenge banks effectively when reviewing their risk models. Useful insights were drawn from the trainer's practical commercial banking experience and the work he performed at the French Banking Commission, Banque de France. The key aspects covered during the programmes included the following:

- *Loss distribution approach (LDA) modelling*: Theoretical background; LDA in practice; and extracting frequency and severity from a loss database.
- *Combining severity and frequency using a Monte Carlo simulation*.
- *Scenario-based approach (SBA): Practical background:* How a combined LDA and SBA approach work, demonstration of extraction of severity and frequency from experts and calculating VaR using Microsoft Excel.
- *What to look for when reviewing banks' AMA projects, testing and back-testing*: How to view AMA capital modelling and economic capital projects in banks (using not only knowledge of their models' output and input, but also looking at their staff bias, population, top management involvement in modelling and budget, or "how not to spend money on models from which you learn nothing").

1.9.3.3 Pillar 3 and IFRS 7 training workshop

During October 2009 a two-day workshop and training exercise was provided by Mr Shamim Diouman, Manager of Risk and Regulation at the Institute of Chartered Accountants of England and Wales (ICAEW). The programme, among other things, covered the following topical areas:

- An introduction to Pillar 3 disclosure requirements: market discipline and characteristics of Pillar 3 disclosure.
- Pillar 3 disclosure requirements: The standardised approach.
- Pillar 3 disclosure requirements: The advanced approach.
- Latest amendments to Pillar 3.
- Introduction to IAS 1 and IFRS 7.

The programme provided participants with insight into the interaction of Pillar 3 disclosure with accounting disclosures and the use of public disclosures by supervisors and was further augmented and given a practical flavour with the involvement of participants in various case studies.

1.9.4 International training interventions

1.9.4.1 Banking regulation and supervision (Gerzenzee, Switzerland)

seminar was designed for central bank staff members

In May 2009 a representative of the Department attended a course on banking regulation and supervision at the Gerzensee Study Centre in Switzerland. The centre offers courses to central bankers across the globe. While the majority of the courses presented are designed for economists, it also offers courses applicable to various other areas within central banks. The seminar was designed for central bank staff members in middle management positions with several years of professional experience in central banking. Twenty-five countries attended.

The course on banking regulation and supervision reviewed the economic rationale for bank regulation and supervision. These two aspects were examined from an analytical and an institutional viewpoint. A major part of the course was to identify the sources of bank risk, such as interest rate, credit, liquidity and market risk. For this purpose, the roles and functions of commercial banks were examined thoroughly. While many of the risks are at the bank level, the macroeconomic environment influences them. A survey of the main macroeconomic factors for banks was provided. A further element of the course focused on an analysis of the manner in which regulation and monitoring could best be implemented and performed in practice. Measures such as capital requirements, deposit insurance and non-bank activity regulation were carefully examined.

1.9.4.2 Advanced Techniques in Stress Testing Seminar (Frankfurt, Germany)

To ensure that the Department stays abreast of global developments in stress-testing practices the Department will continue to work closely with other regulators, where possible, and to develop staff. To achieve this, staff attended the 3rd Stress Testing Expert Forum: Advanced Techniques in Stress Testing Seminar,[8] hosted by the IMF in Frankfurt, Germany, during May 2009. Attendance not only provided the opportunity to network with stress-testing experts from other supervisory agencies and institutions, but also provided detailed information regarding best practice in stress testing as performed by banks and supervisors.

Areas that received particular attention at the seminar included the following:

- The importance of the interaction between risk types (e.g., a spillover from a credit risk scenario to liquidity risk).
- Understanding the impact of the feedback loop between the real and financial economy.
- The importance and complexity of understanding the possibility of spillover between banks.
- The impact of globalisation in terms of cross-border effects.
- Pillar 3 disclosure.

1.9.4.3 Toronto Centre Crisis Preparedness Programme

programme also focused on the importance of a crisis management plan within a financial system

In August 2009 the Toronto Leadership Centre, in partnership with the World Bank, organised a Crisis Preparedness Programme hosted by the Sveriges Riksbank in Stockholm, Sweden. The programme, which was designed for financial regulators and supervisors, central bankers, deposit insurance and senior micro-finance officials, and attended by a representative of the Department, afforded participants the opportunity to participate in a full-scale financial market crisis simulation exercise. Participants

8 www.imf.org/external/np/mcm/financialstability/conf/051909.pdf.

assumed and practised the roles of monetary policy-makers in central banks, supervisory or regulatory authorities and deposit insurance corporations in managing a crisis arising from problems in a potential systemic financial institution. The programme also focused on the importance of a crisis management plan within a financial system. The discussions during the programme focused on the following key issues:

- *Contingency or crisis management planning for financial supervisors*: Contingency planning by financial supervisors enables them to be prepared for events that could destabilise the financial system and result in a financial crisis. Planning for unexpected events in the future, such as disasters and terrorist attacks, enables supervisors to better manage, mitigate or prevent real crises when they emerge. This could result in lower costs during a real crisis and encourages more effective supervision. Accordingly, the main objectives for contingency planning by financial supervisors are to place them in a better position to detect a crisis, to avoid or mitigate crises and to be able to manage a crisis should it occur. It was highlighted that every crisis is unique and a contingency plan cannot accommodate every potential crisis that could take place. Contingency planning is also time consuming and requires a continuous effort by, and utilisation of, senior resources to keep the plan up to date and efficient.

- *Elements of a good contingency plan*: The following aspects were covered:

  – *Understanding the financial system and the systemically important players in the system*: This could be achieved through the evaluation of financial institutions and market vulnerabilities. The major sectors and exposures within the financial system should be identified, as well as the major entities such as the payment and settlement systems. It is also important to set the basic framework and understand which entities are systemically important and to understand the major linkages within the financial system, locally and internationally. The process should enable authorities to assess the immediate impact of a crisis shock on the financial system and the channels by which it would be transmitted to other parts of the system. The different authorities involved should have a shared understanding of the criteria that will be employed to perform the aforementioned assessment and the threshold at which a problem will be judged as systemic, justifying public intervention. A framework for systemic assessment will facilitate the prioritisation of information gathering and sharing, and decision-making.

  – *Understanding the internal and external risks to the financial system*: This could be referred to as 'macroeconomic surveillance' of the financial system by identifying internal and external risks, and by monitoring any changes in the risk areas. Periods of rapid growth in credit, asset values and capital flows would be sufficient cause for concern. It is therefore critical to conduct regular stress tests to evaluate the impact of potential risks on the financial system.

understanding the internal and external risks to the financial system

  – *Identifying the parties with whom the financial supervisor would have to co-operate during a financial crisis*: This could include other government agencies, media outlets, foreign home or host supervisors of parent companies and subsidiaries or branches of local institutions. The names and contact details of key persons and co-ordinators should be readily available and all potential sources of financial assistance should be considered and in place. It needs to be clear in advance how information-sharing, assessment and decision-making among authorities are going to work in practice during a crisis. If the process is not systematic, co-ordination will fail or the full range of considerations or options will not be taken into account in making decisions. Management of the crisis will tend

identifying the parties with whom the financial supervisor would have to co-operate during a financial crisis

to be reactive, rather than proactive and strategic. Inability of the authorities to respond swiftly and decisively to a crisis will add to the public costs and the reputational damage of all parties.

reviewing the legal powers and resources for managing a crisis

– *Reviewing the legal powers and resources for managing a crisis*: This could include the evaluation of crisis preparedness arrangements and inter-agency contingency plans. A list with the main steps in managing a financial crisis should be prepared. There needs to be a review of the financial sector legislation and regulations to ensure that the powers are adequate for each step of the crisis plan to be executed and action should be taken to make the necessary changes and enhancements. All resources should be adequate to manage a crisis, and contingency plans should be in place to obtain and maintain the required resources.

preparing a crisis plan to guide supervisors and others in managing a crisis

– *Preparing a crisis plan to guide supervisors and others in managing a crisis*: All past crisis events in the country and in other countries should be researched, and all lessons learnt should be noted and considered during the development of a crisis plan. The crisis management process should be agreed in advance and tested so that those involved in the process are familiar with their roles and the process can be refined and improved.

summarising the crisis plan in a user-friendly format such as a handbook

– *Summarising the crisis plan in a user-friendly format such as a handbook*: In the event of a real crisis, time is of the essence and key guidance should be summarised in an easy-to-read document, referenced to the master plan. It should be ensured that the handbook, together with the master plan, is kept up to date at all times.

strengthening legal powers, resources and crisis planning

– *Strengthening legal powers, resources and crisis planning in response to lessons from simulations*: Crisis simulation exercises will identify weaknesses in powers, resources, planning and readiness. Therefore, it is important to follow up on all weaknesses and to address them timeously. This may require changes to existing legislation, more resources might be necessary and the crisis handbook may need updating. Crisis management plans and policies should be current and not lag behind structural changes in the system.

1.9.4.4 Advanced bank supervision seminar (Frankfurt, Germany)

seminar organised for specialists working with the advanced Basel II methods

The Deutsche Bundesbank invited the Department to attend an advanced bank supervision seminar in Frankfurt, Germany in September 2009. The seminar was organised specifically for specialists working with the advanced Basel II methods to impart knowledge and expertise on the implementation of Basel II, and to share their experiences from on-site examinations of banks that adopted the IRB approach.

The seminar was attended by participants from 19 different countries and the topics that were covered included the following:

- The IRB approach, its approval processes and subsequent monitoring.
- Recent regulatory developments regarding CRAs. The discussions focused on the future role of external ratings in the calculation of banks' required capital.
- Credit risk mitigation instruments used in different countries. Common findings from on-site examinations were also shared among participants.
- Treatment of securitisation exposures, with special attention being placed on the proposals by the Basel Committee to enhance the Basel II framework relating to re-securitisation structures and liquidity facilities provided by banks.

1.9.4.5 Financial regulation and supervision seminar (Cambridge, United Kingdom)

seminar focused on three broad themes

A representative of the Department attended a financial regulation and supervision seminar in September 2009 which was hosted by Central Banking Events at Clare College, Cambridge, in the United Kingdom (UK). The seminar focused on three broad themes in respect of which participants discussed and shared their views namely:

- Lessons learnt from the financial crisis which covered, among other things, measures under consideration by the Basel Committee and the FSB, and how these measures would impact on national supervisors. In addition, there were discussions on the challenges of home-host supervisory co-ordination.
- New regulatory directions focused on changes to Basel II, frameworks for dealing with troubled financial institutions and a regulatory approach to hedge funds and OTC derivatives. There were also discussions on transparency, disclosure, accounting and valuation rules.
- Financial infrastructure and stress testing, which also included discussions on credit risk and financial stability, valuation models, capital and liquidity.

1.9.4.6 Financial Stability Institute seminar on operational risk management and the recent financial crisis (Basel, Switzerland)

objective of the seminar was to discuss the latest developments on operational risk management

The FSI hosted a seminar on Operational Risk Management and the Recent Financial Crisis in Basel, Switzerland, from 13 to 15 October 2009. The seminar was targeted at banking supervisors who are responsible for developing policy and/or supervising operational risk management. The objective of the seminar was to discuss the latest developments on operational risk management in the context of the financial crisis. In particular, the seminar provided a forum, in which a member of the Department participated, to discuss the following topics:

- Lessons for operational risk regulation and supervision arising from the financial crisis.
- Current operational risk management practices at banks.
- Operational risk loss data collection and AMA implementation during the financial turmoil.
- Recent trends in operational risk events (fraud, legal risk and issues arising from bank restructurings).
- The 2008 Basel Committee loss data collection exercise.
- Current work on Basel II implementation.

1.9.4.7 Financial Stability Institute seminar on supervisory standards and select financial stability issues (Basel, Switzerland)

The FSI held a seminar on supervisory standards and select financial stability issues in Basel, Switzerland, in November 2009 to which the Department was invited. The topics discussed during the seminar included the following:

- An overview of banking soundness and financial stability covering the interaction between accounting standards and prudential regulation, the interaction between the financial sector and the real economy, the nature of systemic risk and the cost of crises and financial instability (including the cost of the dislocation of markets/intermediation and the disruption of investment and consumption patterns).
- A central bank perspective on maintaining financial stability.
- An overview of the Core Principles and the implementation and assessment processes relating thereto, including the FSAP and the ROSC.

- The IMF's perspective on global financial stability and the challenges ahead.
- The insurance core principles and response of the IAIS to the global financial crisis. The key objective of the IAIS is the promotion of global financial stability through policyholders' protection and the promotion of efficient, fair, safe and stable insurance markets. This is achieved, *inter alia*, through the development of principles, standards and guidance, encouraging the implementation of the principles and standards, the development of assessment methodologies, encouraging co-operation amongst insurance supervisors, co-operation with other international organisations and being the representative for insurance supervision.
- An overview of current issues in governance and financial stability.
- The objectives and principles of securities regulation and response of the IOSCO to the global financial crisis. The key objectives of securities regulation included investor protection, fair efficient and transparent markets and the reduction of systemic risk. IOSCO's response to the global financial crisis entailed setting up task groups to deal with various topics, including unregulated entities with specific focus on hedge funds, unregulated markets and products focusing on securitised products, short selling, supervisory co-operation and a review of the IOSCO principles.
- Industry views on compensation practices, corporate governance and financial stability.
- Lessons learnt from the global financial crisis from a CRA's perspective and the role of CRAs. The case for regulation of CRAs was also discussed.
- The recent financial crisis and the Basel Committee's response thereto.
- Systemic risk and a macroprudential framework for supervision, including stress testing.

1.9.4.8 Financial Stability Institute seminar on practical techniques to implement Basel II (Basel, Switzerland)

seminar on practical techniques to implement Pillar 2

A representative of the Department attended a seminar on practical techniques to implement Pillar 2. The seminar, which was hosted by the IMF was held in Basel in November 2009, covered the following topics:

- Latest work of the Basel Committee on Pillar 2 implementation.
- Economic capital in a banking institution.
- Current trends and developments in economic capital and internal capital-adequacy assessment processes (ICAAPs) at banks.
- Implementation of Pillar 2 and its linkages with stress testing.
- ICAAPs analysis and Pillar 2 approach.
- Aspects of Pillar 2 supervision related to financial conglomerates.
- General principles of economic capital models.
- Implementation of Pillar 2 in various jurisdictions.
- A case study on practical techniques to implement Pillar 2.

The presenters were from the financial industry, accounting and consulting firms, banks, central banks and supervisory agencies. Interventions such as these provide invaluable input to benchmark South Africa's Pillar 2 implementation against best practice.

1.9.5 Regional co-operation

1.9.5.1 Regional Seminar on Consolidated Supervision

The FSI invited the Department to attend a regional seminar on consolidated supervision, jointly hosted by the FSI and the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), in Lusaka, Zambia, in October 2009. A senior representative of the Department attended the seminar and presented two topics, namely

- Supervision of financial groups: the South African perspective; and
- Capital-adequacy principles for a financial conglomerate.

Other important topics covered at the seminar included the scope and application of Basel II, accounting issues, aspects of risk and capital assessment as well as cross-border issues and home-host relationships. Presenters of these topics were sourced from the FSI, the FDIC in the US, the Office of the Superintendent of Financial Institutions (OSFI) in Canada, the Reserve Bank of India, the Reserve Bank of Nigeria, the Reserve Bank of Zimbabwe and Standard Chartered Bank Zambia Plc.

important topics covered at the seminar

The seminar was attended by 22 senior delegates from 12 different southern African countries. All delegates contributed to the success of the seminar and valuable information was shared between supervisors of the African region in the round table discussions that took place in the course of the seminar. Delegates were able to share and better understand the challenges supervisors face throughout the Africa region, and attained valuable knowledge and additional skills to facilitate the implementation and/or further enhancement of consolidated supervision in their various jurisdictions.

1.9.5.2 Risk-based supervision on Basel II implementation

The Department participated in a workshop in September 2009 under the auspices of MEFMI in Tanzania on risk-based supervision. The participants at the workshop represented eight African countries. The objectives were, firstly, to focus on ensuring compliance with Basel I, especially in respect of implementing a capital charge for market risk and, secondly, to share the Department's experience on the implementation of Basel II. The following topics, which were presented by a senior official of the Department, were discussed:

workshop on risk-based supervision

- The South African experience: IRB credit model approvals
  - Stages in implementation.
  - Accord Implementation Forum.
  - Process followed for IRB applications.
  - Home/Host involvement and reliance.
  - Post Basel II Implementation.

- Pillar 1: Challenges in implementing IRB
  - How well are banks implementing IRB.
  - Evaluating internal and regulatory capital requirements.
  - Challenges in validating models.

- Pillar 1: IRB: Implications for supervisors
  - Historical loss data.
  - Gaps in data maintained for banks.
  - Checklist for supervisors.
  - Recognition of external credit assessment institutions (ECAIs).

1.9.5.3 International Monetary Fund Mission: Kenya

The IMF, through its support for the development of appropriate regulatory practices, requested assistance from the Department with the implementation of regulations for market risk in Kenya. Under the branch known as 'East AFRITAC' (East Africa Regional

implementation of regulations for market risk in Kenya

Technical Centre), the IMF arranged a mission to the Central Bank of Kenya (CBK) structured around a workshop for members of staff of the Bank Supervision Department of the Central Bank of Kenya (BSD-CBK).

The CBK, with prior assistance from East AFRITAC, had prepared their legislative framework in the form of draft market risk regulations, guidelines and returns and BSD-CBK staff had received initial training in calculating market risk exposures. BSD-CBK sought assistance in further developing its draft market risk framework and training through a review of the draft regulations, guidelines and returns. In particular, BSD-CBK staff members required training on matters relating to the use of regulatory instruments in the calculation of market risk exposures.

A senior representative of the Department conducted the workshop at CBK in October 2009. The scope of the workshop covered the nature and origin of market risk, the rationale behind capital requirements for market risk and characteristics of market risk management in banks. More specifically, the mechanics of calculating capital under the standardised approach to market risk was illustrated in detail. Recommendations were made with regard to the elements of the regulatory framework and the processes involved in conducting appropriate supervision were explained. The mission was regarded as effective and subsequent interaction between the bank supervision departments of the South African and Kenyan central banks was planned for 2010.

1.9.5.4 Meeting with Namibian regulators

the Department met with senior banking supervision representatives of the Bank of Namibia

In August 2009, representatives of the Department met with senior banking supervision representatives of the Bank of Namibia (BoN). The objectives of this meeting were to:

- discuss the general impact of the global financial crisis;
- share the Department's experiences of the key challenges of implementing Basel II, including the results of the Department's assessment and analysis of the so-called "parallel runs", whereby banks were required to submit both the existing and proposed statutory returns.
- Inform the BoN of the proposed amendments to the Regulations relating to Banks, as a result of, among other things, recent publications issued by international standard-setting bodies, such as the Basel Committee, the FSB and the G-20, and the evolvement of the latest risk management practices;
- present an in-depth overview to the BoN of the Department's assessment of the adequacy of a bank's capital, including the key challenges in performing such an assessment;
- discuss the impact of the Basel II requirements on the licensing of new banks; and
- discuss the use and regulation of commercial paper in South Africa.

The BoN found the discussions beneficial as it was in the process of phasing in the implementation of the Basel II standardised approaches in Namibia.

1.10 Issues to receive particular attention during 2010

In addition to fulfilling its normal supervisory and regulatory tasks, the Department will focus specifically on the following issues during 2010:

- Ongoing review and amendment of the banking legislative and regulatory framework in South Africa to ensure that it reflects local and international market developments and complies with international regulatory standards, including responses by various

standard-setting bodies in order to address specific weaknesses revealed by the financial crisis.
- Continued refinement of the Department's supervisory review and evaluation processes.
- Continued participation in the various international fora to formulate further internationally-agreed requirements to strengthen the resilience of the banking sector.
- Participation in the Basel Committee's comprehensive quantitative impact assessment of the capital and liquidity standards proposed in the consultative documents released in December 2009.
- Further development and implementation of the Department's common scenario stress-testing methodology and process in respect of banks' capital adequacy and liquidity.
- Continued performance of thematic reviews focusing on backtesting of credit risk models.
- Ongoing monitoring and assessment of the potential impact on the banking sector of the international framework for liquidity risk measurement as proposed by the Basel Committee.
- An assessment of the degree of proprietary risk taken by banks through trading off the banks' capital base and the level of residual risk resulting from client business and through market-making.
- Ongoing focused reviews of banks making use of advanced approaches to calculate credit risk, market risk and operational risk capital requirements.
- Continued monitoring of banks' compliance with AML/CFT legislation.
- Continued investigation of illegal deposit-taking by unregistered institutions and persons, and participation in consumer education initiatives.
- Ongoing training of staff to meet the challenges of the changing regulatory and supervisory landscape.

continued refinement of the Department's supervisory review and evaluation processes

thematic reviews focusing on backtesting of credit risk models

ongoing training of staff

1.11 Expression of gratitude

I wish to express my appreciation to both the previous and current Ministers of Finance, Mr Trevor Manuel and Mr Pravin Gordhan respectively, for their valued input on requests in terms of statutory requirements and in terms of ongoing general counsel. To the previous Governor of the Bank, Mr Tito Mboweni, the current Governor, Ms Gill Marcus, and Deputy Governor Xolile Guma, thank you for your co-operation, guidance and support during 2009. A word of thanks also to my colleagues with whom I serve on the Governors' Executive Committee of the Bank.

During 2009 the Department also continued its close co-operation with several individuals and organisations, locally and abroad. These include, to name but a few, the senior executives of banking institutions and their external auditors; the Banking Association South Africa; the Standing Committee for the Revision of the Banks Act, 1990; the Chief Executive of the Financial Services Board and his staff; the Basel Committee; the FSI; central bankers and bank supervisors, both in southern Africa and elsewhere in the world; and staff of other departments of the Bank.

Last, but not least, my sincere appreciation goes to the staff members of the Department who continued their efforts, with professionalism and enthusiasm, during a year filled with ever-increasing challenges and demands.

Errol M Kruger
Registrar of Banks

Chapter 2: Promoting the soundness of the banking system: Overview of supervisory activities

2.1 Introduction

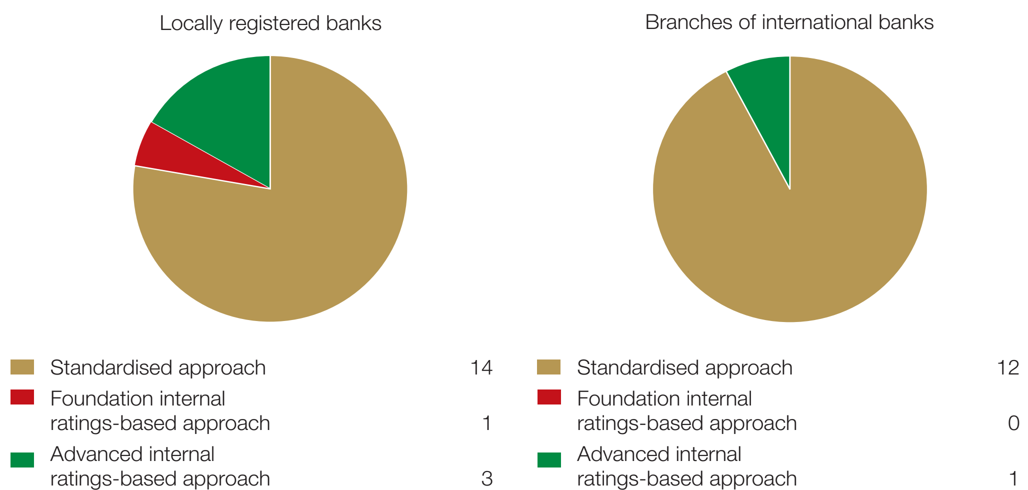
Risk oversight in terms of Basel II includes both compliance-based supervision of Pillar 1 risks[9] and Pillar 2 prudential supervision[10] of a bank's inherent sources of risk and its controls to manage them. This chapter reports on the supervisory activities of the Department, with specific focus on the key Pillar 1 risk areas being monitored, that is, credit risk, market risk and operational risk and the Department's ICAAP under Pillar 2. In addition, the developments in respect of Pillar 3 disclosure, stress testing and consolidated supervision are also discussed.

2.2 Credit risk

menu of approaches to determine the minimum required regulatory capital relating to credit risk

Under Pillar 1, banks in South Africa can choose from a menu of approaches to determine the minimum required regulatory capital relating to credit risk. As at 31 December 2009 South African banks implemented the following approaches:

Figure 2.1 Number of banks per credit risk approach (December 2009)



The Department continued to perform both compliance-based and prudential supervision of banks, and continued to review and monitor the impact of market conditions on South African banks' credit risk profiles and portfolios through a number of initiatives. The work carried out during 2009 covered the following:

- Quantitative analysis.
- Review of self-assessment templates submitted by banks.
- Focused reviews of standardised approach (SA) requirements for credit risk.
- Focused credit risk on-site reviews of IRB requirements.
- Processing of applications by banks to implement new or revised models and rating systems.
- Reassessment of eligible external credit assessment institutions.

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9 Pillar 1 is a subsection of Basel II which sets out the minimum capital requirements to meet credit risk, market risk and operational risk that every bank should strive to meet.

10 Pillar 2 is a subsection of Basel II which sets out the requirements for supervisory review and for banks to assess their capital adequacy relative to their overall risk profile. Supervisors are required, under Pillar 2, to take appropriate actions in response to the assessments performed.

2.2.1 Quantitative analysis

During 2009 the quantitative analysis of credit risk information focused on the quality of regulatory reporting, with specific emphasis on impaired and defaulted advances and specific impairments. Discrepancies and inconsistencies in banks' interpretation of the requirements contained in the Regulations relating to Banks were identified through trend analysis of key credit risk data submitted by banks and through peer-group analysis.

focus on the quality of regulatory reporting

2.2.1.1 Credit risk survey

The Department paid particular attention to the guidelines contained in principles 8 and 9 of the Core Principles which deal with (1) the alignment between a bank's credit risk management processes and capital and the bank's size and complexity and (2) problem assets, provisions and reserves. In order to discharge part of its duties as specified in these principles, the Department undertook a survey on credit risk during the latter half of 2009 which involved nine participating domestic banks.

the Department undertook a survey on credit risk

The survey focused mainly on retail exposures of the banks and covered credit risk management in a wider sense. Participating banks were requested to furnish the Department with the following information in respect of the months ended December 2008 and June 2009:

- Detailed ageing analysis of gross exposures in arrears and accompanying specific impairments held for asset classes and products specified.
- Haircuts, recovery periods and loss experience in respect of collateral held.
- Methodologies underpinning banks' portfolio and specific impairments.
- Detailed loan-to-value analysis of banks' residential mortgage portfolios.

The work carried out entailed mainly trend and peer-group analysis, and benchmarking against international best practice. Generally, the survey confirmed that banks were still experiencing stress in the retail portfolios, particularly in residential mortgages (also refer to section 4 – Credit risk). The results of the survey also revealed certain key issues that formed the basis of in-depth working sessions with selected banks to enhance the quality of credit risk data reporting and to clarify issues of an interpretive nature. In certain instances industry issues were identified that required further investigation to enable the Department to provide bank-specific and/or industry-wide guidance. Furthermore, the results of the credit risk survey highlighted certain issues that may require amendments to the Regulations relating to Banks.

banks were still experiencing stress in the retail portfolios

2.2.1.2 Cyclicality of capital

While stable levels of bank capital are preferred, the level of capital should also be commensurate with the inherent risk of a bank's business, specifically its associated credit risk. In support of the Department's mission to apply international regulatory and supervisory standards, further work was done during 2009 as a follow-up to preliminary findings of the SIGV in respect of the impact of cyclicality on banks that adopted the advanced approaches for measuring capital requirements in respect of credit risk. This was done in order to assess the impact of a downturn on banks' capital relative to the level of credit risk exposure and to ensure that the Department's supervisory actions did not exacerbate the situation. This will remain a focus point going forward and the Department will continue to monitor any further guidance issued by the Basel Committee in this regard.

2.2.2 Review of self-assessment templates submitted by banks

self-assessment templates to assess compliance with the minimum IRB requirements

Each bank that adopted one of the IRB approaches to calculate its exposure to credit risk (the IRB banks) is required to complete self-assessment templates to assess its compliance with the minimum IRB requirements as prescribed in the Regulations relating to Banks. As at December 2009 four domestic banks and one branch of an international bank adopted and implemented one of the IRB approaches.

The Department received the 2009 submission of the self-assessment templates (based on 2008 data) from all the IRB banks which were assessed and reviewed to identify gaps and exceptions. The definition of a 'gap' or an 'exception' as reported in the 2008 *Annual Report* (pages 23 and 24) remained unchanged. In instances where exceptions were noted, banks were required to provide project plans and target dates for compliance with the Regulations relating to Banks.

2.2.2.1 Identified gaps

The following gaps were identified:

- In some instances banks did not provide any information on the progress made to address the exceptions identified in the 2008 self-assessment.
- Similar to the 2008 submission, there was one instance where the required audit status of the work performed by the internal audit function was not provided.

2.2.2.2 Identified exceptions

The following common exceptions were identified:

capital-adequacy stress-testing processes still require improvement

- Sound capital-adequacy stress-testing processes still require improvement in some of the banks.
- Most banks still lack sufficient data history required to estimate internal risk parameters.
- The required annual review (rerating) of assigned borrower and facility ratings was not conducted by some of the banks.

2.2.3 Focused reviews of standardised approach requirements for credit risk

The main thrust of the work undertaken by the Department's Review Team during 2009 was to conduct reviews focusing on the implementation of the SA by banks. This entailed the review of the computation of regulatory capital in respect of credit and counterparty exposures, which, as reported in the 2008 *Annual Report*, was commenced with during 2008.

reviews also included an evaluation of the eligibility of the credit risk mitigation instruments

The reviews were risk-based and assessed the degree of compliance by each bank with the requirements of the Regulations relating to Banks, more specifically, the reviews assessed the correctness of the risk weights applied in the calculation of minimum required capital and reserve funds relating to credit risk, and the reasonableness of the credit risk classifications used. Where banks had availed themselves of credit risk mitigation, the reviews also included an evaluation of the eligibility of the credit risk mitigation instruments, the methodology employed and compliance with the credit risk

mitigation policy. Each bank was reviewed against the same criteria, but the methodology adopted for the reviews was adapted to the materiality of the bank.

The banks reviewed were found to have been diligent in their implementation of the SA and were generally compliant with the requirements of the Regulations relating to Banks as they applied to the SA. Typical findings included the following:

- Using either incorrect external credit assessments or incorrect rating scales to determine the appropriate risk weight.
- Assigning the incorrect CCF to off-balance-sheet exposures.
- Credit policies not incorporating the criteria for risk mitigation set out in the Regulations relating to Banks.
- Intangible assets not being deducted from capital and reserves.

The findings of the reviews were brought to the attention of the senior management of the banks concerned and their concurrence with, and a commitment to, rectifying the identified issues were obtained. The rectification of the issues is followed up in the normal course of the supervisory review and assessment process of the Department.

2.2.4 Focused credit risk on-site reviews of internal ratings-based requirements

The Department had significant interaction with banks during 2009 by means of focused on-site reviews that spanned selected retail and wholesale portfolios. When the results of the reviews undertaken during the approval process in 2007 were compared with reviews undertaken during 2009, it became evident that significant progress had been made by those banks that had adopted the IRB approaches to embed the rating and risk estimation systems and processes throughout the organisations. Internal ratings and default and loss estimates continued to be produced which, in most cases, formed an integral part of the banks' credit approval processes, risk management processes and internal capital allocation processes.

risk-based approach in selecting portfolios

The Department continued to follow a risk-based approach in selecting portfolios to be reviewed while the process for scoping on-site reviews remained unchanged from 2008. Emphasis was placed on progress made in addressing weaknesses identified during the 2008 focused on-site reviews and, in some instances, certain issues remained unresolved, and proved to be a challenge. For these banks the frequency of interaction was significantly increased to ensure that recurring issues received appropriate senior management attention and the relevant banks were required to present plans for resolution of identified issues to the Department.

2.2.4.1 Key findings

- *Governance of model validation:* During on-site reviews the Department stressed the importance of proper model governance processes, with emphasis placed on the composition and functioning of the designated committees appointed by the boards of directors to approve all material aspects of banks' rating and risk estimation processes. In this regard the enhancement of effective challenge was specifically highlighted. Furthermore, the importance of the internal audit function in the model governance processes was emphasised, specifically the timing of process audits performed on material models. The Department encouraged banks to complete

these process audits prior to model-related submissions being made to the designated committees.

some banks failed to complete the prescribed annual validation of models

- *Annual validation of models*: Owing to resource constraints, some banks failed to complete the prescribed annual validation of models. Most of these banks have, however, appointed additional resources to strengthen the existing capacity for validation. In most instances the Department found that the documentation standards and quality relating to processes surrounding validation required attention and improvement.

- *Ongoing monitoring of credit models*: Banks remained focused on improving and enhancing their management information relating to the ongoing monitoring of the performance of credit models. The Department regards this ongoing monitoring as a vital component of validation, but advised banks to guard against the possibility that the required independent validations are neglected. The importance of appropriate tests being performed as part of the monitoring process was also stressed during the on-site reviews.

banks to remain focused on data management and to improve data quality continually

- *Data quality*: The Department expects banks to remain focused on data management and to improve data quality continually.

- *Reasonableness of credit conversion factors applied*: In certain instances zero per cent CCFs were applied to uncommitted corporate facilities and it is the Department's view that, in practice, borrowers tend to utilise more of the credit lines close to the point of default. Applying a zero per cent CCF to an unutilised corporate facility complies with the letter of the Regulations relating to Banks, but does not necessarily reflect the underlying risk of additional drawdown of these credit facilities. Consequently, banks were requested to reassess the application of zero per cent CCFs to unutilised corporate facilities to determine the reasonableness thereof.

2.2.5 Processing of applications by banks to implement new or revised models and rating systems

Most of the IRB banks shifted their focus and efforts to reviewing existing rating and risk estimation systems in order to ensure the effective identification, measurement and monitoring of the risks to which their businesses are exposed. These reviews, in most instances, resulted in significant model and rating system changes.

material internal model changes or developments subject to a formal approval process

As reported in the 2008 *Annual Report*, the original approvals granted to the banks for the use of IRB approaches to calculate the minimum regulatory capital requirement for credit risk relate only to those internal models and rating systems included in the original applications submitted by banks. Any material internal model changes or developments (based on the banks' communication policy with the Department) that fall outside the scope of the original approvals granted by the Department are subject to a formal approval process prior to implementation thereof by banks.

As regards material changes in 2009 to model methodologies, material redevelopments or recalibrations which resulted in an increase in regulatory capital requirements, the Department agreed that banks could continue with the model implementation, provided that the changes had been subjected to the formal governance processes of those banks.

In these circumstances material model changes still need to be communicated to the Department, accompanied by relevant documentation such as model build

documentation and independent validation results. The notification has to contain an executive summary that includes certain prerequisite information and the chief executive officer of the bank concerned needs to certify that the increase in regulatory capital due to the planned model changes is, to the best of his or her knowledge, reflective of the underlying credit risk within the applicable portfolio. The Department, however, reserves the right to call for any further information and, if deemed necessary, might decide to initiate a formal review process.

During 2009 the Department received applications in which material changes to model methodologies, material redevelopments or recalibrations led to a decrease in the regulatory capital requirement. Some of these applications were approved subject to the following conditions:

- For a prescribed period the bank is required to maintain a prescribed percentage of the reduction in the minimum required capital and reserve funds for the specific model as additional capital in terms of regulation 38(4) of the Regulations relating to Banks under Pillar 2b.
- Upon termination of the prescribed period the bank is required to provide an updated calculation of the capital impact and a validation report that includes back-testing results, which is considered by the Department in determining whether the add-on should be maintained or removed.

2.2.6 Reassessment of eligible external credit assessment institutions

Under Basel II a significant level of reliance is placed on ratings issued by eligible institutions, which includes ECAIs and export credit agencies, in the calculation of minimum required capital and reserve funds relating to credit risk and securitisation exposures of banks. Consequently, it has become increasingly important for the Department to ensure that such eligible institutions continue to comply with the criteria outlined in the Regulations relating to Banks in order to assure that the ratings used by banks in determining capital requirements are reliable.

a significant level of reliance is placed on ratings issued by eligible institutions

In October 2009 the Department held meetings with the existing approved eligible institutions in South Africa, namely, Fitch Ratings (Fitch), Moody's Investors Service (Moody's) and S&P, requiring each of these ECAIs to demonstrate that it continues to comply with the minimum requirements for eligible institutions as set out in regulation 51 of the Regulations relating to Banks. In addition to information required in terms of regulation 51, the Department also requested the ECAIs to expand on the following areas:

- Rating methodologies for structured products.
- Significant changes in any eligibility requirement since the ECAI had been approved.
- The back-testing results for rating methodologies.

The Department found that the respective ECAIs improved their corporate governance structures and also improved their rating methodologies for structured products and that they still met the minimum requirements for eligible institutions as prescribed in regulation 51 of the Regulations relating to Banks.

Based on the findings above, the Department affirmed Fitch, Moody's and S&P as eligible institutions. The outcome of the Department's decisions was formally communicated to the respective ECAIs in December 2009.

the Department affirmed Fitch, Moody's and S&P as eligible institutions

2.3 Market risk

2.3.1 Introduction

Aftershocks of the financial crisis played out around the world and in South Africa on financial markets where trading slowed correspondingly. Levels of market risk in South African banks followed the attenuation in secondary market activity on the back of fundamental decline in economic activity in debt, equity, foreign exchange and commodities.

2.3.2 Market risk regulatory reporting methods

The Regulations relating to Banks include two alternative reporting methods for market risk, namely the internal models-based approach (IMA), and a standardised approach. Under approved circumstances, banks are also permitted to apply a combination of standardised and models-based reporting. At present five of the twenty-six banks exposed to market risk have permission to report according to the IMA.

2.3.3 Market risk reviews

Market risk reviews conducted in 2009 by the Department concentrated on banks with approval to use the IMA for regulatory reporting, while a review of the trading activities on one bank was also conducted. No new applications for using the IMA were received or processed.

reviews focus on changes in the sources of risk facing banks

In 2009 an annual review of the trading activities of IMA banks was supplemented by additional quarterly reviews. These reviews focus on changes in the sources of risk facing banks and their reaction in the form of changes in strategy, products, systems, structure, risk limits and capital. Recent performance of trading income generation and effectiveness of risk controls are also examined. The reviews complement the data already received by the Department in the form of regulatory returns and other prudential requirements of IMA banks such as monthly back-testing and stress-testing results. A total of 16 on-site meetings in the form of IMA annual reviews, quarterly reviews and treasury assessments were conducted.

2.3.3.1 Key findings

Key findings included the following:

Operational issues that resulted in poor performance of the VaR model became evident at some banks during the period and the multiplication factor used to prescribe the amount of capital a bank is required to hold was raised for those banks. A dramatic attenuation in market volatilities and consolidation among trading banks' counterparties, led to a general downscaling of trading activity, resulting in many banks struggling to achieve earnings targets from trading activities. Apart from the effects of the economic recession, announcements by international regulatory bodies on proposed new and changed regulations drove most of the retraction of banks and their counterparties from trading appetite.

Banks' exposures to equities that are generally held for investment purposes are included in the banking book for accounting purposes. From a regulatory perspective they receive capital treatment that is independent of the market risk charge and is more punitive, with the risk weighting ranging between 100 and 400 per cent. Fourteen banks

reported exposures of this nature in the course of 2009. Capital charges under these regulations contributed to approximately 5,2 per cent of banks' total capital requirements. For supervisory purposes, equity risk is overseen alongside market risk. Capital held for market risk made up approximately 2,3 per cent of the total capital requirement for the banking sector during the year.

capital held for market risk made up approximately 2,3 per cent of the total capital requirement

2.3.4 Thematic reviews of liquidity risk management and asset and liability management practices

Liquidity problems that brought an end to otherwise solvent and active banks in the US and UK in 2008 led the Department to pay closer attention to the management of liquidity risk and interest rate risk in banks. Liquidity risk management formed the basis of the Department's annual meeting with the boards of directors of banks during 2009. The Department required banks' senior management to assess their bank's compliance with principles for liquidity risk management as set out in the Basel Committee's paper Principles for Sound Liquidity Risk Management and Supervision. In addition, the Department initiated a thematic review of the asset and liability management (ALM) process at banks, examining the durability of liquidity risk management in the current turbulent financial climate and in the future under increasingly stressed circumstances.

the Department initiated a thematic review of the asset and liability management at banks

Under the ALM theme, both liquidity risk and interest rate risk were reviewed. A questionnaire was used to establish the fundamental drivers, controls and governance of ALM at each bank in an off-site assessment. Performance, trends and the structural nature of these risks were examined on the basis of regulatory return data received by the Department. An overall picture of the ALM at banks could then be ascertained. A decision was made, based on the basis of a bank's size, its systemic relevance or apparent weakness in its ALM, to follow up the off-site analysis with an on-site review. Findings were communicated with banks' management and included a need for the further strengthening of liquidity management practices and increased frequency of oversight over liquidity risk indicators. In a few remote instances the concept 'liquidity risk' was not well understood by the banks concerned. Further work in this area will continue in 2010.

Generally, banks in South Africa afford liquidity risk the degree of attention it requires under normal circumstances. However, banks' reaction to idiosyncratic liquidity shortages could benefit from enhanced planning for funding shortages in stressed markets. The structure of the South African financial sector has inherent anomalies that dictate the dominant mechanisms for intermediation and, consequently, funding between institutions involved in the financial sector. The challenge for banks is to develop alternative funding avenues under stressed circumstances and to lengthen the term of their liability structure.

banks' reaction to idiosyncratic liquidity shortages could benefit from enhanced planning for funding shortages in stressed markets

2.4 Operational risk

2.4.1 Introduction

Operational risk is inherent in all business activities. Similar to big natural and man-made disasters, most people largely ignore operational risk until it happens. Operational risk has to be minimised, whereas credit and market risk is normally optimised as it contributes to banking income by virtue of a risk–reward relationship. The scope of operational risk is broad as is the base of operational risk management. Operational risk

management is a reflection of how a bank's management manages the business, and management weakness itself is a significant component of operational risk. The banking system is subject to the full ambit of operational risk which, by definition, is the risk of loss resulting from failed or inadequate processes, people, systems and external events.

the Department recognises the principle of proportionality

The Department promotes sound operational risk management practices at banks and banking groups since it, in turn, contributes significantly to enhancing the soundness of the banking system. In line with the Department's supervisory review and assessment programme, a risk-based approach has been applied to the review of banks' operational risk. The Department recognises the principle of proportionality; in other words, the nature and extent of the operations and exposure of a bank or controlling company will influence the nature, timing and extent of operational risk management within a bank or banking group. According to the Department's principles, each bank and controlling company should have in place risk management policies and processes to identify, assess, monitor and control or mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank and controlling company.

The work completed during 2009 can be summarised in the following three categories:

- Focused operational risk reviews.
- Processing of new applications.
- Feedback regarding the 2008 loss data collection exercise (LDCE).

2.4.2 Focused operational risk reviews

A number of focused operational risk reviews were carried out during 2009. The purpose of the reviews was, among other things, firstly to determine whether risk management policies and procedures banks had in place to identify, assess, monitor and control or mitigate operational risk were effective. Secondly, to determine whether those banks that were using one of the four approaches for calculating operational risk capital, namely the AMA, the standardised approach (TSA), the alternative standardised approach (ASA) or the basic indicator approach (BIA), are meeting the qualifying criteria, and qualitative and quantitative standards.

The reviews were carried out in line with the risk-based supervisory approach and principle of proportionality and typically focused on

- an update of changes in the business environment (with specific reference to internal and external fraud, pressure on processes, exposure to business continuity risk, outsourcing risk as a result of service providers, operational risk related to credit and market risk) and the bank's response to it from an operational risk perspective;
- a detailed review of the management information reports or "dashboards" used for operational risk management on a group consolidated, bank, major subsidiary and material business unit level; and
- for AMA banks, a detailed review of the scenario approval, governance process and specific scenarios used by the bank in the AMA.

2.4.2.1 Key findings

The main findings from the reviews are as follows:

- *Changes in the business environment*: Some banks were encouraged to monitor information technology (IT) system capacity (e.g., pressure on systems due to increased debt collecting), capacity and readiness to handle new processes (e.g., the National Credit Act) and IT-based distribution and service channels (e.g., Internet and mobile

telephone banking) more closely. The Department stated in its 2008 *Annual Report* that IT was an area that required more attention. This statement was echoed during the period under review. IT governance was also one of the important new issues incorporated into the *Report on Governance for South Africa – 2009* (the King III Code).

- *Key supplier watchlists*: The Department recommended that certain banks compile a key supplier watch list (similar to a credit watch list) and monitor the financial status of key suppliers. Banks were referred to the Basel Committee's 2008 LDCE report, Table S4, Panel G: Common scenario descriptions by business line and event type: execution, delivery and process management. One of the most common and severe scenarios in this category was the failure of suppliers or vendors.

monitor the financial status of key suppliers

- *Boundary issues*: With reference to boundary issues, certain banks were requested to confirm that
  - credit risk losses were excluded from the operational risk capital requirement and that they continued to be treated as credit risk for the purpose of calculating minimum regulatory capital;
  - operational risk/market risk boundary events were included in the scope of operational risk for regulatory capital calculation;
  - material operational risk-related credit risk losses were being flagged separately within the internal operational risk database (for internal loss data collection and risk management purposes); and
  - appropriate actions were taken to detect and rectify or to prevent all operational risk-related deficiencies that could, or had, exacerbated material credit risk losses.

- *Operational risk management information*: Banks were encouraged to continuously improve the qualitative characteristics (i.e., reliability, relevance, comparability and understandability) of operational risk management reports on a consolidated, subsidiary and business unit level. Qualitative characteristics are those attributes that make the information provided in operational risk management reports useful. If comprehensive, useful information does not exist, management may not be aware of the true operational risk condition of their bank and key governance players may be misled. The following are the requisite qualitative characteristics of operational risk information:[11]

continuously improve the qualitative characteristics of the operational risk management reports

requisite qualitative characteristics of operational risk information

  - *Relevance*: Information must be relevant because it influences the economic decisions of users by helping them to evaluate past, present and future events or to confirm or correct past assessments. The relevance of information is determined by its nature and material quality. Information overload, however, can force players to sift through a plethora of information for relevant details, making interpretation difficult.

  - *Reliability*: Information should be free from material errors and bias. The key aspects of reliability are faithful representation, priority of substance over form, neutrality, prudence and completeness.

  - *Comparability*: Information should be presented consistently over time and be congruous with related information and other entities or business units to enable users to make comparisons.

11 Based on the IASB's framework for the preparation and presentation of financial statements.

- *Understandability*: Information should be easily comprehended by users with reasonable knowledge of business, banking, economics, accounting and risk management, as well as the willingness to study the information diligently.

AMA banks to assess current practice in addressing scenario biases

- *Scenarios*: The Department requested the governance committees of AMA banks to assess current practice in addressing scenario biases. Scenario biases, when addressed in the scenario development process, typically include over-confidence, motivational, availability, partition, dependence and anchoring.

Furthermore, the Department requested the AMA banks' internal audit departments to include in their audit programmes for 2009/10 an audit of the design and operating effectiveness of scenario policies and procedures. The Department required that these audits include the documentation of the scenario elicitation process, the completeness of the scenario results and the transparency of the underlying processes used.

For the limited number of cases where the Department was not satisfied with the level, status, sophistication or practical application of operational risk management, the banks were requested to address shortcomings or weaknesses and implement improvements. These banks provided feedback to the Department on a regular basis and the Department is comfortable with the progress made.

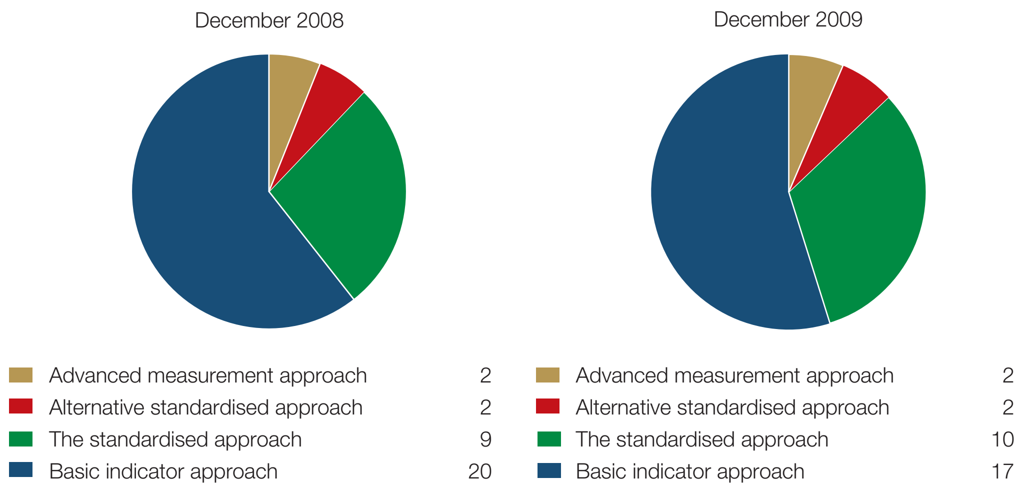
2.4.3 Processing of new applications

The Department received one application from a bank to adopt a more appropriate and sophisticated approach to calculate its operational risk exposure and regulatory capital. The application was in respect of TSA. The application and approval processes were similar to those followed in the previous years.[12] The applicant bank was granted approval to adopt the mentioned approach.

2.4.3.1 Status of banks per operational risk approach

The number of banks that were using the respective approaches for operational risk as at the end of 2009 was as follows:

Figure 2.2 Number of banks per operational risk approach



12 Refer to the Bank Supervision Department 2007 *Annual Report*, pages 33 and 34.

2.4.4 Feedback on the 2008 loss data collection exercise

During 2009 the Department provided participating South African banks with a customised analysis comparing their data with industry data at both the international, and where possible, regional or national levels.

2.4.4.1 Results from the 2008 loss data collection exercise

- *Background*: The 2008 LDCE was conducted by SIGOR. It was the first international effort to collect information on all four data elements that are used in the AMA for operational risk in the Basel II framework. The results were discussed in two related papers, namely *Results from the 2008 Loss Data Collection Exercise for Operational Risk* and *Observed Range of Practice in Key Elements of Advanced Measurement Approaches*.[13] The former paper focuses on internal loss data, scenario analysis and operational risk capital, business environment and internal control factors (BEICFs), and external loss data. The AMA range of practice results are presented in the latter paper.

  first international effort to collect information on all four data elements that are used in the AMA

  The LDCE and observed range of practice (ROP) results provide a unique opportunity to assess operational risk data and practices across regions, thus furthering SIGOR's goal of promoting consistency in the implementation of the Basel II framework. The findings also present an opportunity for banking institutions to compare their operational risk management frameworks with those of other institutions and to identify potential areas for improvement.

  The 2008 LDCE consisted of three parts. The first part, Attachment A, comprised templates for submission of internal loss data and scenario analysis data along with a series of questions to provide information on the processes underlying these two data elements. The second part, Attachment B, requested information on exposure indicators and capital estimates. Exposure indicators included consolidated assets, gross income, Tier 1 capital and business line gross income. The final part, Attachment C, contained ROP questions regarding operational risk modelling, external loss data and BEICFs. Participating banks were asked to submit their LDCE information to their national supervisors.The data collection and analysis process for the 2008 LDCE was structured to preserve the confidentiality of the data submitted using procedures employed in previous Basel Committee exercises, including the 2002 LDCE and QIS-4.[14]

  LDCE consisted of three parts

- *Feedback to participating South African banking groups*: After the July 2009 publication of the two papers, the Department provided participating South African banks with a customised analysis comparing their data with industry data at both the international and, where possible, regional or national levels. The results were used to benchmark a banking institution's loss experience and to gain a better understanding of the completeness of its data. In addition, participating South African banks received an updated range of practice information on scenario analysis, external data, and business environment and internal control factors. This range of practice information can be used by participating institutions to assess and benchmark their practices against industry practices.

  range of practice information used to benchmark their practices against industry practices

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13 The papers are available at http://www.bis.org/publ/bcbs160.htm.

14 www.bis.org. See results from the 2008 LDCE for Operational Risk, Annex A for additional discussion of data security procedures used for the 2008 LDCE.

results provide regional and international comparisons of the frequency and severity of the banking industry's loss experience

- *Loss data collection exercise results*: The primary objective of the exercise was to further both supervisors and banking institutions' understanding of outstanding operational risk implementation issues, and to promote consistency in addressing these issues across jurisdictions. The exercise was open to banking organisations at the group-wide level that were using or implementing one of the Basel II approaches for calculating operational risk capital. Participation was voluntary and banking institutions could choose to participate in the full exercise or submit information only for certain sections. The results provide regional and international comparisons of the frequency and severity of the banking industry's loss experience; scenario analysis practices and estimates; internal loss data and scenario analysis normalised by certain exposure indicators; and operational risk capital levels and the impact of adjustments (e.g., expected loss offsets, correlation and the use of insurance) on AMA capital.

- *Overview of participants*: The LDCE Table 2.1 provides an overview of the number of participants.

Table 2.1: Geographic distribution of participating banks per capital approach

Geographic location	Total number of participants	Participants by capital approach	
		AMA	Non-AMA
Australia	11	5	6
Europe (including South Africa)	60	20	40
Japan	18	7	11
North America	23	10	13
Brazil/India	9	0	9
Total number of banks	121	42	79

five South African banking groups participated

Five South African banking groups participated, two of which were AMA banks and three non-AMA banks. The requirement for a stand-alone geographic breakdown was that a location (country at national level or a region) should have more than three participating banks per capital approach. This requirement would ensure the confidentiality of a bank's data. Since South Africa had only two AMA participants, it was neither possible to have a stand-alone South African geographical location nor to be grouped with the Brazil/India geographical location (since Brazil/India had no AMA participants). By agreement with national supervisors, South African banks were included in the European geographical breakdown.

121 institutions from 17 countries participated in the exercise

A total of 121 institutions from 17 countries participated in the exercise. For the purposes of the LDCE paper, an institution's operational risk approach was considered as either AMA or non-AMA. Of the 121 institutions, 42 were AMA banks and 79 non-AMA banks. Of the non-AMA banks, 51 use TSA and 20 use the BIA. The remaining 8 non-AMA banks were not classified by approach, since the BIA and TSA were not available approaches in the US. Participating institutions were placed into one of five regions: Australia, Europe, Japan, North America and Brazil/India. Europe was the largest region by number of countries and number of participants. This region consists of Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Poland, Spain, Switzerland, and the UK. For the reasons mentioned above, South Africa was also included in the European region for the purposes of this paper. The North American region included Canada and the US. The composition of the remaining regions is reflected by their titles.

- *Main findings*: Some of the paper's main findings are discussed below.[15] Additional results for internal loss data, scenario analysis and capital benchmarking are as follows:

results for internal loss data, scenario analysis and capital benchmarking

  – Overall, banks have made considerable progress in the collection and use of internal loss data since the previous international LDCE was conducted in 2002.

  – The frequency of internal losses of €20 000 or more varies significantly across regions when the data are scaled by various exposure indicators. For example, the typical (median) Japanese bank has a much lower frequency of losses compared with other regions, while typical banks from North America and Brazil/India have a higher frequency of losses. This variation in internal loss frequency may explain some of the regional differences in the combination of data elements in the ROP results.

  – Despite the regional variation in loss frequency noted above, there is some consistency in the severity distribution of operational losses across regions.

  – Most banks' scenario data extend the tail of the loss distribution beyond the point at which they have experienced internal losses. In many banks the number of scenarios greater than €10 million is approximately 20 times larger than the number of internal losses that are greater than this amount.

  – Although the number of large scenarios significantly exceeds the number of large internal losses, the frequency of large losses implied by scenarios and internal data is broadly consistent.

  – AMA banks have a higher frequency of internal losses greater than €100 000 than non-AMA banks, even when the data are scaled by exposure indicators. Some of the differences may be explained by the fact that AMA banks generally are larger, more complex banks with more mature loss data collection processes.

  – Operational risk capital for non-AMA banks is higher than for AMA banks, regardless of the exposure indicator used for scaling. For the typical AMA bank, the ratio of operational risk capital to gross income (10,8 per cent) is significantly below the BIA alpha (15 per cent) and also below the range of TSA betas (12–18 per cent). Furthermore, the amount of capital relative to the frequency of large losses is generally higher at non-AMA banks than at AMA banks.

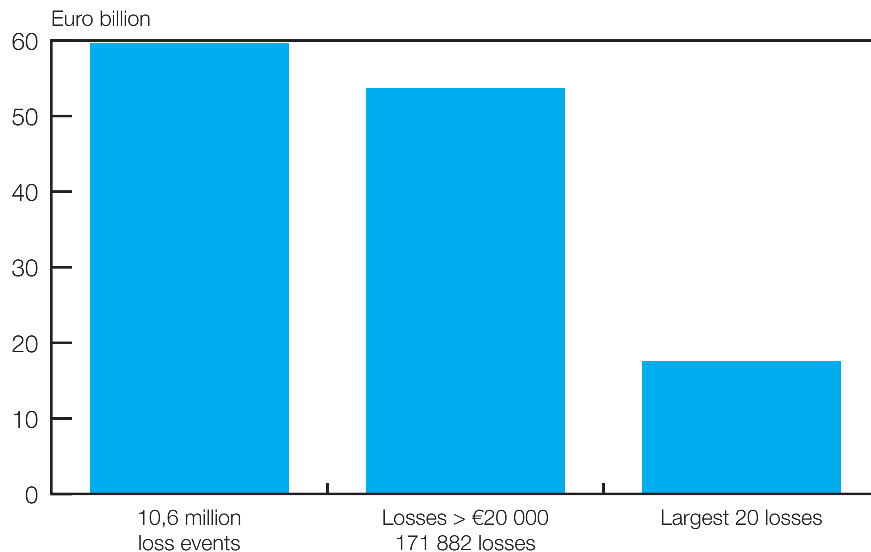
- *Internal loss data*: As most institutions provided data up to 31 December 2007 or 31 March 2008 in the 2008 LDCE, results do not reflect the impact of the recent turmoil in the financial markets. Participating institutions were asked to submit a minimum of three years of internal loss data that they viewed to be reasonably complete.

  As illustrated in Figure 2.3 on page 60, participating institutions submitted a total of 10,6 million internal losses with an overall loss amount of €59,6 billion. For losses of €20 000 or more, 171 882 losses were submitted totalling €53,7 billion. The 20 largest losses collected for this exercise totalled €17,6 billion and accounted for 29,5 per cent of the overall loss amount. The majority of losses of €20 000 or more was submitted by institutions in Europe and North America.

20 largest losses collected for this exercise totalled €17,6 billion

15 As taken from the Basel Committee's 'Results from the 2008 LDCE for operational risk', July 2009, pages 1–2.

Figure 2.3 Internal loss data



Some other notable findings for internal loss data are as follows:

- The business line with the highest loss frequency and total loss amount was retail banking. This result is consistent with the results from the 2002 LDCE and reflects that retail banking continues to be a primary business line for most participants.

event types with the highest frequency of losses were execution, delivery and process management

- As anticipated, the Basel II operational risk event types[16] with the highest frequency of losses were execution, delivery and process management, followed by external fraud.
- The Basel II operational risk event type with the highest annual loss amount was clients, products and business practices. Consistent with the 2002 LDCE, there were a few losses reported for business disruption and system failures, and damage to physical assets.
- The total loss amount for the typical bank for losses of €20 000 or more was €155 555 per annum for each billion euros in consolidated assets. For the typical AMA bank, the loss amount was €196 655, which was higher than the loss amount of €116 838 for the typical non-AMA bank.
- Insurance recoveries were reported for a small proportion of losses, with the typical bank reporting insurance recoveries for 2,1 per cent of losses.

data enables national supervisors to compare scenarios across jurisdictions

- *Scenario data*: The collection of scenario data enables national supervisors to compare scenarios across jurisdictions, and to assess how scenarios relate to internal loss data. The main findings for scenario data include the following:
  - Of the 121 LDCE participants 65 submitted a total of 9,687 scenarios.
  - The median number of scenarios used in participating banks' operational risk frameworks was 115 scenarios. There was significant variation across banks and regions in both the number and size of scenarios used, reflecting different uses and levels of reliance on scenarios for quantification and risk management.

16 The seven Basel II operational risk event types are: (i) internal fraud; (ii) external fraud; (iii) employment practices and workplace safety; (iv) clients, products and business practices; (v) damage to physical assets; (vi) business disruption and system failures; and (vii) execution, delivery and process management.

  - The typical bank had the largest proportion of scenarios in the unallocated business line (36 per cent), which includes group-wide scenarios, and in retail banking (28 per cent). By event type, the typical bank had the highest proportion of scenarios related to execution, delivery and process management (29 per cent) and clients, products, and business practices (20 per cent).
  - Most banks' scenario data extends the tail of the loss distribution beyond the point at which they have experienced internal losses.

- *Capital estimates*:

  - The typical AMA bank has a ratio of operational risk capital relative to gross income that is lower than the 15 per cent alpha for the BIA and the range of betas (12–18 per cent) used in TSA.
  - For AMA banks,
    - o use of insurance as a capital offset is limited with only a few banks calculating such an offset;
    - o expected losses account for about 11 per cent of operational risk capital at the typical participating bank. The use of expected loss offsets is limited, with half of the participants taking no capital offset, and three quarters of participants taking an offset of less than 1 per cent of operational risk capital;
    - o the modelling of dependence at the typical bank results in a modest (8,3 per cent) increase in operational risk capital relative to the assumption of full independence; and
    - o the typical bank decreases operational risk capital by 22,4 per cent due to diversification effects across operational risk categories.

expected losses account for about 11 per cent of operational risk capital

2.4.4.2 Range of practice results

The Basel II framework envisions that, over time, the operational risk discipline will mature and converge towards a narrower band of effective risk management and risk measurement practices. Understanding the current range of observed operational risk management and measurement practices both within, and across, geographic regions contributes significantly to SIGOR's efforts to establish consistent supervisory expectations. Through the analysis of existing practices, SIGOR is better able to promote the maturation of operational risk practices and support supervisors in developing more consistent regulatory expectations. As such, the Range of Practice report provides supervisors with an opportunity to engage banks individually in discussions of their operational risk management and measurement practices relative to their peers in domestic and international markets.

- The Range of Practice report
  - frames the discussion of observed practice in the management and measurement of operational risk, and identifies both emerging effective practices and practices that are inconsistent with supervisory expectations;
  - highlights supervisory issues encountered in the supervisory reviews of operational risk, whether related to governance, data or modelling; and
  - provides a resource for both banks and national supervisors to use in their respective implementation processes and ongoing development or monitoring of AMA frameworks.

The diversity in operational risk practices is consistent with the evolutionary nature of operational risk management as an emerging risk management discipline. To encourage growth in the discipline, the Basel II framework intentionally provides banks with a significant degree of flexibility in developing operational risk management frameworks under the AMA. This flexibility, however, does not suggest that supervisors are prepared

diversity in operational risk practices is consistent with the evolutionary nature of operational risk management

to accept any practice or process that the banks adopt in implementing their AMA frameworks. On the contrary, supervisors are concerned with identifying and encouraging bank operational risk practices that achieve robust and effective operational risk management and measurement systems that are consistent with the objectives of soundness and a level playing field.

- *Overview of participants*: For reporting ROP results, SIGOR decided to use only the responses from banks that had been accredited to use an AMA framework and those that member supervisors deemed to be serious AMA candidates. Consequently, the results included in the report highlight reasonably well-established and mature practices.

Table 2.2 Geographic distribution of participating banks

Geographic location	Number of participating banks
Australia	5
Europe (including South Africa)[17]	20
Japan	7
North America	10
Total	42

wide and diverse range of practices in key governance, data and modelling processes

- *Conclusions and observations*: The Range of Practice report states that SIGOR has seen a maturation of practice in many areas of operational risk management and measurement. Another important observation SIGOR makes is that there continues to be a wide and diverse range of practices in key governance, data and modelling processes that raise numerous issues regarding the consistency and reliability of AMA capital estimates in the industry. These key issues are listed below. With respect to each, SIGOR believes that further enhancement and evolution of practice is appropriate. Towards this end, SIGOR will continue to engage the industry in discussion to facilitate convergence of practice, where appropriate, and will undertake policy initiatives to clarify supervisory expectations, when necessary. Key issues identified included the following:

  – *Internal governance*

    o *Scenario analysis*: The current range of practices identifies a lack of consistent controls to address scenario analysis bias. SIGOR encourages the industry to continue to develop and improve AMA governance standards for scenario analysis, and will formulate additional guidance if needed to assist the industry.

    o Maintaining the integrity of BEICFs: There is little use in internal or external audit reviewing the integrity of BEICFs. Supervisors expect more active internal or external audit involvement in the review of a bank's use of BEICFs as AMA frameworks continue to mature.

  – *Data*

    o *Legal event losses*: Loss amounts from legal events tend to be used for risk measurement purposes after the legal events have been entered into the loss database. There is, however, a broad range of practices for when the loss amounts from legal events are used as a direct input into the model that

17 As agreed to by national supervisors, the two South African AMA banks were included in the European geographical breakdown. The reason for this was discussed in section 2.4.4.1 of this report.

quantifies operational capital, which raises questions of transparency and industry consistency in how these operational risk exposures are quantified for capital purposes. SIGOR encourages less variation in how legal settlements are treated and recorded as operational risk loss events, given their considerable impact on regulatory capital modelling.

less variation in how legal settlements are treated and recorded as operational risk loss events

- *Gross versus net internal loss amounts*: The absence of definitions in the Basel II text for 'gross loss' or 'recoveries' and varying loss data collection practices among AMA banks results in differences in the loss amounts recorded for similar events. This practice may lead to potentially large differences in banks' respective capital calculations. The range of practices is broad, particularly with regard to how AMA banks use 'net losses (gross loss net of non-insurance recoveries)' for risk quantification purposes. SIGOR believes a more consistent practice to the use of 'net losses' is needed.

- *Data collection thresholds*: Data collection thresholds vary widely across institutions and types of activity. Some institutions prefer to apply high thresholds that avoid enlarging their databases with events that are judged to be immaterial, while others choose lower thresholds in order to obtain more information for risk management purposes. Banks should be aware of the impact that their choice of thresholds has on operational risk capital computations. SIGOR believes the differences in how internal loss data are used or restricted in AMA capital models are significant and that the range of practice should be narrowed.

data collection thresholds vary widely across institutions and types of activity

– *Modelling or quantification*

- *Granularity*: The granularity of an AMA reflects the degree to which the framework separately models individual operational risk exposures. At present there is considerable diversity across banks in the choice of granularity of their models, which may be driven as much by the modeller's preferences as by actual differences in operational risk profiles. Under Basel II the number of operational risk categories employed in an AMA model should be sufficient to capture the major drivers of operational risk within the institution. Banks should test the relevance of their choice of classes in order to ensure the homogeneity of the classes and verify that other divisions would not have been better suited to their risk profile. SIGOR also believes it is desirable to progressively narrow the current range of practices in terms of how operational risk categories are used in modelling operational risk capital.

- *Dependence or correlation*: There remains a wide range of practices applied by AMA banks in their approach to, and modelling of, dependence or correlation. Given the uncertainties in calculating correlations, supervisors encourage more robust methods for calculating meaningful dependence relationships among operational losses. In addition, when estimating capital, AMA institutions should demonstrate that their models do not underestimate the probability of joint extreme events and, given these uncertainties, should include a suitable margin of conservatism in the calculation of dependence.

- *Distributional assumptions*: Nearly all banks model the severity and frequency distributions separately. While it is common for banks to use the Poisson distribution for estimating frequency, there is still a very wide range of practices in the choice of the severity distribution. SIGOR has identified principles in the

paper *Observed range of practice in key elements of advanced measurement approaches*.[18] that will help institutions choose distributions that are consistent with the underlying data. SIGOR believes banks should employ these or similar principles as part of their normal process to test the appropriateness of the choice of distributional assumptions.

- o *Use of the four elements*: The combination and weighting of the four elements are a significant issue for many banks, given the many possible combination techniques. This is an area where the range of practices is particularly broad and can complicate comparisons among banks. While the industry has made progress in the use of BEICFs, many banks are still not using them in their measurement frameworks. Scenarios are widely used. However, their use in risk measurement methodologies varies considerably from bank to bank. SIGOR believes that further convergence of practice in these areas is desirable. In addition to having a credible, transparent, well-documented and verifiable approach for the weighting of the four elements in their measurement system, banks should understand the impact that every element has on their capital calculation and the role that the element has in the measurement framework.

internal validation of model inputs, methodology and outputs

- o *Validation*: Given the multiple measurement frameworks and the "model risk" inherent in the estimation of operational risk exposures, SIGOR believes banks should perform additional activities in order to ensure the soundness of the capital measurement process. These activities may include internal validation of model inputs, methodology and outputs by reviewers with suitable expertise; more internal (or external) audit involvement; sensitivity and uncertainty analysis of capital (testing the accuracy of the capital estimate); and back-testing and benchmarking comparisons.

2.4.5 Conclusion

Although the Department is generally satisfied with the management of operational risk from a sectoral perspective, there is room for improvement. Banks are again encouraged to monitor the progression of operational risk towards the act of managing risk rather than merely keeping score. Since operational risk is an evolving management science and the business environment is constantly changing, management should ensure that the operational risk framework, policies and procedures are sufficient and appropriate. Improvements in operational risk will depend on the voice of operational risk managers being heard more clearly and their warnings acted upon. A constant challenge for management is to validate that sufficient assurance can be placed on the design and operating effectiveness of the operational risk framework, policies, procedures and internal controls to identify, assess, monitor and control or mitigate operational risk to which the entity is exposed.

2.5 Pillar 2: Internal capital-adequacy assessment process

2.5.1 Introduction

the adequacy of a bank's capital needs to be assessed by both the bank and the Department

In terms of the Banks Act, 1990, banks and banking groups are required to maintain, at all times, overall financial resources that are adequate in respect of both amount and quality to ensure that the risk that they cannot meet their liabilities as they fall due is minimised. To put into practice the aforementioned, the adequacy of a bank's and banking group's capital needs to be assessed by both the bank and the Department.

18 The paper is available at http://www.bis.org/publ/bcbs160.htm.

In terms of the Banks Act, 1990 and the Regulations relating to Banks,
- banks and banking groups are required to perform an ICAAP; and
- the Department is required to carry out a supervisory review and evaluation process (SREP).

2.5.2 Focus areas during 2009

As stated in the 2008 *Annual Report*, the focus of the ICAAP reviews for 2008 was on the five largest banks. The Department concluded in the report that future work would focus on the following:

- Thematic review of the larger banks in 2009.
- A review and discussion of the smaller banks' ICAAPs during 2009.

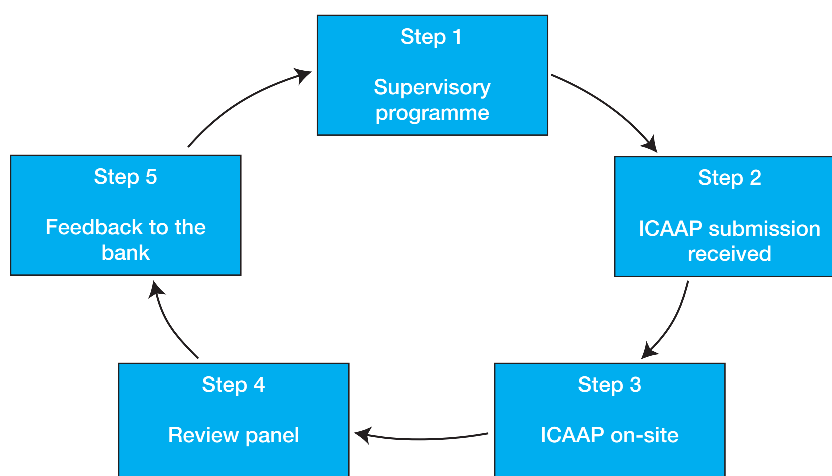
Pillar 2 stress testing would be a focus area for the thematic reviews in 2009

Consequently, it was decided that Pillar 2 stress testing would be a focus area for the thematic reviews in 2009. Large banks that made use of the advanced approaches for credit and market risk were targeted for the thematic review which is covered in more detail in section 2.7.4 of this report. In respect of the smaller banks' ICAAPs, the majority of these were visited and assessed. The Department intends to complete the process in 2010.

2.5.3 Process for the assessment of an internal capital-adequacy assessment processes

The ICAAP review process followed for the smaller banks was similar to the one followed for the five largest banks in 2008. In the Department a typical ICAAP process consists of the following steps:

Figure 2.4 Process for the assessment of an ICAAP



Step 1: The supervisory programme is communicated to the bank together with an ICAAP submission and on-site dates.

Step 2: The Department receives the ICAAP submission on the due date. Desktop analysis of the submission is done. Communication takes place between the Department and the bank to clarify specific areas (i.e., where areas of

uncertainty exist with regard to the submission or more clarity is requested). The information received is compared with the information gathered from the SREP cycle (as discussed in the Department's 2007 *Annual Report,* page 28–30).

Step 3: The results of the desktop analysis and ICAAP submission are discussed with the bank. The bank and the Department challenge each other on their findings to ensure that a structured dialogue takes place. A conclusion is reached on the way forward. More detailed reviews may be requested on specific areas.

Step 4: The conclusion is presented to the Department's review panel for consideration. The review panel decides on the conclusion to be presented to the bank.

Step 5: The conclusion is presented to the bank and the bank is afforded an opportunity to comment.

a structured dialogue on the following areas of the ICAAP is very useful

Of paramount importance in the above-mentioned process is Step 3 which culminates in the Department's detailed interaction with the bank. It is therefore important that the aspects covered in Step 3 are highlighted. The Department has found that a structured dialogue on, among other things, the following areas of the ICAAP is very useful:

- *An executive summary of the bank's ICAAP focusing on the*
  - main findings of the ICAAP;
  - main business activities;
  - financial performance;
  - material risk exposures; and
  - breakdown of the regulatory capital requirement versus the internal bank capital requirement.

- *Corporate governance*: The review, challenge and approval process of the ICAAP, together with an overview of the corporate governance philosophy and environment of the bank.

- *Statement of risk appetite*: The statement of the bank broken down into its quantitative and qualitative elements, including a discussion of how the statement of risk appetite is filtered into the risk and business units of the bank.

- *Material risk exposures*: In respect of the risk areas, a discussion is held with the bank as to the manner in which it identifies and outlines its material risk exposures. The following subsets of risk are covered, that is, management, monitoring, measurement, mitigation as well as methodologies relating to the following main categories as per the Basel II text:

  - Pillar 1 risks covered (i.e., credit, market and operational risk).
  - Pillar 1 risks not fully covered (i.e., residual and operational risk).
  - Pillar 2 risks not covered (i.e., interest rate risk in the banking book and liquidity, concentration, strategic, reputational and pension fund deficit risk).

- *Capital planning*: The bank's "baseline" capital plan over the medium to long term (normally three to five years), together with assumptions used such as retention ratio, dividend cover policy and sustainable asset growth rate.

- *Stress and scenario testing*: Stress and scenario tests undertaken and the rationale for their choices, such as the methodology and assumptions used in each scenario tested, and how the institution would manage its business and capital so as to ensure that minimum regulatory requirements are met at all times and, where

mitigating actions are relied on, to provide the results of the stress tests on both a gross and net controls and credible manageable action basis. It is also important that banks are able to demonstrate the manner in which the stress and scenario testing relates to the "baseline" capital plan in terms of minimum required capital, risk-weighted assets and liquidity risk.

- *The use test*: This is the extent to which the ICAAP is used by the bank in the allocation of capital, pricing of products and performance measurement such as risk-adjusted return on capital, bonus payments and strategy determination.

2.5.4 Interim conclusions reached stemming from the reviews performed in 2009

Although some outstanding work remains in respect of the review of the smaller banks, the Department is in a position to comment on the main preliminary conclusions reached thus far, which are as follows:

- The ICAAPs of the smaller banks need to be commensurate with the nature and extent of the business activities of the bank. It was found that in the majority of the cases, the smaller banks used the Pillar 1 regulatory definition of required and qualifying capital for their internal capital purposes. The Department indicated to these banks that (without the need to invest in expensive technology) adjustments to the banks' required capital could be more reflective of the banks' actual capital and risk position (i.e., regulatory minimum required capital does not necessarily mean adequate capital).

Pillar 2 risks were generally not adequately capitalised

- Pillar 2 risks were generally not adequately capitalised. The reasons were mostly a lack of sophisticated models to estimate the capital requirements (e.g., models used to determine capital requirements for interest rate risk in the banking book, credit concentration risk and business risk), as well as common international standards for estimating the capital requirements for these risk areas. In some cases the lack of an internationally acceptable definition of some of the risk areas (such as business risk) also existed. In this regard, two risk areas should be highlighted, namely interest rate risk in the banking book and credit concentration risk, which were of specific relevance to the smaller banks in the system.
  - Interest rate risk in the banking book for some of the smaller banks was substantial because of the large amount of capital invested in the institution, which is non-rate-sensitive (this results in a natural interest rate risk mismatch). The risk is furthermore exacerbated by the impact of a sudden rate drop on variable rate assets, coupled with low-interest deposits, resulting in a significant margin squeeze.
  - Owing to the size of the smaller banks' balance sheets, concentration risk is also substantial. To mitigate this risk in most of the cases the Department applied a large-exposure capital requirement for exposures that were in excess of 25 per cent of the bank's net qualifying capital and reserves. This requirement was in addition to the minimum required capital as estimated by the Department in its Pillar 2b capital add-on.
- Capital planning, and stress and scenario testing could be enhanced significantly. In its communication with smaller banks, the Department stated that stress and scenario testing for smaller banks did not necessarily have to adopt sophisticated macroeconomic models, but simple stresses could be performed, such as a standardised adverse parallel-rate shock for interest rate risk, a name credit concentration risk shock or a shock in the loan-to-value ratios of the advances portfolio of these smaller banks.

- Owing to the conservative nature of these banks, liquidity risk appeared to be covered adequately as substantial amounts of excess cash were normally kept on the balance sheets.

2.6 Developments in respect of Pillar 3 disclosure

2.6.1 Key activities during 2009

With regard to Pillar 3 disclosure, the Department determined and performed an analysis of the level of disclosure by banks in South Africa. Banks that were found not to be disclosing appropriately and where the frequency of disclosure was not in accordance with the provisions of regulation 43 of the Regulations relating to Banks were identified and formally informed by the Department of their non-compliance and/or of those areas where deficiencies were identified. Emphasis was placed on small and medium banks in terms of the analysis of the disclosures.

Most of the South African branches of foreign institutions requested that they be exempted in terms of regulation 43 (3) of the Regulations relating to Banks. In this regard a proposal relating to the disclosure requirements of branches of foreign institutions was submitted to the Policy Committee of the Department. It was agreed that branches of international banks would be subject to disclosure requirements, but that these requirements would be less onerous than those of local banks. The process of drafting a revised policy document and a directive to be issued to banks will be finalised during 2010.

a Pillar 3 in-house disclosure template was created

A template was developed in order to analyse banks' Pillar 3 disclosures. The purpose of the disclosure template is to benchmark the Pillar 3 disclosure requirements of banks against the requirements of the Regulations relating to Banks and best practice applied by the industry. This benchmarking process will be a focus area in 2010.

Internal training was provided to the Department's staff to enhance their knowledge and understanding of Pillar 3 disclosure.

2.6.2 Overview of the guidance or recommendations issued by international standard-setting bodies

In its press release dated 13 July 2009, the Basel Committee announced enhancements to the Basel II capital framework. In respect of Pillar 3 these enhancements entailed the following six areas:

- Securitisation exposures in the trading book.
- Sponsorship of off-balance-sheet vehicles.
- The internal assessment approach (IAA) for securitisations and other asset-backed commercial paper liquidity facilities.
- Resecuritisation exposures.
- Valuation with regard to securitisation exposures.
- Pipeline and warehousing risks with regard to securitisation exposures.

These disclosures are intended to complement the other two pillars of the Basel II framework by allowing market participants to assess the capital adequacy of a bank

through key pieces of information on the scope of application, capital, risk exposure and risk assessment process.

The Basel Committee's proposal includes certain disclosure requirements that are not solely related to the understanding of Pillar 1 capital requirements (e.g., disclosures concerning a bank's sponsorship of off-balance-sheet vehicles). These are intended to help market participants better understand a bank's overall risk profile. The Basel Committee is of the view that these proposed enhanced disclosure requirements will help to avoid a recurrence of market uncertainties about the strength of banks' balance sheets related to their securitisation activities.

proposed enhanced disclosure requirements will help to avoid market uncertainties about the strength of banks' balance sheets

Subsequent to the aforementioned press release the Basel Committee issued a consultative document in December 2009 entitled *Strengthening the Resilience of the Banking Sector*. This document proposed, among other things, additional disclosure requirements for raising the transparency of the capital base. To this end, the Basel Committee was of the view that the disclosure provided by banks about their regulatory capital bases was frequently deficient. The Basel Committee is of the view that often there is insufficient detail on the components of capital, making an accurate assessment of its quality or a meaningful comparison between banks difficult. Furthermore, reconciliation with the reported accounts is often absent. Disclosures that may, among other things, be required in respect of the capital base are as follows:

additional disclosure requirements for raising the transparency of the capital base

- A full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements.
- Separate disclosure of all regulatory adjustments.
- A description of all limits and minimums, identifying the positive and negative elements of capital to which the limits and minimums apply.
- A description of the main features of capital instruments issued.
- Banks that disclose ratios involving components of regulatory capital (e.g., "Equity Tier 1", "Core Tier 1" or "Tangible Common Equity" ratios) should include a comprehensive explanation of how these ratios are calculated.

In respect of ECAIs, it is proposed that an ECAI should disclose its code of conduct; its compensation arrangements with assessed entities; its assessment methodologies, including the definition of default, the time horizon and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, for example, the likelihood of AA ratings becoming A ratings over time.

Certain detailed requirements for the computation of the leverage ratio are also proposed. The Basel Committee is of the view that the transparency and disclosure of the leverage ratio will be important in gaining credibility and market acceptance. Stronger disclosure requirements on a bank's or banking group's provisioning policies are also proposed.

detailed requirements for the computation of the leverage ratio are proposed

2.6.3 The Department's response to guidance or recommendations made

In keeping with the Department's objectives to maintain its legislative and regulatory framework up to date and relevant, these recommendations will be considered in future amendments to the aforementioned framework.

2.7 Stress testing

2.7.1 Introduction

stress testing is a key tool used by the regulator

Stress testing, as defined by the BIS[19] is a risk management technique that is used to evaluate the potential effects of a specific event and/or movement in a set of financial variables on an institution's financial condition. As capital resources fall and as regulatory capital requirements are likely to rise in times of stress, stress testing is a key tool used by the regulator in understanding the appropriate level of regulatory capital to ensure that banks remain solvent during difficult times. From a supervisory perspective, it is of paramount importance that the Department objectively establishes that South African banks are capitalised adequately. In this regard, the capital buffer, as confirmed in the stress-testing approach, forms a major element.

It is necessary for banks and other financial institutions to hold substantial capital buffers to protect themselves against large unexpected losses. Shareholders, investors and depositors need to be confident that banks will not become distressed, whatever the future state of the economy. Stress testing is an important input to the capital-adequacy process and decisions concerning the adequacy of capital buffer requirements.[20]

2.7.2 International stress-testing developments

one of the problems of the global financial market crisis was inadequate stress testing

The Basel Committee document titled the *Principles for Sound Stress Testing Practices and Supervision*, published in May 2009 was an outflow of the examination of the stress-testing practices of large internationally active banks. The document reveals, among other things, that one of the problems of the global financial market crisis was inadequate stress testing. It states: "The depth and duration of the financial crisis has led many banks and supervisory authorities to question whether stress-testing practices were sufficient prior to the crisis and whether they were adequate to cope with rapidly changing circumstances."[21] A direct link to the buffer (as per the individual capital requirement framework of the Department) is also established. In this regard it states: "Stress testing alerts bank management to adverse unexpected outcomes related to a variety of risks and provides an indication of how much capital might be needed to absorb losses should large shocks occur."[22]

The principles relate to the sound governance, design and implementation of stress-testing programmes at banks, and highlight weaknesses in such programmes, particularly the financial crisis and the expectations for the role and responsibilities of supervisors when evaluating banks' stress-testing practices.

stress testing is a key tool in countering procyclicality

As mentioned previously in this report, the Basel Committee also published a consultative document in December 2009 entitled *Strengthening the Resilience of the Banking Sector*,[23] with a view to strengthening the global capital framework. Stress testing is covered as part of the requirements for counterparty credit risk (especially paragraphs 171 to 173) and is a key tool in countering procyclicality.

The failure of stress testing to prevent the economic crisis was reviewed during 2009 in order to better understand its shortcomings and to prevent future occurrences. The BIS

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19 http://www.bis.org/publ/cgfs24.pdf.

20 Commonly referred to as 'Pillar 2 stress testing'.

21 https://www.bis.org/publ/bcbs155.pdf?noframes=1 – page 1.

22 https://www.bis.org/publ/bcbs155.pdf?noframes=1 – page 1.

23 http://www.bis.org/publ/bcbs164.htm.

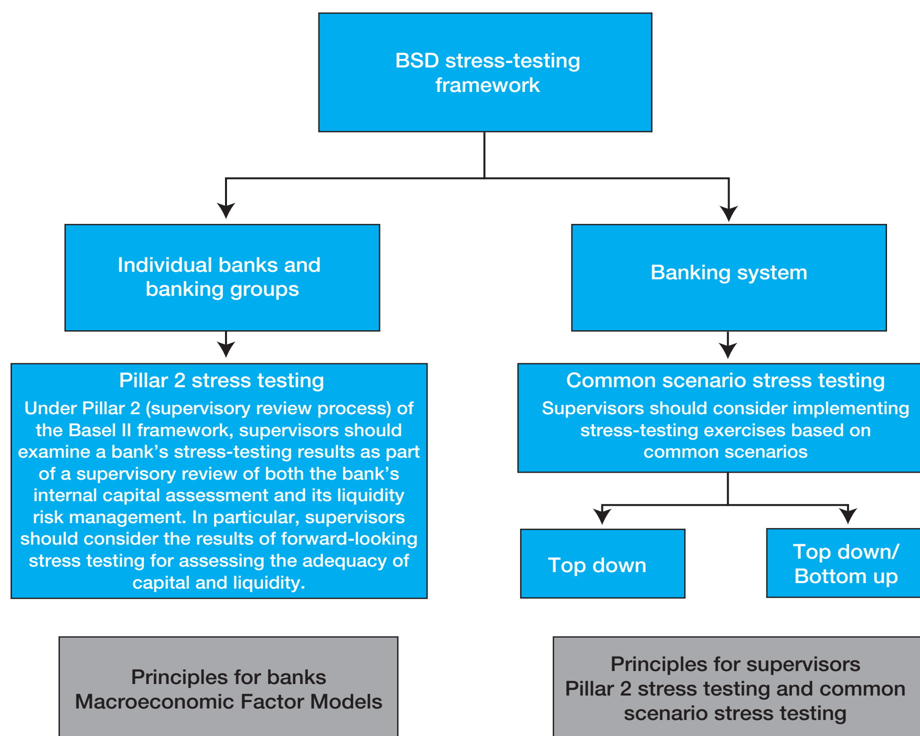
published such a review in its December 2009 quarterly review.[24] Furthermore, in December 2009 the Financial Services Authority (FSA) UK published its final rules on stress testing in Policy Statement 20/09 which includes the requirement for firms, regulated by the FSA, to perform reverse stress testing.[25]

The year under review was also marked by several common global scenario stress-testing[26] exercises. Most notable among these was the Supervisory Capital Assessment Program (SCAP),[27] conducted among the 19 largest US bank holding companies and the CEBS EU-wide stress-testing exercise, based on a sample of 22 major European banks. The principal difference between these two exercises was that the SCAP focused on the capital adequacy of the individual bank holding companies, including publishing the individual results,[28] whereas the CEBS exercise focused on the aggregate information, with no objective to assess individual banks recapitalisation needs.[29]

2.7.3 Overall stress-testing framework

The overall stress-testing framework of the Department consists of the following major elements as set out in Figure 2.5.

Figure 2.5



24 http://www.bis.org/publ/qtrpdf/r_qt0912.htm. Macro stress tests and crises: what can we learn? by Rodrigo Alfaro and Mathias Drehmann.

25 http://www.fsa.gov.uk/pubs/policy/ps09_20.pdf.

26 A common scenario stress-testing exercise is when the supervisor (or another body) prescribes the same stress testing scenario to banks in their jurisdiction. Such an exercise is part of the expectations of supervisors introduced in the principles for sound stress-testing practices and supervision, specifically principle 20.

27 http://www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm.

28 http://www.federalreserve.gov/newsevents/press/bcreg/20090507a.htm.

29 http://www.c-ebs.org/News--Communications/Latest-news/CEBS-press-release-on-the-results-of-the-EU-wide-s.aspx.

Pillar 2 stress testing informs the Department whether the capital buffers of the individual banks are sufficient

The stress-testing framework consists primarily of two main work streams. In the first work stream the focus of stress testing is on banks. This process forms part of the Pillar 2 ICAAP assessment. The risk focus is on the entire spectrum of risk covered in, among other things, the economic capital framework of the bank. The outcome of the Pillar 2 stress testing informs the Department whether the capital buffers of the individual banks are sufficient (i.e., a conclusion on the capital buffer requirement). The thematic review undertaken with the four largest banks in South Africa during 2009 focused on Pillar 2 stress testing.

The second work stream deals with common scenario stress testing. Two areas are investigated, namely a top-down rudimentary approach, where regulatory data are used to perform stress testing based on a common scenario, and a top-down and bottom-up approach that makes use of the banks' macroeconomic factor models to generate the stress-testing results based on the common scenario. It is important to note that with regard to the top-down and bottom-up approach, the Department utilises the information obtained from the first work stream in order to construct a common scenario and top-down and bottom-up stress-testing methodology. Interaction also takes place with the industry and the Research Department of the Bank on the construction of a severe common scenario to be used. Banks are then required to apply the aforementioned scenario in their macroeconomic factor models and to report the results, in a specified format, to the Department.

2.7.4 Thematic stress-testing reviews undertaken in 2009

As mentioned above, as a result of the ICAAP reviews undertaken in 2008 and conclusions reached subsequent to the reviews, stress testing was identified as an area that would require further development by the majority of the IRB banks. The Department also anticipated that the work performed on Pillar 2 stress testing would be invaluable for the common scenario stress testing to be conducted in 2010.

2.7.4.1 Pillar 2 stress testing

Pillar 2 stress testing forms part of the ICAAP assessment process

Pillar 2 stress testing forms part of the ICAAP assessment process and is ideally undertaken on a quarterly basis by banks. The risk focus of Pillar 2 stress testing is on the full spectrum of risk covered, among other things, in the economic capital framework of the banks. The outcome of the Pillar 2 stress testing focuses on the capital adequacy of the individual banks and whether their capital buffers are sufficient, given a severe stress scenario.

Only the banks that had adopted the advanced approaches for credit and market risk and that had implemented fairly sophisticated economic capital models were reviewed.

The foundation of the Department's Pillar 2 stress-testing review objectives was obtained from the Basel Committee document titled *Principles for sound stress testing practices and supervision*, published in May 2009. From the 2008 ICAAP reviews, the Department identified that most of the banks using the advanced approaches had implemented macroeconomic factor stress-testing models. The review therefore combined the elements of a macroeconomic factor model with the aforementioned Basel Committee document.

In line with the aforementioned, the main elements of the review included the following:

- The manner in which the stress-testing framework fitted into the overall governance structure of the bank, including the board-approved stress-testing framework and

policy document, independent review of the stress-testing framework and the extent to which the board and senior management understand the execution of stress testing within the organisation.
- Whether the bank's stress-testing methodology is commensurate with the nature and complexity of the extent of the bank's business activities.
- The development and selection of severe scenarios by the bank relative to the risk appetite and tolerance levels of the bank, including the use of reverse stress testing and historical versus forward looking (hypothetical) stress testing.
- The translation of the macroeconomic scenarios into macroeconomic drivers, and the appropriateness of the macroeconomic drivers for the scenario selected.
- The process through which the macroeconomic drivers were regressed into key risk drivers and the validation of the regression models used.
- Details of the stress-testing calculations per risk type, including a detailed discussion of stress-testing calculations performed for credit risk, market risk, operational risk, equity risk in the banking book, interest rate risk in the banking book, business risk and other risk areas not listed, and the aggregation of the stress-testing calculations for the bank.
- The results of the stress testing on the asset values, accounting profit and loss, economic profit and loss, regulatory capital or risk-weighted assets, economic capital requirements and liquidity and funding gaps.
- The use of the stress-testing results in the strategic decision-making process, evaluation of new products, determination of hot spots, evaluation of risk appetite and risk tolerance, and pre-emptive actions taken.

Based on the aforementioned information obtained, a benchmarking exercise was conducted that compared the information received with the aforementioned Basel Committee document.

2.7.4.2 Findings

The macroeconomic factor stress-testing models of the banks are in development and significant progress has been made since 2008. Key findings included the following:

macroeconomic factor stress-testing models of the banks are in development

- Stress testing is widely used as part of the risk management, and strategic and capital planning processes of banks.
- Stress testing of business risk was inconsistently performed by banks (in terms of the approaches used and the results of stress testing performed).
- The justification of the selection and quantification of scenarios varied greatly between banks.
- The ability to perform ad hoc stress testing varied between banks and risk types.
- The processes implemented by banks to ensure the independent review of stress-testing frameworks and methodologies are still at their infancy stage.
- Changes to the liquidity profile of banks due to macroeconomic conditions were generally not considered and the consideration of the relationship between asset and funding liquidity was limited.
- The granularity at which stress testing is performed varied greatly. Banks that performed stress testing at a very granular level had difficulty with the regularity at which stress testing was performed, the period in which the stress testing could be performed and extending the time horizon for the stress-testing scenarios. However, these banks received the benefit of having the stress-testing information at a very granular level.
- Reverse stress testing was found to be rudimentary and generally of a quantitative nature only. Identification of points where a bank became unviable, before breaching the regulatory minimum, had proven to be a challenge for most banks.

- For credit risk, the processes applied by banks to stress LGD and EAD estimates were less developed than those applied to stress PD estimates.
- The stressing of correlations between risk types was found to be limited.

2.7.4.3 Consequences

findings will be used to further align stress-testing practices with international best practice

A substantial amount of information was obtained to improve the Department's approach to common scenario stress testing to be carried out in 2010. The findings of the thematic reviews have been communicated to the individual banks and progress made by the banks in addressing these issues will be followed up in the course of 2010. Furthermore, the findings will be used to further align stress-testing practices with international best practice.

2.8 Developments in consolidated supervision

Lehman Brothers was one of the first banks to fail in September 2008, followed by a series of cascading defaults of major international banks, which sparked the beginning of the global financial market crisis and the resultant worldwide economic recession. This, in turn, led to a strong focus on improvements required in global regulatory and supervisory practices.

There has since been ongoing analysis and discussions between market practitioners and academics of the possible causes of the crisis and the revisions required in terms of prudential supervision frameworks, problem bank resolutions and strategies to avoid future systemic challenges.

The global financial crisis has demonstrated that critical deficiencies are still prevalent in risk management systems. Areas in need of critical enhancements include identifying and assessing key risks within and across borders, stress testing and macroprudential analysis to determine the impact on the financial system; monitoring; developing co-ordination protocols; reviewing regulatory frameworks; and adopting appropriate risk management frameworks and international accounting standards.

renewed focus on consolidated supervision

Some role-players regard inadequate consolidated supervision and regulation of large, highly leveraged and substantially interconnected financial companies as a key factor that contributed to the international financial market crisis. The sudden collapse of large investment banks and insurance companies was among the most destabilising events during the crisis. It has been alleged that these companies were ineffectively supervised and regulated on a consolidated basis and, as a consequence, did not have sufficient capital or liquidity buffers to withstand the deterioration in financial conditions that occurred in 2008. These events have renewed the focus on consolidated supervision, particularly with regard to systemically important large internationally diversified financial groups.

Other aspects that were identified that had also impacted on consolidated supervision included the following:

- *Non-bank financial institutions*: The regulatory system was not structured for an environment in which an increasingly large amount of credit intermediation was occurring in non-bank financial institutions. As a consequence, less attention was paid to the systemic implications of the actions of increasingly important financial institutions, including securities firms, insurance conglomerates and monopolies. Both banking and non-banking financial institutions play an important role in credit intermediation, but are subject to differing degrees of regulation and supervision by

different regulatory authorities. Certain systemically important activities are therefore conducted outside the regulatory ambit.

The global financial crisis has clearly demonstrated that risks to the financial system can arise not only from banks, but also from other financial entities. In future all systemically important financial institutions will be subjected to a more robust regime of consolidated supervision from the ultimate parent company downwards.

- *Group structure*: Complexity and interconnectivity within large institutions are areas of focus for the Basel Committee. Often the complexity of group structures is motivated by tax or regulatory factors, rather than a clear business purpose. The CBRG of the Basel Committee is working on recommendations aimed at simplifying such complex structures.

complexity and interconnectivity within large institutions are areas of focus for the Basel Committee

- *Home host relationships*: The growing complexity of financial systems across the globe negatively impacts on the ability of regulators to monitor and assess risk exposure effectively across large diversified financial groups. This also complicates the identification of areas where there are regulatory gaps. This problem is exacerbated during times of distress. It is therefore critical that information-sharing agreements between home- and host-country supervisors are well designed and effectively implemented. During the crisis it also became evident that instances occurred where regulators were required to make decisions about systemically important entities not supervised by them. The lack of information from these entities also complicated the decision-making process.

- *Capital and liquidity rules*: Changes to the capital and liquidity rules that will impact on banks and banking groups on a solo and consolidated basis can be expected during 2010 and thereafter. Regulators are calling for significantly stronger capital standards that will improve both the quality and quantity of capital. Cyclical standards may be considered that will require entities and groups to build larger capital buffers in good times, and allow them to be drawn down during periods of stress. The crisis demonstrated that issues around cross-border liquidity support are difficult. Liquidity pressures may arise in unexpected places; time for co-ordination is short and the failure in one jurisdiction will likely spread quickly to other jurisdictions.

crisis demonstrated that issues around cross-border liquidity support are difficult

  The crisis also highlighted weaknesses in group and cross-border liquidity management. In response, in December 2009 the Basel Committee issued for consultation a package of proposals to strengthen global capital and liquidity regulations with a view to promoting a more resilient banking sector. In terms of the proposals, the Basel Committee developed two internationally consistent regulatory standards for liquidity risk supervision as a cornerstone of a global framework to strengthen liquidity risk management and supervision. In addition to meeting these standards, banks will also be expected to adhere to all the principles set out in the September 2008 Basel Committee paper titled *Principles for Sound Liquidity Risk Management and Supervision*.

- *Cross-border issues*: The pending or actual failure of a large internationally active financial entity inevitably complicates the already challenging process of resolution. Mismatches in the amount and maturities of assets and liabilities held by entities in the various countries in which they operate can lead to host regulators taking special action to protect the interests of depositors and creditors in their own jurisdictions. Different insolvency regimes apply to separately incorporated subsidiaries across the world that are substantially inconsistent with one another. Insolvency regimes in different countries therefore do not cater for the special characteristics of large

establish and harmonise appropriate solvency regimes throughout the world

international entities. It is proposed that role-players consider the implementation of an international treaty that would establish and harmonise appropriate solvency regimes throughout the world.

Internationally active banks and other financial entities operate across national borders and legal jurisdictions with complex structures. They manage their businesses in an integrated manner with little regard for the corporate and national boundaries. This happens while the legal, supervisory and insolvency rules remain nationally based.

The above-mentioned gaps in supervision existed for years; their consequences were not obvious until the crisis, which revealed critical deficiencies in the toolkits available to regulators to deal with non-bank institutions in distress. Regulators are, however, developing and implementing new regulations and policy guidance that take on the broad lessons of the crisis. A regulatory structure that provides for comprehensive and consistent oversight of all elements of the financial system is required. This includes effective consolidated oversight of all the largest and interconnected financial institutions, and oversight of the payment and settlement systems.

actions to further improve the supervision of banking groups

During the year under review the Department proactively took the following actions to further improve the supervision of banking groups:

- Regular supervisory meetings between the Department and the Financial Services Board were instituted for the three largest significant systemic banking and insurance groups. The purpose of the supervisory meetings was to enhance information sharing, identify issues of mutual relevance and to work together towards greater consistency of approach, where appropriate.
- The Department has made a policy decision to allow only the acquisition or establishment of cross-border banking operations (inwards and outwards) in instances where a memorandum of understanding (MoU) with the cross-border banking supervisor had been concluded. MoUs are entered into with local and foreign supervisors. This is a more formalised approach to share information and to protect the confidentiality of such information.
- The Department is also planning to host a supervisory college in 2010 with those African supervisors in whose countries South African banking groups have a presence.
- The establishment or acquisition of cross-border operations by South African banking groups requires the prior approval of the Registrar of Banks in terms of the Banks Act, 1990. In view of the market turmoil in 2009, the Department requested banking groups to rather focus their energy on the challenges facing their existing local and foreign operations as opposed to pursuing new strategic international expansions.
- In order to improve the supervision of banking groups on a consolidated basis, the Department recommended to one of the large banking groups to undergo a restructure, which restructuring would enable the Department to supervise the entire conglomerate, which was not previously the case. It is expected that the said restructure will be concluded in the course of 2010.

2.8.1 Supervisory colleges

establishment of supervisory colleges and crisis management within larger groups

International developments subsequent to the financial market crisis have renewed the focus on various key areas such as the development of a macroprudential approach to supervision; the enhancement of adherence to international supervisory and regulatory standards; and the establishment of supervisory colleges and crisis management within larger groups. In this regard, as outlined above, regular supervisory meetings between the Department and the Financial Services Board were instituted during 2009 in respect of the three largest systemically relevant South African banking and insurance groups.

Supervisory meetings between the Financial Services Board and the Department were scheduled and held in September and October 2009 to discuss the following financial conglomerate groups:

- Standard Bank Group Limited/Liberty Holdings Limited.
- FirstRand Limited/Momentum Group Limited.
- Old Mutual Limited/Nedbank Group Limited.

The agenda of the meetings covered various quantitative and qualitative issues such as corporate governance, management structures, risk management, compliance, control environment and regulatory concerns, group structures, and systemic and contagion risk. Both supervisors emphasised that all three banking and insurance groups discussed during the supervisory meetings were of material systemic importance in the South African banking sector, insurance sector and in the economy as a whole.

The supervisory meetings facilitated a platform to

- discuss material issues of mutual relevance;
- communicate emerging issues and developments of a material and potentially adverse nature;
- establish and maintain contact between the two offices; and
- establish a climate of co-operation and trust.

Valuable information was shared during the supervisory meetings. The Financial Services Board and the Department obtained a better understanding of the respective institutions' supervisory frameworks, as well as the risks that banking groups and insurance groups are facing. It was agreed that at future supervisory meetings there would also be interaction on the combined banking and insurance businesses of Absa Group Limited, Investec Group Limited and African Bank Investments Limited. The decision to include these three groups was based on the materiality of their banking and insurance businesses.

Chapter 3: Developments relating to banking legislation

3.1 Introduction

A key responsibility of the Department is to ensure that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant and current. Consequently, the legal framework pertaining to banking regulation has to reflect local and international market developments, and to comply with the applicable international regulatory and supervisory standards and best practice. The Department is therefore required to review the banking legislation, that is, the Banks Act, 1990, the Mutual Banks Act, 1993 (Act No. 124 of 1993), the Regulations relating to Banks issued in respect thereof and other pieces of related banking legislation on an ongoing basis and to make recommendations to the Minister of Finance to effect the necessary amendments. Accordingly, this chapter provides an overview of the key initiatives monitored, and developments considered, by the Department in this regard.

In addition, details of proposed amendments to the Banks Act, 1990 and the Regulations relating to Banks are provided, as well as information relating to illegal deposit-taking, the New Companies Act, 2008 (Act No. 71 of 2008), co-operative banks, Postbank and the King report on corporate governance for South Africa. Finally, an overview is provided of the decision of the Board of Review in the review of the Registrar's decision in respect of an application for authorisation to establish a bank.

3.2 The Banks Act, 1990 and the Regulations relating to Banks

The Banks Act, 1990 and Regulations relating to Banks were last amended on 1 January 2008, in the main, to align the South African banking legislative framework with the principles of Basel II. Since then, the Department has been monitoring, among others things, the developments relating to the G-20 discussions and publications and directives issued by the Basel Committee and the FSB on the one hand, and developments relating to the New Companies Act, King III and court decisions, on the other, in order to identify possible areas that would necessitate amendments to the Banks Act, 1990 or the Regulations relating to Banks.

sufficient certainty has been obtained in various areas to crystallise certain proposed amendments

Although finality has not been reached on all the initiatives monitored by the Department, sufficient certainty has been obtained in various areas to crystallise certain proposed amendments to the Banks Act, 1990 and the Regulations relating to Banks.

3.3 Initiatives monitored and developments considered by the Department

3.3.1 International developments related to the global financial crisis

Following the sub-prime and international financial market crisis, and the resultant effects globally, the FSB issued a paper on the causes, effects and regulatory response to the crisis during April 2008. Although South Africa was fortunate in not being directly affected by the primary crisis, it has obviously been affected by the so-called 'second-round' or secondary effects.

The Department has participated in working groups that were established by National Treasury in order to comment on, and implement proposals, made by the G-20 working groups that were established to deal with the causes and effects of the global financial

crisis. Thus far, the Department has not identified any issue that would necessitate material amendments to the Banks Act, 1990, although various amendments to the Regulations relating to Banks will be required.

Based mainly on the comprehensive initiatives and strategies of, and the various new, amended or proposed requirements or standards issued by, various international standard-setting bodies, such as the G-20, the FSB and the Basel Committee, the Department identified the internationally agreed strategic focus areas that will, or are likely to, require amendments to the regulatory framework.

Furthermore, since the introduction on 1 January 2008 of the amended Regulations relating to Banks that incorporated, among other things, the requirements of the internationally agreed Basel II framework, the Department had to take various internal policy decisions in respect of certain matters that have to be incorporated into the Regulations relating to Banks, and identified areas in the Regulations relating to Banks that require correction or further clarification.

The Department is in the process of amending its regulatory and supervisory framework to remain aligned with the aforesaid internationally agreed standards, practices or requirements, and to incorporate the aforesaid policy decisions, corrections and clarifications into the regulatory framework.

The Department plans to issue draft documents in 2010 of the proposed amended Banks Act, 1990, and Regulations relating to Banks for review and comment by key role players.

the Department to issue draft documents of the proposed amended Banks Act and Regulations during 2010

3.3.2 Companies Act, 2008 (Act No. 71 of 2008)

The New Companies Act was promulgated in April 2009, but is set to become effective only during the second half of 2010. The Department commissioned external legal consultants to conduct a thorough comparison of the New Companies Act with the Banks Act, 1990 and to advise the Department on the various changes and possible impact on the Banks Act, 1990. The consultants' report will serve as a guide to identify possible amendments to the Banks Act, 1990 in consultation with the banking industry.

3.3.3 Current Directives, Circulars and Guidance Notes

The Department is currently considering the inclusion of previously issued Directives, Circulars and Guidance Notes into either the Banks Act, 1990 or the Regulations relating to Banks.

3.3.4 Board of Review findings

An application for authorisation to establish a bank was refused by the Department. The Registrar's decision was taken on review in terms of section 9 of the Banks Act, 1990 to the Board of Review who, in turn, dismissed the application and upheld the Registrar's decision.

an application for authorisation to establish a bank was refused by the Department

The applicant then applied to the High Court (Pretoria) to have the decision of the Board of Review set aside. The application was, however, dismissed with costs on 24 October 2009. This matter is discussed in greater detail in section 3.11.2 of this report.

3.4 Proposed amendments to the Banks Act, 1990

Please note that **[words in bold and in square brackets]** represent proposed deletions from, and <u>underlined words</u> represent proposed inclusions in, existing provisions of the Banks Act, 1990.

<u>Definitions (Section 1(1))</u>

[“co-operative”]	– replacing the reference to the ‘Co-operatives Act, 1981 (Act No. 91 of 1981)” with the “Co-operatives Act, 2005 (Act No. 14 of 2005)”.
[“Companies Act”]	– changing to reference to the “New Companies Act”.
[“director”]	– amending definition to prohibit banks from using the name “director” in respect of persons that are not duly appointed company directors.
[“holding company”]	– changing in line with New Companies Act.
[“liquid assets”]	– replacing the reference to the Co-operatives Act, 1981 (Act No. 91 of 1981) with the Co-operatives Act, 2005 (Act No. 14 of 2005). – deleting the reference to the Marketing Act, 1968 (Act No. 59 of 1968) which has been repealed. – considering proposals to change the elements within the definition.
[“Registrar of Companies”]	– changing in line with the New Companies Act.
[“Regulations relating to branches”]	– replacing the reference to the *Government Gazette* No. 30627 of 1 January 2008.

<u>Exclusions from the application of the Act (section 2)</u>

The reference to “Public Investment Commissioners” should be changed to “Public Investment Corporation” and the reference to the “Public Investment Commissioners Act, 1984” should be changed to the “Public Investment Corporations Act, 2004 (Act No. 23 of 2004)”.

<u>Review of decisions taken by the Registrar (section 9)</u>

The findings made by the Board of Review and the court’s judgment will be studied to identify possible amendments to section 9 of the Banks Act, 1990.

Annual report by Registrar (section 10)

Amending subsection (2) as follows:

"(2) The Minister shall **[lay]** table a copy of the report referred to in subsection(1) **[upon the Tables]** in Parliament within 14 days after receipt of such report, if Parliament is then in ordinary session, or, if Parliament is not then in ordinary session, within 14 days after the commencement of its next ensuing ordinary session."

Authorisation to establish a bank (sections 12 and 13)

The findings made by the Review Board and the court's judgment will be studied to identify possible amendments to sections 12 and 13 of the Banks Act, 1990.

Use of the name bank (section 22)

Amend subsection (1) as follows:

"(1) Subject to the provisions of subsection (2), an institution which is registered as a bank or a foreign institution which is authorized under section 18A to conduct the business of a bank by means of a branch in the Republic or an institution which is registered as a representative office of a foreign institution under section 34 shall not:–

(a) in the case of such bank use, or refer to itself by, a name other than the name under which it is so registered, [or]

(b) in the case of such foreign institution, in respect of the branch concerned use, or refer to the branch by, a name other than the name under which the conduct of the business of a bank in the Republic was so authorised, or

(c) in the case of such foreign institution, in respect of the representative office use, or refer to the representative office by, a name other than the name under which the representative office was so registered,

or any literal translation or abbreviation of such name which has been approved by the Registrar: Provided that the Registrar may, if he or she deems it desirable, authorise the use of a name by which such bank or foreign institution is otherwise generally known."

Cancellation or suspension of registration by Registrar (section 23)

It is proposed that provision be made in the case of a material contravention of the Financial Intelligence Centre Act for the suspension or cancellation of the registration of a bank. The amendment is necessitated by a recommendation made by the FATF in its report following an assessment of AML/CFT measures in South Africa during 2008.

Registration of shares in the name of nominees (section 38)

Subsection (2) to be amended as follows:

"(2) Subsection (1) shall not affect the allotment or issue, or the registration of the transfer, of shares in a bank or controlling company –

(a) [in the name of a trustee of a unit trust scheme as defined in section 1 of the Unit Trusts Control Act, 1981 (Act No. 54 of 1981), or of a nominated company of the trustee approved by the Registrar of Unit Trust Companies;]

in the name of the manager or trustee of a collective investment scheme as defined by section 1 of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), or of a nominated company of the manager or trustee approved by the Registrar of Collective Investment Schemes;

(b) in the name of any executor, administrator, trustee, curator, guardian or liquidator in the circumstances mentioned in section 103(3) of the Companies Act;

(c) for a period of not more than six months, in the name of a stock broker [or of a company established by such stock broker for a purpose mentioned in section 12(3) of the Stock Exchanges Control Act, 1985 (Act No. 1 of 1985)] as defined in section 1 of the Securities Services Act, 2004 (Act No. 36 of 2004), or of a company controlled by the bank or of an employee of the bank, if it is necessary that the shares be so allotted, issued or registered in order to facilitate delivery to the purchaser or to protect the rights of the beneficiary in respect of those shares or where the beneficiary is not known;

(d) in the name of a person in other special circumstances determined by the Minister by notice in the Gazette; or

(e) in the name of a central securities depository as **[defined in section 1 of the Safe Deposit of Securities Act, 1992]** provided for in the Securities Services Act, 2004 (Act No. 36 of 2004)

Application of Companies Act to banks and controlling companies (section 51)

The Department expects that the appointed consultants will propose amendments to this section that will conform to the New Companies Act.

Compromises, amalgamations, arrangements and affected transactions (section 54)

The Taxation Laws Amendment Bill, 2009, as introduced by the Minister of Finance on 1 September 2009 contains a provision that aims to amend section 54 of the Banks Act, 1990 as follows:

"90. Amendment of section 54 of Act 94 of 1990, as substituted by section 6 of Act 42 of 1992 and amended by sections 12 and 25 of Act 9 of 1993, Proclamation

No. 132 of 1994, section 36 of Act 26 of 1994, section 5 of Act 55 of 1996, section 36 of Act 19 of 2003 and section 13 of Act 20 of 2007 –

Section 54 of the Banks Act, 1990; is hereby amended by the substitution for subsection (8A) of the following subsection:

"(8A) No transfer duty, **[stamp duty]** securities transfer tax, registration fees, licence duty or other charges shall be payable in respect of –

(a) a transfer contemplated in subsection (8) taking place in the execution of a transaction entered into at the instance of the Registrar in the interest of the effective supervision of banks or the maintenance of a stable banking sector; or

(b) any endorsement or alteration made to record such transfer, upon submission to the Registrar of Companies, or the Master, office or person referred to in subsection (8), as the case may be, of a written confirmation by the Registrar of Banks that the Minister, on the recommendation of the last-mentioned Registrar and after consultation with the Commissioner **[for Inland Revenue]** of the South African Revenue Service has consented to the waiver of such tax, fees or charges."

Directors and officers of a bank or controlling company (section 60)

This Department expects that the appointed consultants will propose amendments to this section that will conform to the New Companies Act.

This Department will prohibit banks from using the title "director" in respect of persons not duly appointed as company directors in terms of the Companies Act, 2008.

Amendments are also considered in respect of the process provided for in subsections (5) and (6) to provide for the Registrar to stay the period in the case where it is necessary to obtain further information.

Appointment of auditor (section 61)

The reference to "Public Accountants' and Auditors' Board" is to be replaced with "Independent Regulatory Board for Auditors".

Functions of auditors in relation to Registrar (section 63)

The reference to "Public Accountants' and Auditors' Board" is to be replaced with "Independent Regulatory Board for Auditors".

Concentration risk (section 73)

It is proposed that section 73 of the Banks Act, 1990 be amended to include the term "major risk exposures" as prescribed by principle 8 of the Core Principles.

3.5 Amendments to the Regulations relating to Banks

The key internationally agreed strategic focus areas that will, or are likely to, require amendments to the regulatory framework and the Department's response thereto are set out in further detail as follows:

Key international focus area	Bank Supervision Department response or action required
1. On 13 July 2009, the Basel Committee issued a final package of measures to strengthen the 1996 rules governing banks' trading-book capital and to enhance the three pillars of the Basel II framework. *The Basel II enhancements* The Basel II enhancements include • higher capital requirements to capture the credit risk of complex trading activities; • a stressed VaR requirement; • strengthening the treatment for certain securitisations in Pillar 1 (minimum capital requirements); • higher risk weights for resecuritisation exposures to better reflect the risk inherent in these products; • raising the credit conversion factor for short-term liquidity facilities to certain off-balance-sheet conduits; • requirements for banks to conduct more rigorous credit analyses of externally rated securitisation exposures; • supplemental guidance under Pillar 2 (the supervisory review process), that include the FSB's *Principles for sound compensation practices*; and • enhancements to the framework's third pillar (market discipline) to strengthen disclosure requirements for securitisations, off-balance-sheet exposures and trading activities. *Pillar 1 and Pillar 3 enhancements* The Pillar 1 and Pillar 3 enhancements must be implemented by the end of 2010, while Pillar 2 risk management standards became effective immediately.	The Department is in the process of amending its regulatory and supervisory framework and will, in accordance with international agreement, implement the amended Pillar 1 capital requirements and Pillar 3 disclosure requirements on 1 January 2011. The further Pillar 2 supplemental guidance either already forms part of the Department's regulatory and supervisory framework or is in the process of being incorporated. The Department will issue draft documents of the proposed amended Regulations relating to Banks during 2010 for review and comment by key role players.
2. Raise the quality, consistency and transparency of the Tier 1 capital base. The proposal is to strengthen that component of the Tier 1 capital base which is fully available to absorb losses on a going concern basis, thus contributing to a reduction of systemic risk emanating from the banking sector. For example, under the current Basel Committee standard, banks may hold as little as 2 per cent common equity to risk-based assets, before the application of key regulatory adjustments.	No material amendment to the regulatory framework is currently foreseen in respect of the quality, consistency and transparency of the primary or the Tier 1 capital base. At present South African banks are required to maintain a minimum primary capital or Tier 1 ratio of 7 per cent, well above the Basel II requirement of 4 per cent, with strict requirements related to the qualifying components or composition of the primary or Tier 1 capital base. At present South African banks generally have primary or Tier 1 capital ratios well in excess of the minimum requirement of 7 per cent.

Key international focus area	Bank Supervision Department response or action required
	The Department will continue to monitor international developments regarding the quality, consistency and transparency of the Tier 1 capital base, and amend its regulatory framework when or where necessary.
3. Introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration.	The average leverage ratio of South African banks is less than 20 times, well below the international trend of between 30 times and up to 60 times. At present the leverage ratios of South African banks are being monitored as part of the Department's SREP, but the existing regulatory framework does not prescribe a specific limit in respect of a leverage ratio. Once finalised by the Basel Committee, requirements related to the calculation and limit of a leverage ratio will be incorporated into the regulatory framework. It is envisaged that South African banks are likely to be well within any proposed recommendations or internationally agreed requirement.
4. Develop a framework for countercyclical capital buffers above the minimum requirement.	The current regulatory framework already makes provision for additional capital requirements to be specified in addition to the minimum requirement. Once finalised by the Basel Committee, specific requirements related to countercyclical capital buffers above the minimum requirement will be incorporated into the regulatory framework.
5. Implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking. Compensation should be aligned with prudent risk-taking and long-term, sustainable performance.	The supplemental guidance under Pillar 2 of the Basel II framework, issued by the Basel Committee during July 2009 as part of the enhancements to the Basel II framework, also incorporates the FSB Principles for Sound Compensation Practices, issued by the FSB in April 2009. In September 2009 the FSB published the FSB Principles for Sound Compensation Practices: Implementation Standards.

current regulatory framework already makes provision for additional capital requirements

Key international focus area	Bank Supervision Department response or action required
	The further Pillar 2 supplemental guidance issued by the Basel Committee in July 2009 either already forms part of the Department's regulatory and supervisory framework or is in the process of being incorporated. The requirements related to banks' compensation practices issued by the FSB in September 2009 will be incorporated in the amended Regulations relating to Banks to become effective in January 2011. Furthermore, in view of the risk posed by inappropriately structured incentive schemes, the Department focused extensively on remuneration practices during the past years. For example, the Department's 2007 *Annual Report* opened with some cautionary remarks on remuneration practices and informed the banking industry of the Department's intention to perform a review on incentive schemes during 2008. During 2008, the Department engaged with all South African banks and conducted a thematic review in respect of their compensation schemes which is reported on in paragraph 1.6.3 of this report.
6. Enhance and expand the scope of regulation and oversight of OTC derivative instruments.	The framework used during the aforesaid discussions with banks was similar to the proposals now issued internationally. The current regulatory framework contains extensive reporting requirements related to derivative instruments, including OTC derivative instruments. Once finalised by the Basel Committee, any relevant further requirements related to OTC derivative instruments will be incorporated into the regulatory framework.
7. Commit to conducting robust and transparent stress tests as required.	The current regulatory framework contains extensive requirements for banks and banking groups to conduct stress testing. Furthermore, stress testing is performed by the Department on a "business-as-usual" basis, as part of its SREP.

the Department focused on remuneration practices during the past years

stress testing performed by the Department as part of its SREP

Key international focus area	Bank Supervision Department response or action required
	In addition, the Department's stress-testing methodology is being refined on an ongoing basis. Once finalised internationally, any relevant further requirements related to stress testing will be incorporated into the regulatory framework.
8. Implement minimum global standards for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio.	The current regulatory framework contains extensive requirements related to banks' contractual mismatches, "business-as-usual" mismatches and bank-specific stress mismatches, available sources of stress funding, potential concentrations in funding, and explicit minimum requirements related to liquid assets. However, the regulatory framework does not contain minimum requirements related to a stressed liquidity coverage ratio or a structural liquidity ratio. Nevertheless, banks' alignment with the *Principles for Sound Liquidity Risk Management*, issued by the Basel Committee in 2008, was a "flavour-of-the-year" topic that was discussed with banks' boards of directors in 2009. In December 2009 the Basel Committee issued a consultative document titled *International Framework for Liquidity Risk Measurement, Standards and Monitoring* which deals with key measurements including a liquidity coverage ratio, a net stable funding ratio and monitoring tools with regard to liquidity. Once finalised in the course of 2010 by the Basel Committee, these requirements related to a stressed liquidity coverage ratio or a structural liquidity ratio will be considered for incorporation into the regulatory framework. However, ultimately, liquidity in the South African financial sector is mainly a structural matter that is likely to require extensive dialogue between various key role-players such as the National Treasury, the central bank, the Financial Services Board and the Department.

extensive requirements related to banks' contractual mismatches, "business-as-usual" mismatches and bank-specific stress mismatches

liquidity in the South African financial sector is mainly a structural matter

3.6 Illegal deposit-taking

One of the auxiliary functions of the Department is to inspect and investigate persons and institutions suspected of taking deposits from the general public in contravention of the provisions of the Banks Act, 1990.

In brief, the taking of deposits from the general public by persons neither registered as a bank nor falling within or complying with one of the exemptions provided for in the Banks Act, 1990 is a criminal offence. The ultimate prosecution of a person committing a contravention of the Banks Act, 1990 falls within the area of responsibility of the South African Police Service (SAPS) and the prosecuting authorities.

The role and function of the Department in this regard are clearly set out in the Banks Act, 1990. As a creature of statute, the Department is permitted to perform only the duties and functions for which the Banks Act, 1990 makes provision. The Department is afforded certain powers in terms of the provisions of sections 81 to 84 of the Banks Act, 1990 to "control" the activities of unregistered persons. These "activities", however, are confined to illegal deposit-taking.

The rationale for the above-mentioned powers is the following:

it would be irresponsible to allow unregistered persons to take deposits from the general public

- Banks, duly registered in terms of the Banks Act, 1990, may accept deposits from the general public and are subject to strict regulation and supervision in terms of the Banks Act, 1990 and the Regulations relating to Banks. It would be irresponsible to allow unregistered persons to accept deposits from the general public while not registered and not subject to intense regulation. The Department is therefore empowered to institute action against unregistered persons.
- Besides the fact that the acceptance of deposits from the general public by an unregistered person is a criminal offence, such schemes are generally operated on a fraudulent basis and are harmful not only to the established and regulated banking system, but also to the economy as a whole.

In order, therefore, to prevent the development of a secondary illegal, harmful and fraudulent "banking" system, it is necessary for the Department to be afforded the above-mentioned powers. The funds obtained by means of an illegal deposit-taking scheme are sometimes transferred to accounts in other countries in contravention of the regulations pertaining to exchange control and the evasion of taxation provisions is also common place within such schemes.

the Department can act only when complaints are received

Since the Department does not register, regulate or supervise unregistered persons, it is generally not aware of such illegal deposit-taking schemes unless it is informed of them by members of the public and/or other regulators. In general, therefore, the Department can act only when complaints are received, provided that such complaints contain sufficient detail and documentary evidence to justify the Department invoking its powers in terms of the Banks Act, 1990.

In many instances, however, illegal deposit-taking schemes are not reported to the Department, but are handled independently – more often than not without the

knowledge of the Department – either by the SAPS in terms of a criminal investigation and prosecution or, when a scheme is liquidated, by the liquidator appointed to wind down the scheme.

In such cases, the Department merely provides assistance when requested to do so. When a scheme has been liquidated, the provisions of the Insolvency Act, 1936 (Act No. 24 of 1936) take precedence over the provisions of the Banks Act, 1990 in respect of the repayment process. However, the Department has the power to recommend to the Master of the High Court whom to appoint as liquidator in cases where the Department is in the process of investigating the scheme in question.

Staff members of the Department were also subpoenaed to provide evidence in court proceedings relating to the prosecution of persons allegedly contravening the Banks Act, 1990. The Department also forwarded information to other regulatory bodies to ensure that all possible contraventions that might have been committed by unregistered persons were brought to the attention of the appropriate authorities. Furthermore, departmental employees gave presentations on illegal deposit-taking as part of the SAPS's course on Commercial Crime Level 11 as well as to prosecutors, at the Commercial Crime Court in Durban.

In the opinion of the Department, the continued prevalence of illegal deposit-taking schemes may be ascribed to factors such as greed, on the one hand, and a lack of financial literacy, on the other, on the part of some investors. Some of the schemes are operated by well-educated individuals in such a manner that the investment opportunity appears to be legitimate. Members of the general public are thus misled and regard such schemes as trustworthy investment opportunities.

schemes are operated by well-educated individuals in such a manner that the investment opportunity appears to be legitimate

The Department has compiled a five-year review of the schemes investigated from January 2005 to December 2009 (refer Table 3.1 and Figure 3.1 below). During the aforementioned period, the Department received 66 new complains relating to illegal deposit-taking schemes, while 27 schemes were carried over from years prior to 2005.

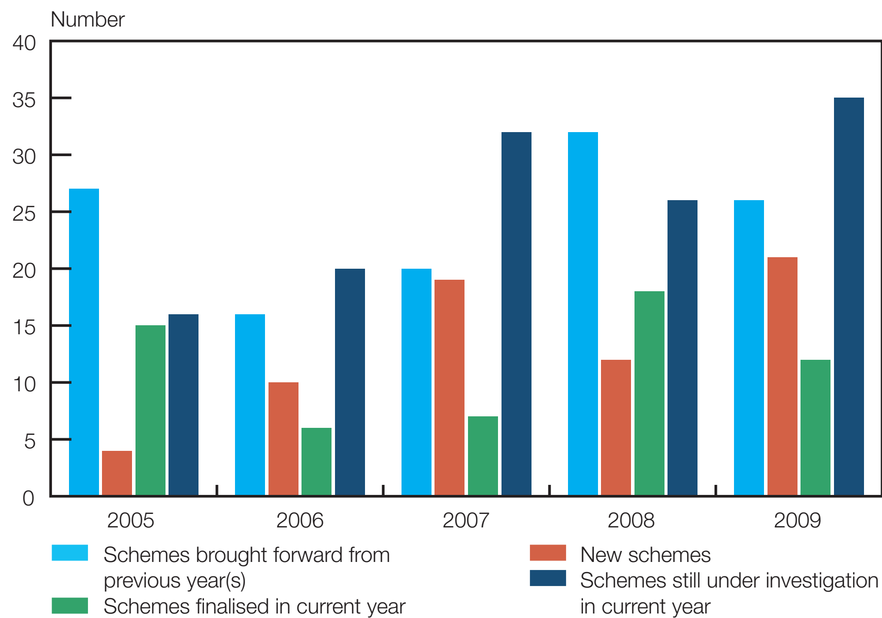
During 2009, 21 new investigations, together with 26 investigations carried over from previous years, were undertaken. Of this total of 47 investigations 12 were completed during this period and 35 still remained under investigation as at 31 December 2009.

during 2009, 21 new investigations were undertaken

Table 3.1 Inspections relating to illegal deposit-taking

Year	Schemes brought forward from previous year(s)	New schemes	Schemes finalised in current year	Schemes still under investigation in current year
2005	27	4	15	16
2006	16	10	6	20
2007	20	19	7	32
2008	32	12	18	26
2009	26	21	12	35

Figure 3.1 Inspection of illegal deposit-taking



However, this information does not project a complete picture of the prevalence of illegal deposit-taking as it only shows schemes that were reported to the Department.

billions of rands are invested in these illegal deposit-taking schemes

Billions of rand are invested in these illegal deposit-taking schemes every year to the detriment of the banking sector and the general economy. In most instances the funds available in these schemes to repay investors are either limited or non-existent. The costs related to the inspection of these schemes are borne by the Department in that it appoints temporary inspectors to assist with the forensic investigation of such schemes. These inspections are funded via the budget allocated to the Department by the Bank.

During the past five years the public invested approximately R13,7 billion in illegal deposit-taking schemes that were investigated by the Department, at an associated cost, as at the date of this report, of approximately R59,3 million in the form of payments to appointed temporary inspectors. These associated costs will further escalate pending finalisation of the investigations pertaining to the number of current schemes as reflected in Table 3.1.

3.7 The New Companies Act, 2008 (Act No. 71 of 2008)

the New Companies Act was signed into law on 8 April 2009

The New Companies Act was signed into law by the President of the Republic of South Africa on 8 April 2009 and gazetted on 9 April 2009. According to General Notice No. 1663 of 2009 dated 22 December 2009 issued by the Minister of Trade and Industry, the Act will come into legal force in 2010 through a proclamation to be issued by the President. The proclamation will provide a specific date on which the Act will come into effect upon which it will repeal the Companies Act, 1973 (Act No. 61 of 1973), subject to transitional arrangements set out in Schedule 5 thereof.

In terms of the provisions of section 5(4)(a) of the New Companies Act, if there is any inconsistency between any provision of the New Companies Act and provisions of the Banks Act, 1990, then the provisions of both Acts apply concurrently to the extent that it is possible to apply and comply with one of the inconsistent provisions without contravening the second. Section 5(4)(b)(i)(gg) of the New Companies Act further provides that in respect of the Banks Act, 1990, to the extent that it is impossible to

apply or comply with one of the inconsistent provisions without contravening the second, then the Banks Act, 1990 shall prevail.

It is against this background that the Department mandated an external legal firm in September 2009 to conduct an assessment of the implications of the New Companies Act in relation to the Banks Act, 1990. In terms of the mandate, the external legal firm was required to identify

- direct conflicts between the New Companies Act and the Banks Act, 1990, and make recommendations on how to resolve such conflicts;
- areas of duplication or overlap between the two Acts and make recommendations on how these Acts should be reconciled; and
- any gaps between the two Acts, being areas in which the exercise by the Registrar of his or her powers and functions will not be effective without amendments to those statutes, as a result of changes to corporate law brought about by the New Companies Act, and make recommendations on how these gaps should be dealt with.

the Department mandated an external legal firm to conduct an assessment of the implications of the New Companies Act in relation to the Banks Act

Arising from its assessment, the external legal firm produced a comprehensive matrix of its key findings identifying inconsistent, overlapping and duplicated provisions, and they made recommendations on how to address identified problem areas.

In general, the external legal firm found that the provisions of the New Companies Act and the Banks Act, 1990 could be applied concurrently and that in isolated instances where it was not possible, this should not be problematic because the New Companies Act provided for general provisions governing all companies, whereas the Banks Act, 1990 provided for specific requirements applicable to banks and controlling companies.

In the event that there may be an inconsistency, which may only come to light when the New Companies Act comes into effect, it will be covered by

- section 5(4)(a) of the Companies Act, 2008, as outlined above; and
- section 51 of the Banks Act, 1990, which in effect allows the Companies Act, 2008

to apply to banks and their controlling companies to the extent that such provisions are not inconsistent with any provisions of the Banks Act, 1990.

Preparations are under way to address the inconsistent, overlapping and duplicated provisions identified. The Department will consider the following key provisions:

the Department will consider key provisions

- Implementing legislative amendments to the Banks Act, 1990 where, for example,
  - reference is made to the “Companies Act”, which is defined in section 1 of the Banks Act, 1990 as the 1973 Companies Act;
  - reference is made to obsolete terminology in the Companies Act, 1973 which is utilised in the Banks Act, 1990, such as “Registrar of Companies” and “memorandum of association” and be replaced with analogous terminology in the New Companies Act;
  - provisions are defined with reference to the Companies Act, 1973, such as “subsidiary”;
  - definitions in the New Companies Act, which have either a wider or a more restricted meaning than in the Companies Act, 1973 and would have a consequential effect on terms used in the Banks Act, 1990, for example, the wider definition of “subsidiary” would have a consequential effect on a term such as “holding company” in the Banks Act, 1990;
  - the New Companies Act contains new definitions not previously included in the Companies Act, 1973; the Department may need to consider whether these terms should be incorporated into the Banks Act, 1990; and

- the New Companies Act allows companies extensive freedom and flexibility, which may be problematic when applied to the Banks Act, 1990. Similarly, the flexibility in requirements for the passing of special and ordinary resolutions may enjoin the Department to consider a framework for all banks and controlling companies to specify requirements regarding special resolutions in respect of banks and controlling companies.

- Section 51(2) of the Banks Act, 1990 provides that the Minister of Finance (with the concurrence of the Minister of Trade and Industry) may declare by way of notice in a *Government Gazette* that certain provisions of the Companies Act, 2008
  - shall not apply to any registered bank or controlling company;
  - shall only apply subject to adjustments; or
  - the administration of which vests with the Registrar of Companies, shall in respect of companies registered as banks, vest in the Registrar of Banks.

- As part of the consultation process with banks, the Department plans to facilitate a workshop in 2010 to discuss the proposed amendments to the Banks Act, 1990 and other issues concerning the New Companies Act.

Regulations pursuant to the New Companies Act

The Regulations pursuant to the New Companies Act were published for public comment per *Government Gazette* No. 32832, on 22 December 2009. Members of the public were invited to submit their comments by no later than 1 March 2010.

the Regulations provide guidelines to implementing chapters of the Companies Act

According to General Notice 1664 of 2009, the Regulations provide guidelines to implementing chapters of the Companies Act, 2008 and provide details about, among other things,
- reserving, transferring and registering company names, including defensive names;
- what documentation is required when incorporating a company or amending its constitutional documents, together with a number of short and long standard forms of Memoranda of Incorporation for certain different company types;
- the record-keeping requirements for companies, including accounting records to be maintained, information to be retained concerning directors and details of how such records may be accessed;
- the financial reporting standards that apply to different company types and the requirements for “audits” or “independent reviews” of annual financial statements (where applicable);
- how the conversion of par value shares to no par value shares should be dealt with;
- what information must be kept in a company's securities register and in what form;
- the conversion of certificated securities into uncertificated securities and the duties of the company in this regard;
- how the holders of beneficial interests may cast their votes;
- the wide range of senior company personnel who will constitute “prescribed officers” and therefore be subject to the same liabilities to which directors of a company are exposed;
- when a public or state-owned company will be exempted from the obligation to have a social and ethics committee and if not exempted, details regarding such committee’s composition and functions;
- the requirements for offers for the subscription or sale of securities, including details regarding prospectus requirements and contents;
- requirements applicable to fundamental transactions and affected transactions;

- the establishment of a Business Rescue Practice Regulatory Board to regulate the appointment of business rescue practitioners and the required qualifications for a person to be appointed as a business rescue practitioner; and
- how complaints, applications and Companies Tribunal hearings under the 2008 Act are to be made and dealt with.

The Regulations also contain the format of the Memoranda of Incorporation of the different types of companies envisaged in the Act, being profit and non-profit entities. Profit companies include state-owned, private, public and personal liability companies. But companies will not be compelled to make use of these prescribed forms and are free to compile their own document provided that the document is consistent with the Act. No other statutory forms that will be used for the ongoing administration of companies have yet been published for comment.

3.8 Update regarding co-operative banks

The Co-operative Banks Act, 2007 (Act No. 40 of 2007) (CBA) was assented to by the President on 18 February 2008 and published as Government Notice No. 737 in *Government Gazette* No. 30802 on 22 February 2008. The short title of the CBA, however, provides that it will come into operation on a date determined by the Minister of Finance by notice in the gazette, which was 1 August 2008.

The CBA seeks to create a development strategy and a regulatory environment for deposit-taking financial co-operative institutions. The CBA defines a 'co-operative bank' as

> a co-operative registered as a co-operative bank in terms of the Act whose members:–
>
> a. are of similar occupation or profession or who are employed by a common employer or who are employed within the same business district; or
> b. have common membership in an association or organisation, including a business, religious, social, co-operative, labour or educational group; or
> c. reside within the same defined community or geographical area.

Section 54 of the CBA establishes the Co-operative Banks Development Agency (CBDA). On 15 August 2008, the Minister of Finance, acting in terms of section 58 of the Act, appointed the following persons as the board members of the CBDA:

section 54 of the CBA establishes the Co-operative Banks Development Agency

1. Mr Sifiso Mthwalo Ndwandwe (Chairperson): Chief Executive Officer of Mineworkers Development Agency (MDA).
2. Ms Gugulethu Princess Africa (Deputy Chairperson): Regional Manager of South African Revenue Service (SARS).
3. Mr Vishwas Satgar: Executive Director of the Co-operatives and Policy Alternative Centre (COPAC).
4. Ms Daphne Hamilton: Head of Research and Development at the Institute of Bankers.
5. Adv. Neville John Melville: Admitted advocate and a consultant in the Office of the Public Protector.
6. Mr KeaObaka Mahuma: Founder and currently Chief Executive of Grandstone Group, an accounting, tax consulting and transaction advisory services firm.
7. Mr Jan Theron: Practising attorney and a part-time co-ordinator of Labour and Enterprise Project, Institute of Development and Labour Law at the University of Cape Town.

8. Adv. Edith Jabulile Zanele Kuzwayo: Head: Regulations Division of the Bank Supervision Department of the Bank.
9. Ms Nelisiwe Mokoena: Deputy Manager in the Co-operatives Unit at the KwaZulu-Natal Department of Economic Development.
10. Ms Olaotse Matshane: Director of Financial Inclusion in the Financial Sector Development Unit (FSDU) at the National Treasury.
11. Ms Nomvula Masango-Makgotlho: Director of Co-operative Development at the Department of Trade and Industry.

The CBDA is currently housed at National Treasury, 241 Vermeulen Street, Pretoria. Ms Sharda Naidoo is its Managing Director.

The CBA provides for the following four types of co-operative banks:

i Primary savings co-operative bank.
ii Primary savings and loans co-operative bank.
iii Secondary co-operative bank.
iv Tertiary co-operative bank.

the CBDA supervises primary co-operative banks that hold deposits of R20 million or less

The CBDA supervises primary co-operative banks that hold deposits of R20 million or less. Primary co-operative banks that hold deposits of above R20 million, secondary and tertiary co-operative banks are supervised by the Co-operative Banks Division of the Financial Stability Department (FinStab) of the Bank.

For the CBDA, Mr David de Jong was appointed as the Supervisor, while Mr André Bezuidenhout, head of the FinStab, is the Supervisor of the primary co-operative banks that hold deposits of above R20 million, secondary and tertiary co-operative banks.

Among other functions, both Messrs de Jong and Bezuidenhout are responsible for overseeing the registration of new co-operative banks falling within their respective jurisdictions, as well as developing and managing the regulatory guidelines, policies and procedures for monitoring, supervising and regulating co-operative banks.

the Regulations relating to Co-operative Banks were signed into law on 1 July 2009

The Regulations relating to Co-operative Banks were signed into law by the Minister of Finance and came into effect on 1 July 2009.

On 1 July 2009 the draft Co-operative Banks Act Combined Rules were published for public comment in terms of sections 46(1) and 57(1) of the CBA. The rules have now been published as final, and are entitled the Co-Operative Banks Act Supervisors' Rules, as per *Government Gazette* No. 32860 on 12 January 2010. The release of the rules will facilitate the registration of co-operative banks by the CBDA and the Bank.

3.9 Developments regarding Postbank

Postbank operates under an exclusion provided for in section 2(vii) of the Banks Act, 1990

Postbank is a division of the South African Post Office (SAPO) and is currently regulated by the Postal Services Act, 1998 (Act No. 124 of 1998) Chapter VI (sections 51 to 58) of the Postal Services Act, 1998 under the auspices of the Department of Communications. It operates under an exclusion provided for in section 2(vii) of the Banks Act, 1990. The exclusion notice was published in *Government Gazette* No. 13744 of 24 January 1992. It does not operate under a special exemption from the provisions of the Banks Act, 1990, as is erroneously stated in the *White Paper on Postal Policy* of 14 May 1998.

White Paper stipulates the government's intention to restructure its banking interest in the Post Office

The White Paper stipulates the government's intention to restructure its banking interest in the SAPO and proposes that such restructuring should be implemented in a three-phased process:

- Phase I envisages that Postbank would operate as a profit centre providing greater autonomy within the existing divisional structure, and it was further proposed that the savings product range be expanded.
- Phase II envisages that Postbank would operate as a fully owned subsidiary of the SAPO or Government, providing a complete range of payment and funds transfer services, and also to expand the deposit service range.
- Phase III envisages that Postbank would operate as a savings bank that is an autonomous company owned by the SAPO or government and operated as a fully-fledged savings bank extending lending facilities.

What is of importance to note is that the White Paper further envisages that the Bank shall exercise supervisory control over the activities of Postbank in terms of the reporting requirements of the Banks Act, 1990.

An MoU between the then Minister of Finance, Mr Trevor Manuel, and the then Minister of Communications, the late Dr Ivy Matsepe-Casaburri, was signed in 2005 to give effect to the stipulations in the White Paper. The MoU governs the principles and process to be followed in the restructuring and corporatisation of Postbank and includes milestones to be reached until the process is finalised.

To that end, the National Treasury has convened a working committee involving representatives of several stakeholder organisations, including the Department, to process the details, legal issues and practicalities required to complete the project. The milestones identified in terms of the project include

- reaching agreement on the minimum prudential regulatory requirements with the Department and to present them to Postbank;
- establishing an interim regulatory framework pending the promulgation of the Dedicated Banks Bill; and
- registering Postbank in terms of the New Companies Act and listing it as a public entity in terms of the Public Finance Management Act, 1999 (Act No. 1 of 1999).

As part of the first milestone, the Department made a submission setting out the minimum criteria for the registration and supervision of a bank that would also be applicable to Postbank if it were to be registered and supervised by the Department.

minimum criteria for the registration and supervision of a bank would also be applicable to Postbank

As part of the second milestone, the Department, in the same submission as the one referred to above, further outlined the possibility of supervising Postbank by means of an exemption to the Banks Act, 1990, subject to certain conditions that could be supervised by the Department. These conditions included an independent board of directors, appropriate corporate governance structures, appropriate risk management structures, and compliance with the same capital requirements and information systems as those required of banks. These requirements have to date not been met by Postbank.

The process regarding the third milestone is currently under way as the South African Postbank Bill was tabled in Parliament in November 2009. The Department supports the Bill in principle as it believes it will be a first step in the process of corporatising Postbank. However, the Banks Act, 1990 requires that a person conducting the business of a bank must be a public company. In view of the provisions of the New Companies Act which defines “public company” as “a profit company that is not a state-owned company, a private company or a personal liability company”, the Department is of the view that this development could result in amendments being made to the above-mentioned project.

The restructuring of SAPO’s banking interests, and the future legislative and supervisory framework under which it will operate, will be closely monitored by the Department during 2010, with specific focus on the resolution of outstanding legal issues and practicalities required to complete the project.

3.10 The King Report on Corporate Governance for South Africa – 2009

The King Committee is acknowledged to be the standard-setting body for corporate governance in South Africa, and is among one of many such bodies in this regard internationally. The Department monitors, on an ongoing basis, developments emanating from the committee and other such international bodies.

The King III Code will come into effect on 1 March 2010, replacing the King II Code.

The King III Code was inspired by, and its release coincides with, the New Companies Act which is discussed in section 3.7 of this report.

King III Code applies to all entities regardless of the manner and form of incorporation or establishment

In contrast to the King I and II codes, the King III Code applies to all entities regardless of the manner and form of incorporation or establishment, and whether in the public, private or non-profit sectors. All entities, including banking institutions, are expected to apply the principles set out therein and consider the best practice recommendations.

The King III Code applies to entities incorporated and resident in South Africa. The code recommends that foreign subsidiaries of local companies should apply the code to the extent prescribed by the holding company and subject to entity-specific foreign legislation. The King III Code comprises 114 principles covering the following topics:

- Ethical leadership and corporate citizenship.
- Boards and directors.
- Audit committees.
- The governance of risk.
- The governance of IT.
- Compliance with laws, rules, codes and standards.
- Internal audit.
- Governing stakeholder relationships.
- Integrated reporting and disclosure.

According to the King III Code, each principle is of equal importance and, together, will form a holistic approach to governance. The Department is in the process of considering the King III Code in order to determine whether any amendments to the Banks Act, 1990, and/or Regulations relating to Banks would be necessary or appropriate.

3.11 Decision of the Board of Review in the review of the decision of the Registrar in respect of an application for authorisation to establish a bank

In 2006 the Department received an application for authorisation to establish a bank. The Department refused the application on the grounds that the Applicant could not satisfy many of the prescribed requirements.

3.11.1 Board of Review

the Department's decision was taken on review to the Board of Review

The Department's decision was taken on review to the Board of Review (established in terms of section 9 of the Banks Act, 1990) by the Applicant. The Department opposed the application. The hearing of the matter took place on 11 and 12 February 2008, and the decision was delivered by the Honourable Mr Justice F C Kirk-Cohen on Wednesday, 23 April 2008.

The findings were as follows:

- The decision confirmed that the Board's jurisdiction was confined to establish whether or not, in deciding to refuse the application for authorisation to establish a bank, the Registrar exercised his discretion properly and in good faith.
- Whether or not the Registrar acted in "good faith" was never an issue raised by the Applicant and the Board found that it was common cause that the Registrar acted in good faith.
- The only issue that had to be decided upon by the Board was whether or not the Registrar exercised his discretion "properly". The Board not only found that the Registrar had exercised his decision properly, but also that his decision was correct as the Applicant had not complied with the legal requirements in this regard.
- The Board could not set aside or vary the decision of the Registrar where he had exercised his discretion properly (and correctly). More specifically, the Board found that it could not direct the Registrar to grant the Applicant the authority in terms of section 13(1) of the Banks Act, 1990 to establish a bank.
- The Board unanimously refused the review application by the Applicant and confirmed the Registrar's decision.

3.11.2 High Court application

In August 2009 the Applicant brought an application in the High Court (Pretoria) for the review of both the Registrar's and the Board's decisions.

application in the High Court for the review of both the Registrar's and the Board's decisions

The Applicant averred that the Registrar's decision to decline the application for authorisation to establish a bank was "materially influenced by an error of law" and that the decision was "so unreasonable that no reasonable person could have exercised that power or performed the particular function".

In his judgment, the Honourable Mr Justice Bill Prinsloo, however, agreed with the Board's decision and stated that "where bona fides is not an issue, the Board is therefore confined to establishing whether or not, in the taking of the relevant decision, the Registrar exercised his or her discretion properly.".

A key finding in relation to the consideration of an application for the registration as a bank by the Department is to be found in the following remarks made by the judge:

> Counsel for the Registrar point out, correctly in my view, that the Registrar plays a crucial role with regard to the stability and soundness of the South African Banking System. As such his role as "gatekeeper" with regard to the authorisation of prospective applicants to establish a bank is paramount. The Registrar has a duty to ensure that when an applicant ultimately progresses to the stage of consideration for registration as a bank, he can be content that he has taken all reasonable steps to assure himself that the bank will operate successfully as such, and is unlikely to fail or conduct itself in a manner which might place the South African Banking System at risk. These sentiments are in harmony with the provisions of section 13(2) of the Act.

The judge referred to the reasoning of the Department in its conclusion that the application for authorisation to establish a bank by the Applicant should be dismissed and stated that the Board, "in its comprehensive and well-reasoned judgment, came to the same conclusions. I see no basis for interfering with the findings of the Board".

The Applicant's application to the High Court to have the Registrar's decision set aside by the Board was dismissed with costs.

Chapter 4: Banking-sector overview

4.1 Introduction

This chapter provides an overview of the financial and risk information, compiled by means of the aggregation of data relating to the domestic operations of individual South African-registered banks, including domestic branches of international banks (offshore branches and subsidiaries of domestic banks are excluded). Information mostly represents aggregated banks' solo information, except where indicated that it represents the consolidated banking groups concerned (refer to sections 4.3.4 and 4.6.2 for consolidated banking group information). Section 4.2.3 on the global presence of South African banks includes the banks' offshore subsidiaries, branches and representative offices (Figure 4.2). Also, it should be noted that information presented in respect of credit risk does not in all instances represent aggregated total banks; rather the aggregated amount relating to groupings of banks that adopted certain approaches to calculate minimum capital requirements.

Information in this chapter is presented for 2008 and 2009, except in areas where smoothed ratios (i.e., 12-month moving averages) are calculated, in which instances these ratios are only provided for 2009.

the four largest banks contributed 84,6 per cent of the banking sector

The South African banking-sector information is dominated by the four largest banks, which contributed 84,6 per cent to the balance-sheet size of the banking sector. Appendix 2 provides the balance-sheet sizes of all individual banks and Appendix 6 provides additional financial and risk information tables.

4.2 Structural features of the banking sector

4.2.1 Banking entities registered in South Africa

Table 4.1 reflects the number of entities that have been registered or licensed with the Department since 2001. During 2009 the number of registered banks reduced from 19 to 18 due to a transaction in which Absa Group Limited acquired all the shares in Meeg Bank Limited (Meeg). Following the divisionalisation of Meeg into Absa Bank Limited, Meeg's banking licence was cancelled with effect from 25 May 2009.

Table 4.1 South African banking sector: Number of entities registered or licensed

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Banks*	41	30	22	20	19	19	19	19	18
Mutual banks	2	2	2	2	2	2	2	2	2
Branches of international banks in the Republic of South Africa	15	14	15	15	15	14	14	14	13
Representative offices	56	52	44	43	47	43	46	43	42
Controlling companies	37	27	19	16	15	15	15	15	15
Banks under curatorship	1	1	1	0	0	0	0	0	0
Banks in receivership	0	2	2	0	0	0	0	0	0
Banks in final liquidation	1	1	1	2	2	2	2	2	2

* Includes active banks and banks exempted by the Registrar of Banks (with effect from 1 July 1996) in terms of the Supervision of Financial Institutions Rationalisation Act, 1996 (Act No. 32 of 1996) and section 1(cc) of the Banks Act, 1990.

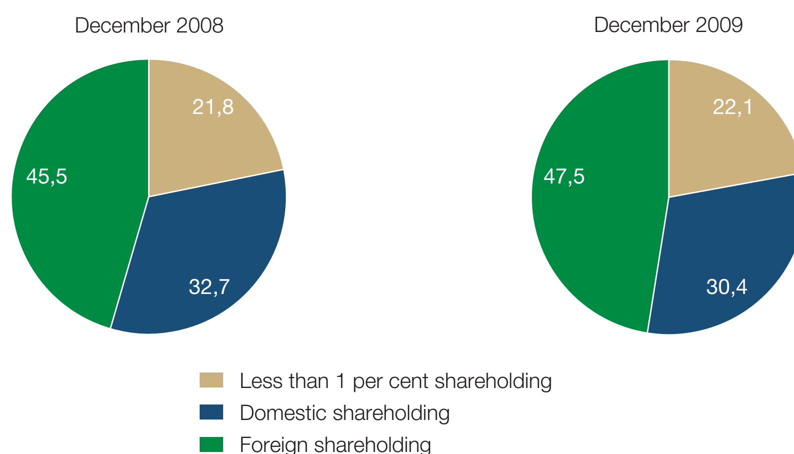
Furthermore, the number of branches of foreign banking institutions also declined from 14 at the end of 2008 to 13 at the end of 2009 owing to the conversion of Commerz Bank Aktiengesellschaft (Johannesburg Branch) from a branch to a representative office. During 2009 four representative offices decided to close down and three new representative offices were registered. Appendices 2, 3, 4, 5 and 8 provide information regarding the entities registered or licensed with the Office of the Registrar of Banks at the end of 2009.

4.2.2 Shareholding structure

The shareholding structure of South African banks is set out in Figure 4.1. Foreign shareholders held 47,5 per cent of the nominal value of the South African banking sector's shares in issue at the end of December 2009, slightly higher than the 45,5 per cent recorded at the end of December 2008. A large foreign shareholding in one of the largest banks, Absa Bank Limited, contributes significantly to the high percentage of shares held by foreign shareholders. Domestic shareholders accounted for 30,4 per cent and minority shareholders 22,1 per cent of the nominal value of banking sector shares in issue at the end of December 2009 (December 2008: 32,7 per cent and 21,8 per cent respectively).

foreign shareholders held 47,5 per cent of banking sector's

Figure 4.1 Shareholding structure of the South African banking sector (nominal value of shares) (per cent)



4.2.3 Approval of local and foreign expansions by South African banking groups

The Core Principles prescribe that banking supervisors should have the power to review major acquisitions or investments by a bank or a bank controlling company against prescribed criteria, including the establishment of cross-border operations. This review should confirm that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision. Section 52 of the Banks Act, 1990, requires that banking groups obtain the prior approval of the Registrar for the establishment or acquisition of any subsidiary, cross-border branch, representative office or any undertaking that has its registered office or principal place of business outside South Africa. Table 4.2 reflects the number of applications that have been approved by the Department since 2001. The vast majority of applications processed by the Department are submitted by the five largest banking groups.

banking supervisors should have the power to review major acquisitions

Table 4.2 South African banking sector: Number of approvals for local and international expansions granted in terms of section 52 of the Banks Act, 1990

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Local	72	47	28	16	29	16	12	15	10
Foreign	44	43	31	20	17	8	25	19	28
Total	116	90	59	36	46	24	37	34	38

4.2.4 Banking-sector global presence

Figure 4.2 provides the global representation of South African banking groups in respect of branches, subsidiaries and representative offices.

Figure 4.2 Global presence of South African banks

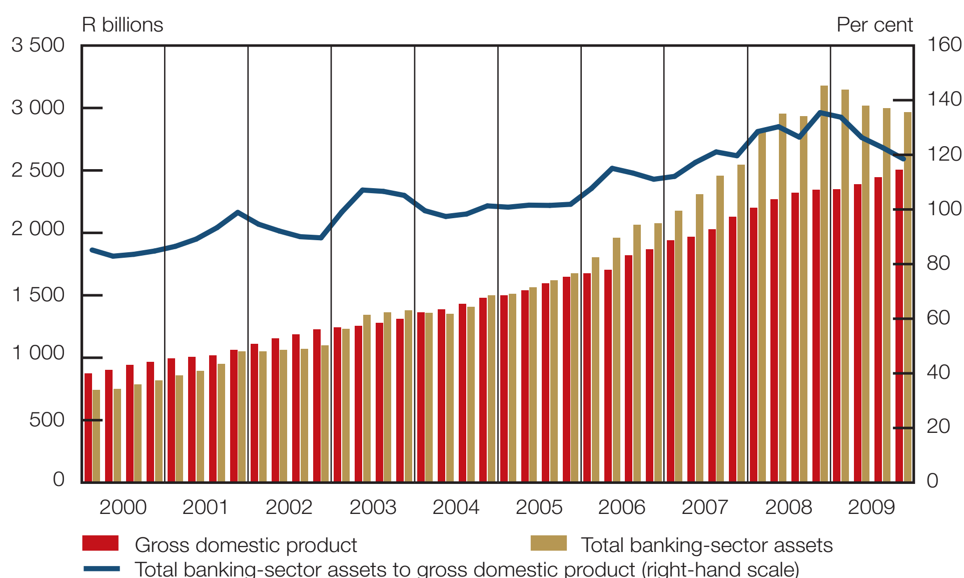
4.2.5 Banking-sector assets to gross domestic product

slowdown in the growth of gross loans and advances during 2009

Figure 4.3 measures the balance-sheet size of the banking sector relative to that of the gross domestic product[30] (GDP). The banking sector balance-sheet size grew to R3 177 billion in December 2008 (135,4 per cent of GDP), the highest quarter-end level during that period, followed by a decline in asset growth during 2009, ending the year at R2 967 billion (118,5 per cent of GDP). As described in section 4.3.1 below, a substantial increase in derivative financial instruments during October 2008, and subsequent decline thereof during 2009 was the main contributor to fluctuations in balance sheet growth from the latter part of 2008 to the end of 2009. A slowdown in the growth of gross loans and advances during 2009 further added to the decline in the growth of total assets (refer to Figure 4.6).

30 'Gross domestic product' refers to the gross domestic product at market prices, as published in the South African Reserve Bank *Quarterly Bulletin*, reference code NRI 6006L.

Figure 4.3 Total banking-sector assets to gross domestic product



4.3 Balance sheet

4.3.1 Assets

Figure 4.4 illustrates the growth in banking-sector assets, and gross loans and advances from January 2008 to December 2009. There was a notable decline in banking-sector assets during 2009, as opposed to significant growth in the preceding year. In 2008 the rate of growth in banking-sector assets remained above 20 per cent reaching a peak of 30 per cent at the end of October 2008 (mainly due to a material increase in the value of derivative financial instruments, in particular at the height of the international financial crisis) prior to slowing down ending the year at 24,8 per cent. The slowdown in the growth of banking-sector assets continued throughout 2009, reaching 2,2 per cent at the end of September 2009 and turning negative, year on year, during the last quarter of 2009.

slowdown growth of banking-sector assets continued throughout 2009

At the end of December 2009, banking-sector assets amounted to R2 967 billion (December 2008: R3 177), representing a decline of 6,6 per cent at the end of 2009. The decline in banking-sector assets during 2009 can be attributed to the strong and consistent monthly decreases in the value of derivative financial instruments coupled with a general slowdown in the growth of gross loans and advances. Figure 4.6 provides further detail in this regard.

Gross loans and advances declined by 2,6 per cent from R2 316 billion at the end of December 2008 to R2 257 billion at the end of December 2009 (December 2008: 9 per cent increase). As shown in Figure 4.5, banking-sector assets comprise mainly loans and advances, followed by derivative financial instruments. Derivative financial instruments increased from R245 billion at the end of September 2008 to R507 billion at the end of October 2008 due to fair value adjustments necessitated by the turmoil experienced in international financial markets at the time. This resulted in a substantial increase in the percentage composition of derivative financial instruments

fair value adjustments necessitated by turmoil in international financial markets

derivative financial instruments represented 8,9 per cent of banking-sector assets

during the aforementioned period. The subsequent monthly decreases in the fair value of derivative financial instruments were due to the re-adjustment of financial markets subsequent to the height of the international financial market crisis. By the end of 2009 derivative financial instruments represented 8,9 per cent of banking-sector assets (December 2008: 14,3 per cent) and loans and advances represented 74,3 per cent of banking-sector assets (December 2008: 71,7 per cent).

Figure 4.4 Total assets, gross loans and advances, and their respective growth rates (year on year)

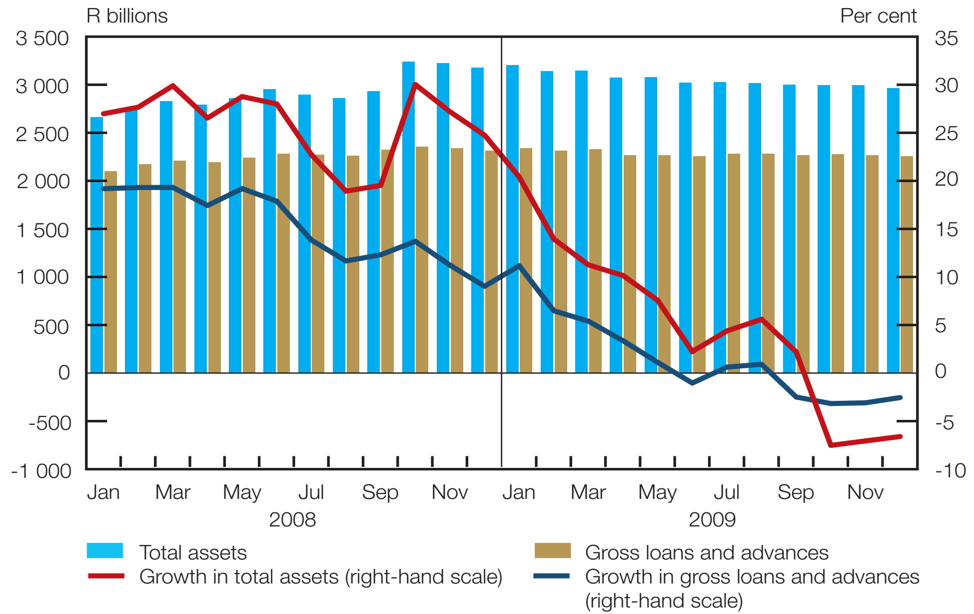


Figure 4.5 Composition of total assets

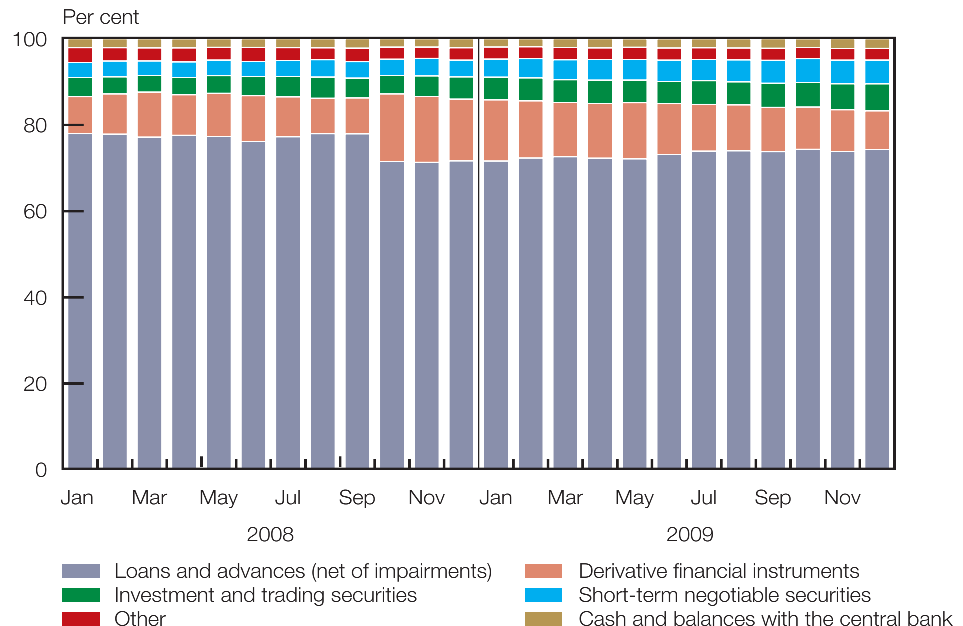


Figure 4.6 depicts the growth rates of various types of loans and advances during 2009. The decline in total gross loans and advances was mainly attributable to declines in the growth rates of homeloans, term loans, lease and instalment debtors, commercial mortgages, bank intra-group balances, and other loans. The annual growth in homeloans (which constituted 34,8 per cent of gross loans and advances) declined from

10,5 per cent at the end of January 2009 to 3,0 per cent at the end of December 2009. Term loans (contributing 16,8 per cent to gross loans and advances) also grew at a much slower pace at the end of 2009; being down from 35,4 per cent at the end of January 2009 to 0,15 per cent at the end of December 2009. Prevailing economic conditions, including lower income growth, the level of indebtedness of consumers and a general decline in consumer confidence contributed to the lower levels of growth in loans and advances during the period under review.

term loans grew at a much slower pace

Figure 4.6 Growth rates of selected asset classes within loans and advances (year on year)

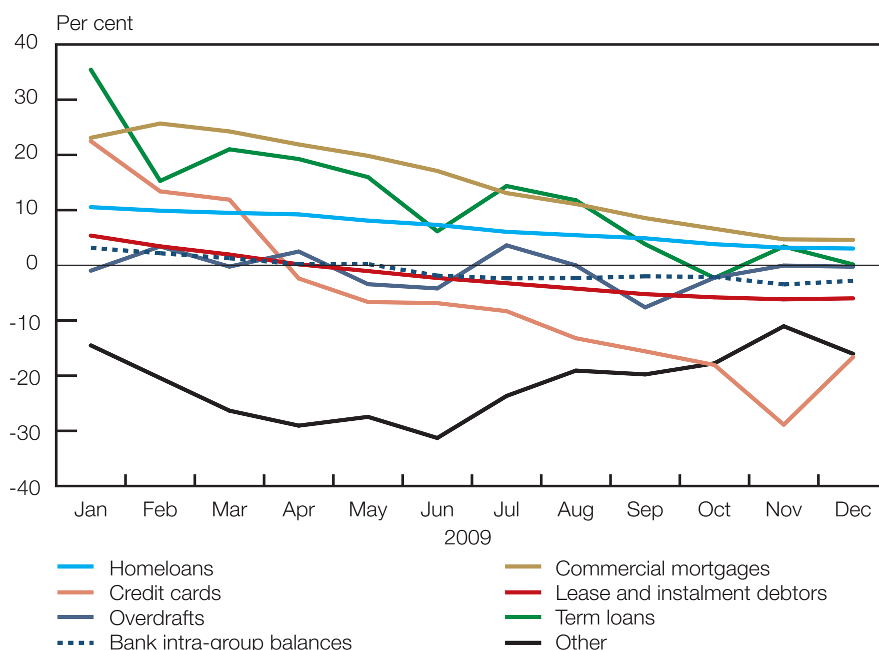
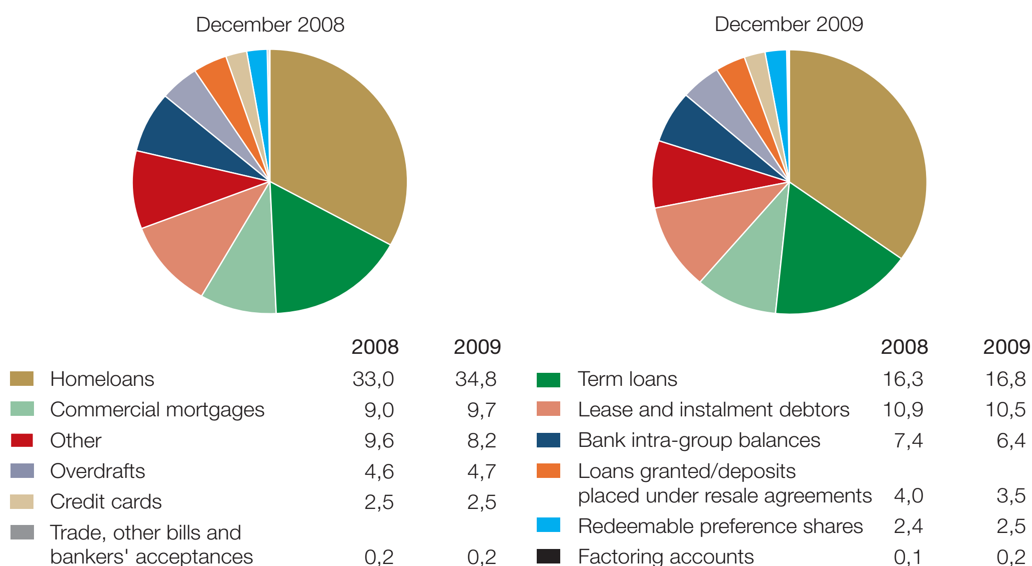


Figure 4.7 provides a breakdown of gross loans and advances. Homeloans and term loans represented approximately 52 per cent of gross loans and advances at the end of December 2009, slightly higher than the level recorded at the end of December 2008. Lease and instalment debtors represented 10,5 per cent, commercial mortgages 9,7 per

homeloans and term loans represented 52 per cent of gross loans and advances

Figure 4.7 Composition of gross loans and advances (per cent)



	2008	2009
Homeloans	33,0	34,8
Commercial mortgages	9,0	9,7
Other	9,6	8,2
Overdrafts	4,6	4,7
Credit cards	2,5	2,5
Trade, other bills and bankers' acceptances	0,2	0,2
Term loans	16,3	16,8
Lease and instalment debtors	10,9	10,5
Bank intra-group balances	7,4	6,4
Loans granted/deposits placed under resale agreements	4,0	3,5
Redeemable preference shares	2,4	2,5
Factoring accounts	0,1	0,2

cent, bank intra-group balances 6,4 per cent and other loans 8,2 per cent at the end of December 2009. Overdrafts, loans granted or deposits placed under resale agreements, credit cards, redeemable preference shares, factoring accounts, other bills and bankers' acceptances, each constituted less than 5 per cent of gross loans and advances at the end of both December 2008 and December 2009.

loans and advances to banks remained fairly stable

Loans and advances to banks, as shown in Figure 4.8, remained fairly stable during 2009 compared with 2008 where they fluctuated between R332,8 billion and R409,2 billion. By the end of December 2009, loans and advances to banks amounted to R293,7 billion (December 2008: R332,8 billion), representing a year-on-year decrease of 11,8 per cent. Expressed as a percentage of gross loans and advances, loans and advances to banks fluctuated between 12,8 per and 14,8 throughout 2009 and constituted 13 per cent of gross loans and advances at the end of December 2009 (December 2008: 14,4 per cent).

Figure 4.8 Loans and advances to banks

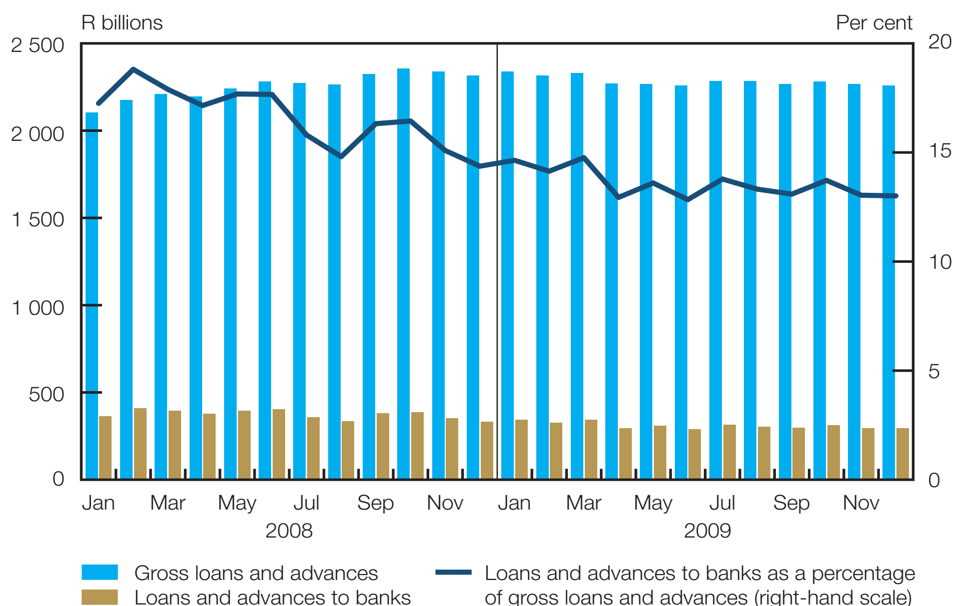


Figure 4.9 depicts foreign-currency loans and advances, and foreign-currency deposits and foreign-currency funding. There was a substantial decrease in foreign-currency loans and advances at the end of April 2009, September 2009 and to some extent November 2009. The decrease in April 2009 was reported mainly by one large bank, while the decreases in September 2009 and November 2009 were reported by a few large banks and some of the branches of international banks. By the end of December 2009 foreign-currency loans and advances amounted to R163,8 billion (December 2008: R177,5 billion). Expressed as a percentage of banking-sector assets, foreign-currency loans and advances represented 5,5 per cent of banking-sector assets at the end of December 2009 (December 2008: 5,6 per cent).

Moreover, foreign-currency deposits and foreign-currency funding were lower during 2009 compared with the levels recorded during 2008, indicating that South African banks are not overly dependent on foreign sources of funding and deposits. Significant decreases were reported during April 2009 and May 2009 by some of the large banks and two branches of international banks. By the end of December 2009, foreign-currency deposits and foreign-currency funding amounted to R119,1 billion (December 2008: R152,3 billion). Expressed as a percentage of banking-sector liabilities, foreign-currency deposits and foreign-currency funding constituted 4,3 per cent of banking-sector liabilities (December 2008: 5,1 per cent).

South African banks are not overly dependent on foreign sources of funding and deposits

Figure 4.9 Foreign-currency loans and advances (as a percentage of total assets) and the total of foreign-currency deposits and foreign-currency funding (as a percentage of total liabilities)

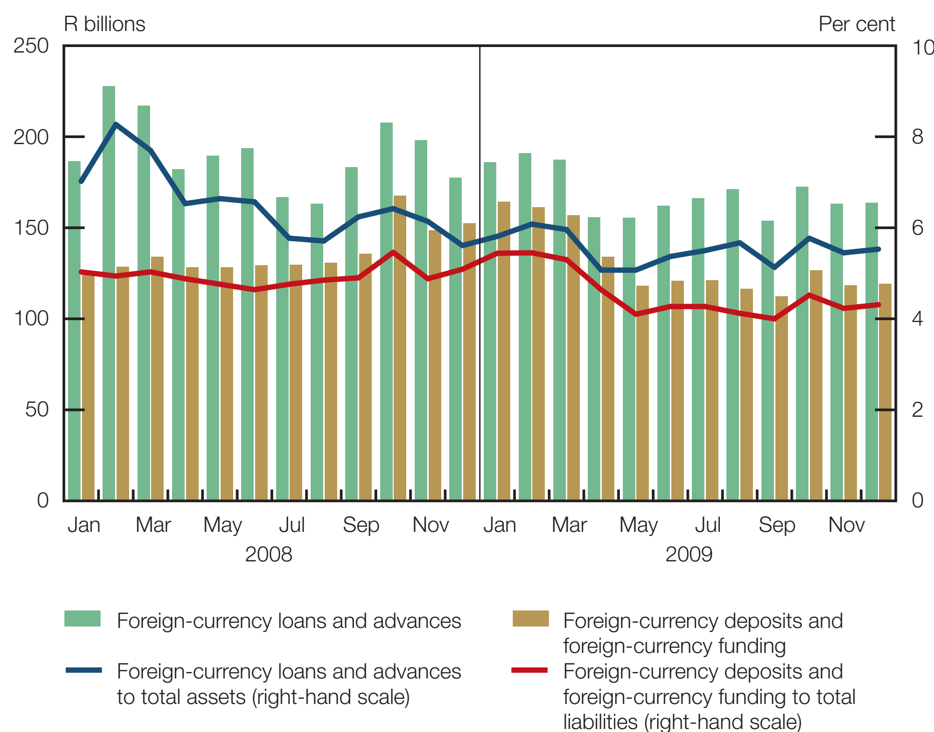
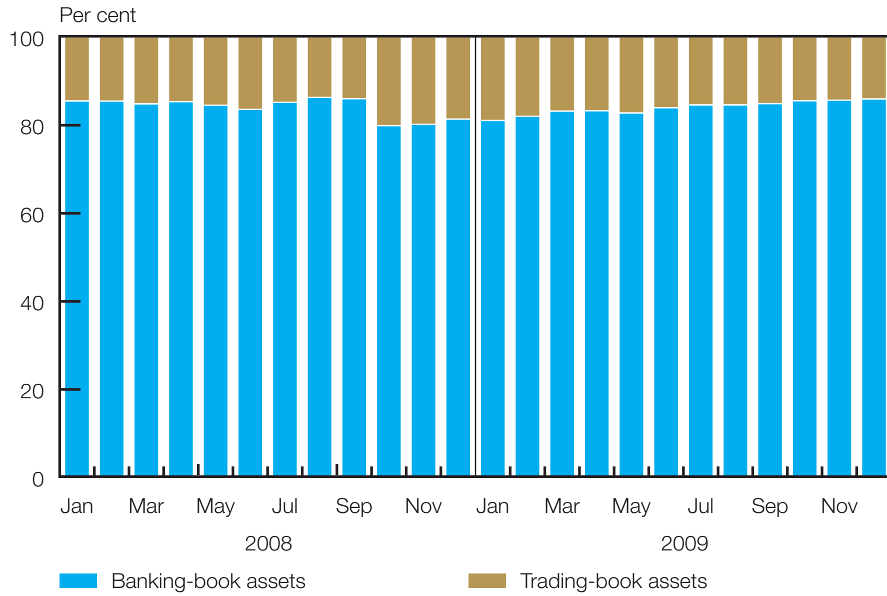


Figure 4.10 illustrates the composition of banking-sector assets in terms of banking-book and trading-book assets. Trading-book assets increased from 14,0 per cent at the end of September 2008 to 20,1 per cent at the end of October 2008 due to an increase in derivative activities and the value thereof, as mentioned in Figure 4.5 above. The trading-book assets have since been declining and represented 14,0 per cent of banking-sector assets (December 2008: 18,6 per cent), while banking-book assets represented 86,0 per cent of banking-sector assets at the end of 2009 (December 2008: 81,4 per cent).

Figure 4.10 Banking-book versus trading-book assets (as a percentage of total assets)

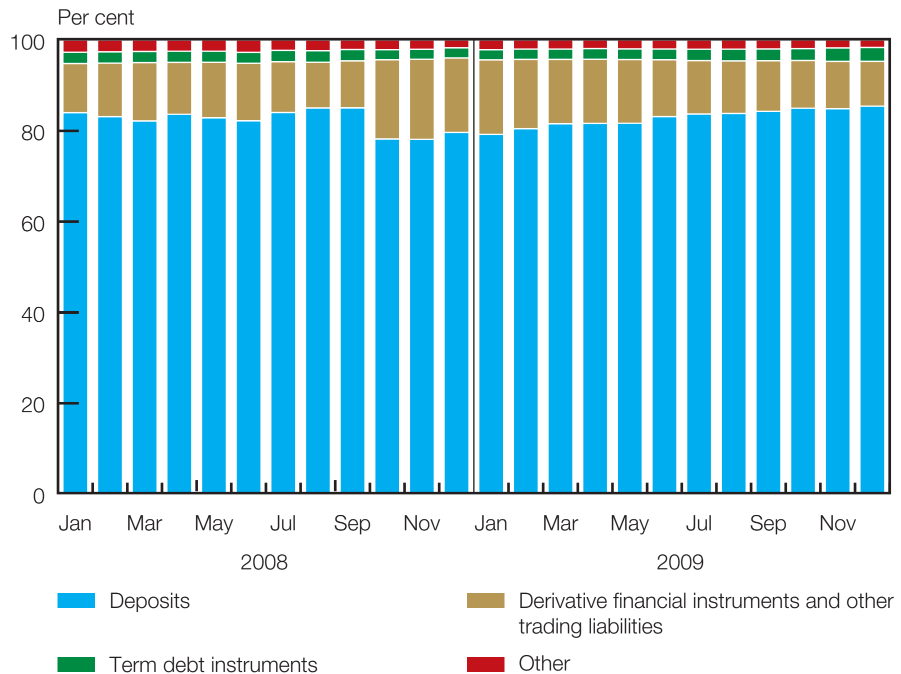


4.3.2 Liabilities

deposits constitute a significant percentage of banking-sector liabilities

The composition of banking-sector liabilities is shown in Figure 4.11. Deposits continued to constitute a significant percentage of banking-sector liabilities throughout 2009, amounting to 85,4 per cent at the end of December 2009 (December 2008: 79,6 per cent). Derivative financial instruments and other trading liabilities amounted to 9,9 per cent of banking-sector liabilities at the end of December 2009 (December 2008: 16,4 per cent). The liability position in derivative financial instruments mirrored the month

Figure 4.11 Composition of liabilities



on month movements of the asset position in derivative financial instruments as discussed above (refer to Figure 4.5). Term debt instruments and other liabilities represented a small portion, 3,1 per cent and 1,6 per cent respectively, of banking-sector liabilities at the end of December 2009 (December 2008: 2,2 per cent and 1,7 per cent respectively).

The asset and liability positions in financial derivatives, expressed as a percentage of equity attributable to equity holders, are depicted in Figure 4.12. The asset and liability positions remained fairly matched throughout the period under review. The ratios at the end of December 2009 were at levels similar to those reflected in January 2008.

asset and liability positions remained fairly matched

Figure 4.12 Asset and liability position in financial derivatives (as a percentage of equity attributable to shareholders)

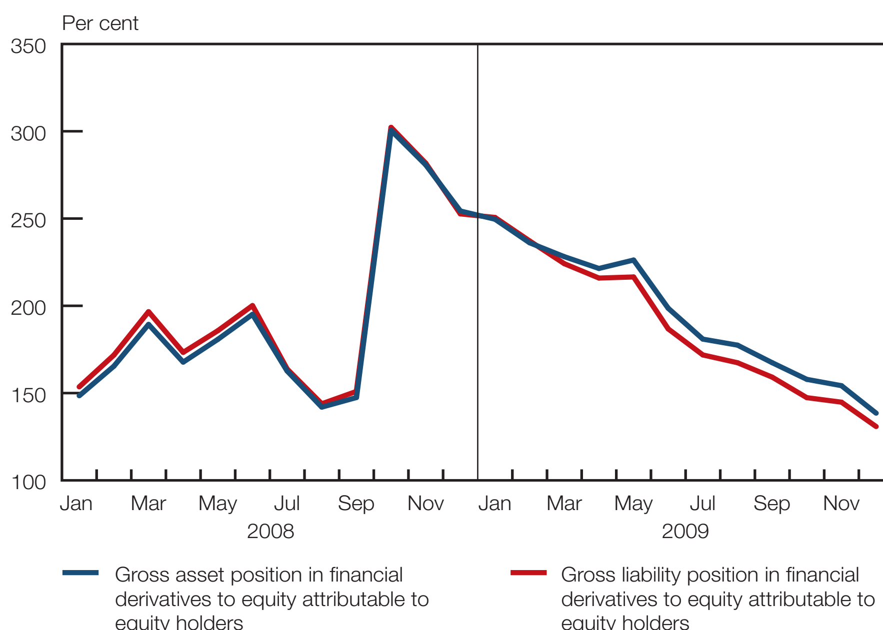


Figure 4.13 illustrates total term debt instruments and term debt instruments qualifying as regulatory capital. While term debt instruments remained fairly stable during the first half of 2009, at approximately R68 billion, they increased during the second half of 2009 to R84,7 billion at the end of December 2009 (December 2008: R67,2 billion). The increase in November 2009 was mainly due to the issue of term debt instruments by two of the large banks.

By the end of 2009, 68,1 per cent of total term debt instruments qualified as regulatory capital (December 2008: 73,6 per cent).

68,1 per cent of total term debt instruments qualified as regulatory capital

The composition of deposits, as shown in Figure 4.14, remained fairly stable between December 2008 and December 2009. By the end of December 2009, deposits amounted to R2 366 billion, of which fixed and notice deposits accounted for 27,4 per cent (December 2008: 24,9 per cent). Negotiable certificates of deposit represented 18,0 per cent, call deposits 18,0 per cent, current accounts 16,8 per cent and other deposits 10,5 per cent of deposits at the end of December 2009 (December 2008: 16,2 per cent, 22,0 per cent, 17,4 per cent and 10,2 per cent, respectively). Savings deposits and repurchase agreements, combined, constituted approximately 10 per cent of deposits.

Figure 4.13 Term debt instruments qualifying as regulatory capital (as a percentage of total term debt instruments)

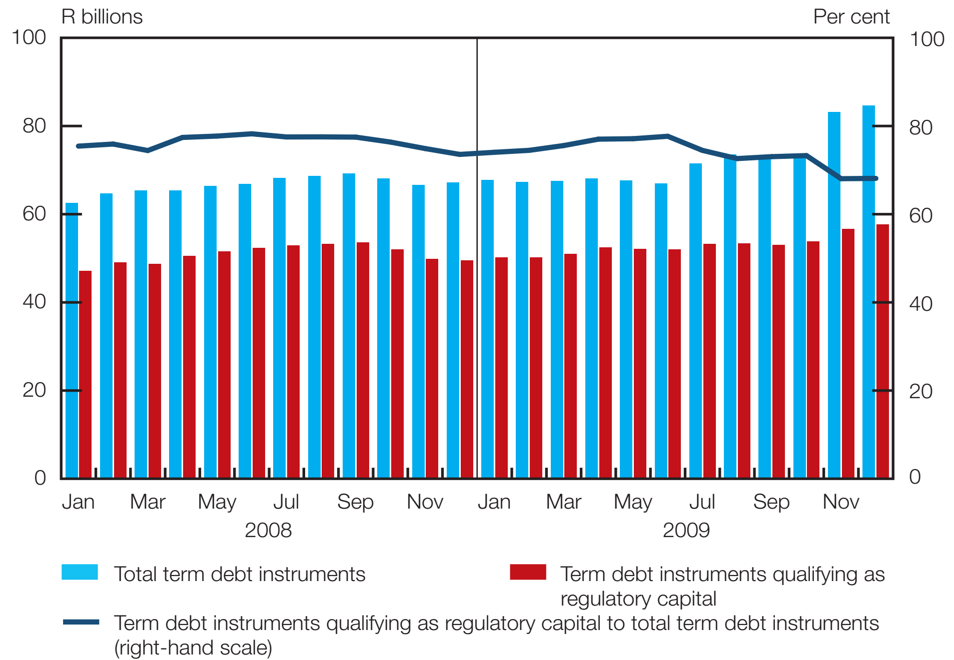
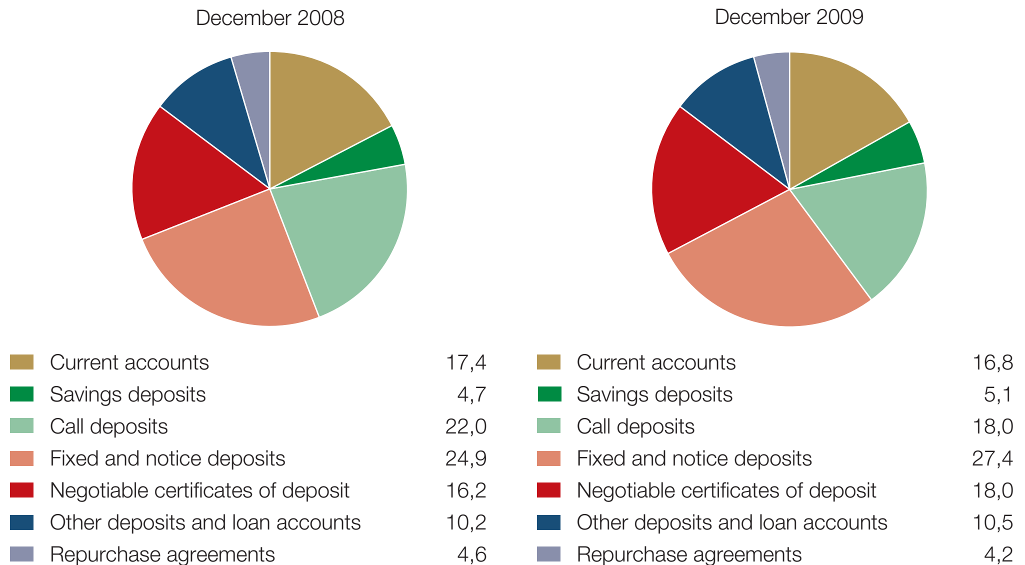


Figure 4.14 Composition of deposits (per cent)



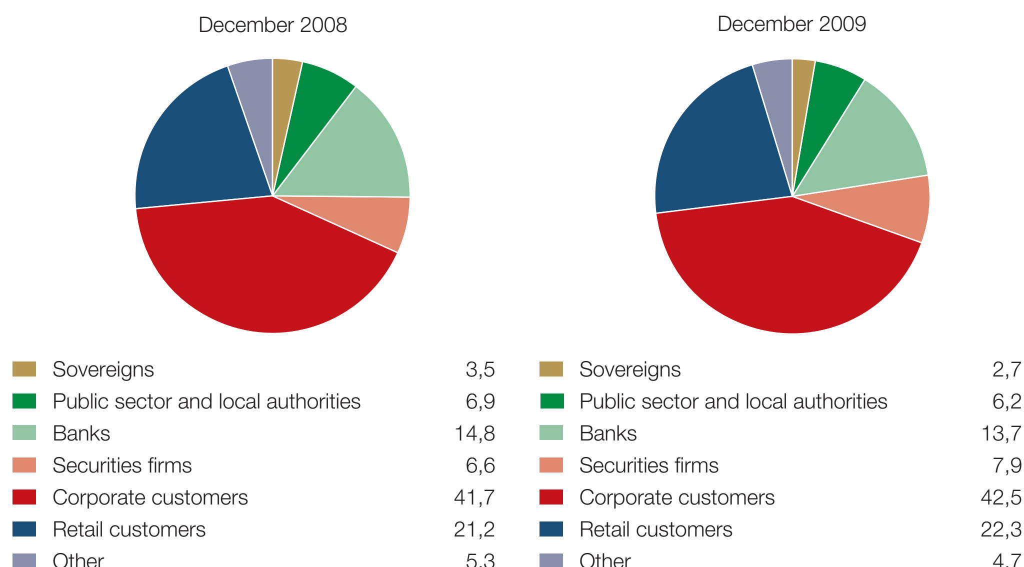
December 2008	
Current accounts	17,4
Savings deposits	4,7
Call deposits	22,0
Fixed and notice deposits	24,9
Negotiable certificates of deposit	16,2
Other deposits and loan accounts	10,2
Repurchase agreements	4,6

December 2009	
Current accounts	16,8
Savings deposits	5,1
Call deposits	18,0
Fixed and notice deposits	27,4
Negotiable certificates of deposit	18,0
Other deposits and loan accounts	10,5
Repurchase agreements	4,2

sources of deposits remained fairly stable

Sources of banking-sector deposits are reflected in Figure 4.15. As shown, the sources of deposits between December 2008 and December 2009 remained fairly stable. Deposits by corporate customers constituted the larger portion of banking-sector deposits amounting to 42,5 per cent at the end of December 2009, followed by retail customers and bank deposits, which accounted for 22,3 per cent and 13,7 per cent respectively, at the end of December 2009. The banking sector also received deposits from securities firms, public sector and local authorities, sovereigns and other sources, which represented 7,9 per cent, 6,2 per cent, 2,7 per cent and 4,7 per cent respectively at the end of December 2009.

Figure 4.15 Sources of total deposits (as a percentage of total deposits)

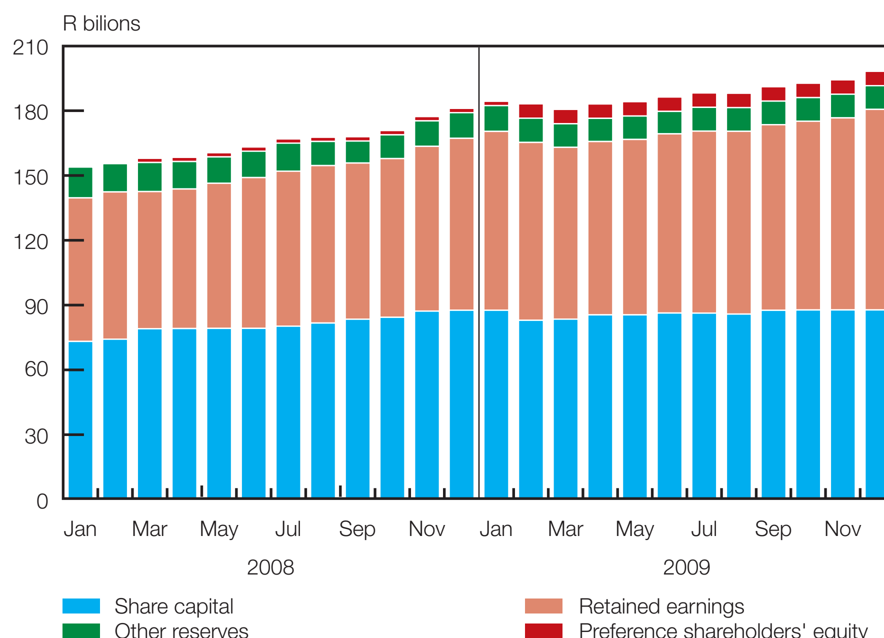


4.3.3 Equity

Figure 4.16 provides a breakdown of total equity. Total equity amounted to R198,2 billion at the end of December 2009 (December 2008: R181,1 billion), representing an annual increase of 9,5 per cent. Share capital and retained earnings cumulatively constituted approximately 91 per cent of total equity throughout 2009 (December 2009: share capital 44,3 per cent and retained earnings 46,8 per cent). Other reserves and preference shareholders' equity cumulatively accounted for less than 10 per cent of total equity during 2009 (December 2009: other reserves 5,5 per cent and preference shareholders' equity 3,4 per cent). Preference shareholders' equity increased from R2 billion at the end of January 2009 to R6,6 billion at the end of February 2009, and remained at this level throughout 2009.

share capital and retained earnings constituted 91 per cent of total equity throughout 2009

Figure 4.16 Composition of total equity



financial leverage ratio improved during 2009

During 2009, the Basel Committee proposed measures to strengthen the Basel II capital framework which included, *inter alia*, the introduction of a leverage ratio as an additional prudential tool to limit excessive leverage in a banking system, as was evident in some jurisdictions during the international financial market crisis. The financial leverage ratio for the South African banking sector is illustrated in Figure 4.17, and is calculated using total assets divided by total equity attributable to equity holders. The financial leverage ratio improved during 2009, ending the year at 15,7 times (December 2008: 17,9 times). The lower financial leverage ratio during 2009 may be attributed mainly to the decline in banking-sector asset growth (December 2009: 6,6 per cent decrease measured year on year) and the strong growth in total equity attributable to equity holders, which remained above 10 per cent year on year, during the first three quarters of 2009, before declining to 7,0 per cent at the end of December 2009. The respective growth rates in banking-sector assets and total equity attributable to equity holders are reflected in Figure 4.18.

Figure 4.17 Financial leverage ratio

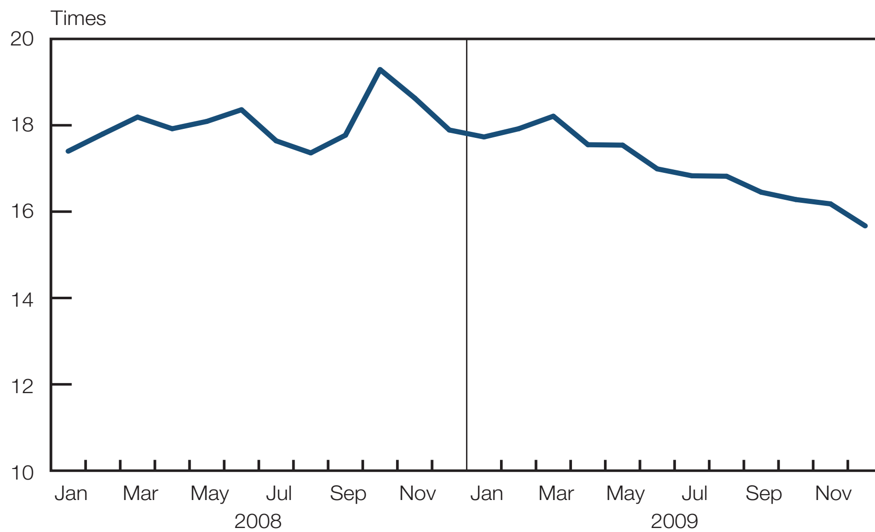
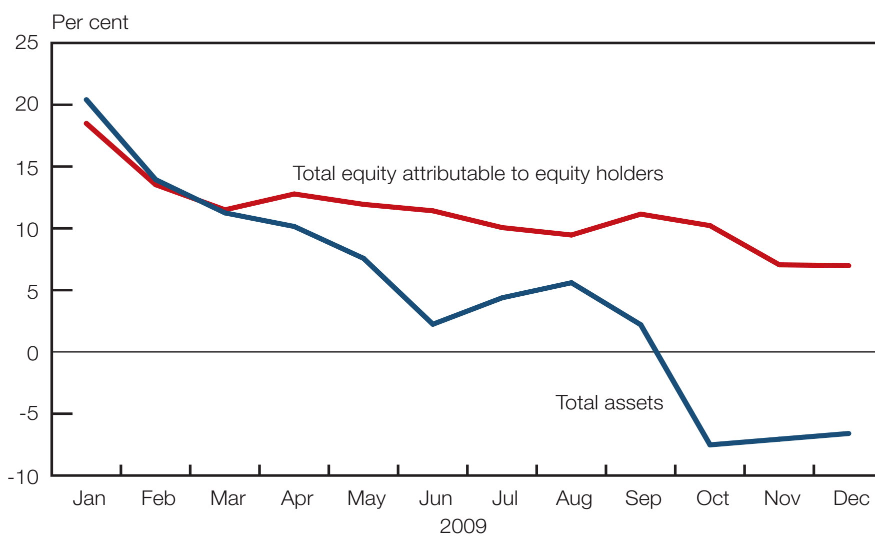


Figure 4.18 Growth rates of total assets and equity attributable to equity holders (year on year)



4.3.4 Balance-sheet information of the total consolidated banking groups

Similar to banking-sector assets in respect of banks solo, banking-sector assets in respect of consolidated banking groups also experienced negative annual growth, declining by

8,0 per cent to R3 790 billion at the end of December 2009 (December 2008: R4 118 billion). Figure 4.19 presents total assets in respect of banks' solo and consolidated banking groups, and the respective percentages relating to the five largest banks, branches of international banks and other banks. Figure 4.20 reflects the aggregated total of banking-sector assets for banks solo[31] (excluding their foreign branches), banks consolidated[32] (including their foreign branches) and consolidated banking groups.[33]

Figure 4.19 Composition of total banking-sector assets in respect of the five largest banks, branches of international banks and other banks (per cent)

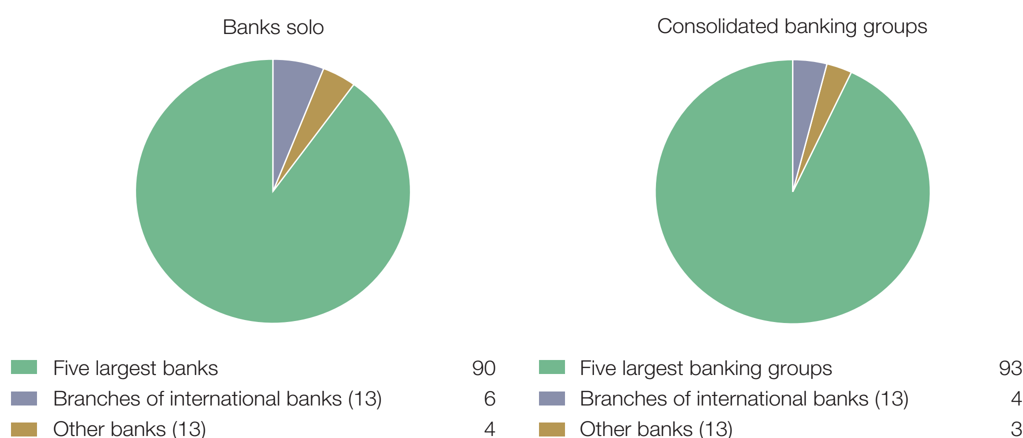
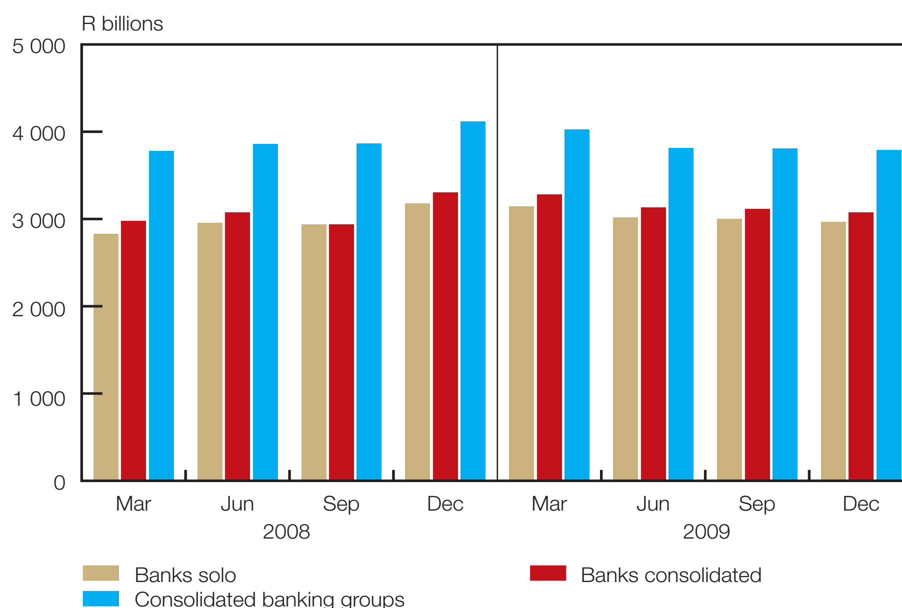


Figure 4.20 Banking-sector assets for banks solo, banks consolidated and consolidated banking groups



As illustrated in Figure 4.21, the total equity of consolidated banking groups increased by 4,7 per cent from R289 billion at the end of December 2008 to R303 billion at the end of December 2009. Retained earnings amounting to R189 billion (December 2008: R170 billion), represented 62,3 per cent of total equity at the end of December 2009.

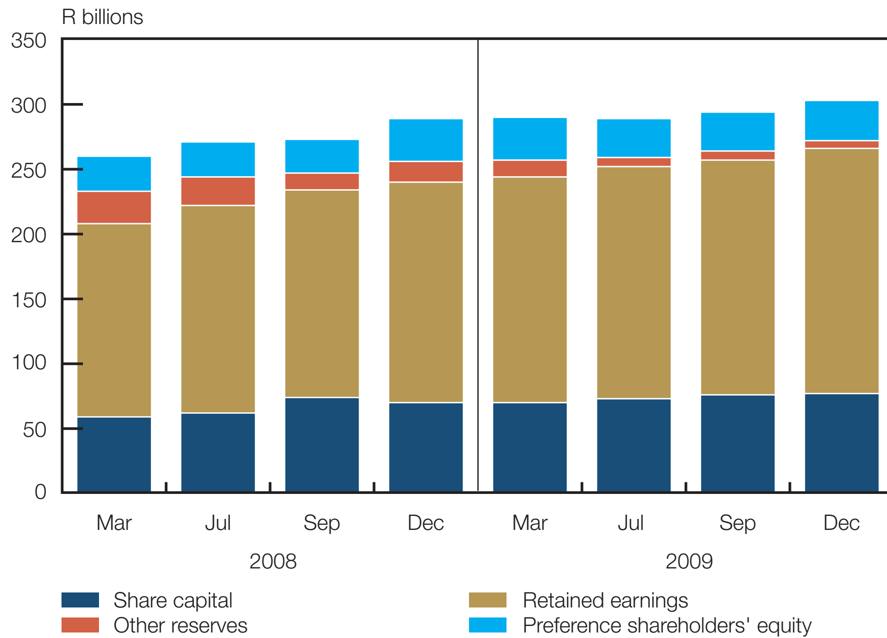
total equity of consolidated banking groups increased by 4,7 per cent

31 'Banks solo' includes the aggregate of banks incorporated in South Africa (excluding their foreign branches, subsidiaries and associates), and all local branches of international banks.

32 'Banks consolidated' includes the aggregate of banks incorporated in South Africa together with their foreign branches, subsidiaries and associates, as well as all local branches of international banks.

33 'Consolidated banking groups' includes the aggregate of registered bank controlling companies, the remaining registered banks incorporated in South Africa (that do not have registered controlling companies) and local branches of international banks.

Figure 4.21 Composition of total equity for consolidated banking groups

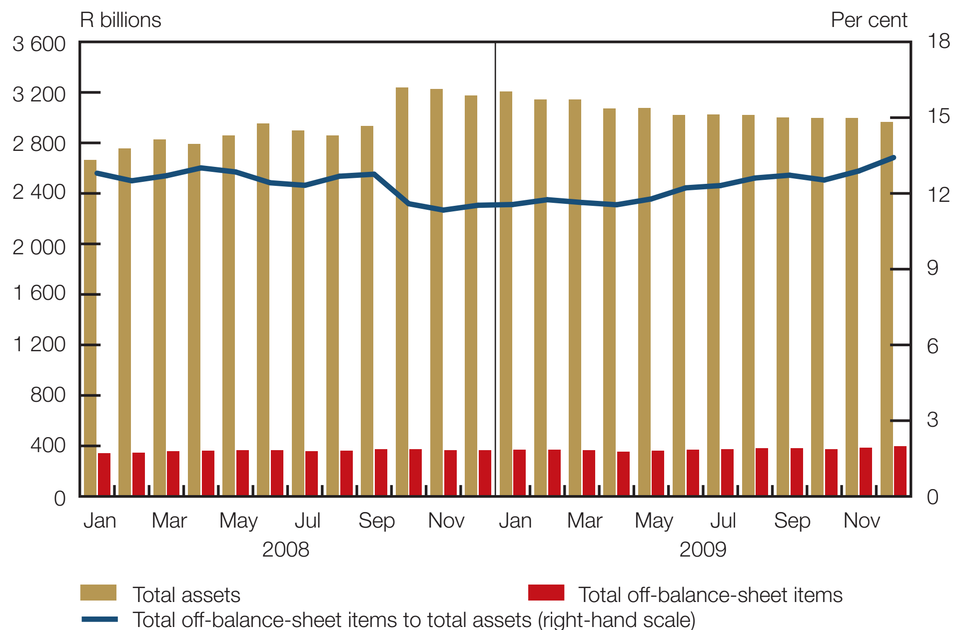


4.4 Off-balance-sheet activities

ratio of off-balance-sheet items to banking-sector assets increased during 2009

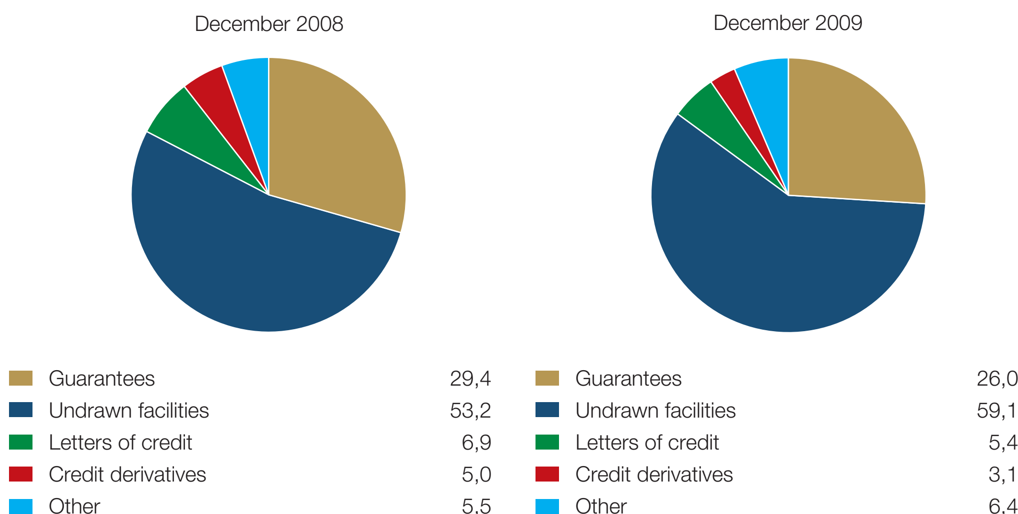
As illustrated in Figure 4.22, off-balance-sheet items increased with 8,7 per cent during 2009 and amounted to R398,3 billion at the end of December 2009 (December 2008: R366,4 billion). The ratio of off-balance-sheet items to banking-sector assets increased during 2009 mainly due to a slowdown in the growth of banking-sector assets. The ratio was 13,4 per cent at the end of December 2009 (December 2008: 11,5 per cent).

Figure 4.22 Total off-balance-sheet items to total assets



As illustrated in Figure 4.23, undrawn facilities at 59,1 per cent represented a larger portion of off-balance-sheet items at the end of 2009 when compared to 53,2 per cent at the end of December 2008.

Figure 4.23 Composition of total off-balance-sheet items (per cent)



4.5 Profitability

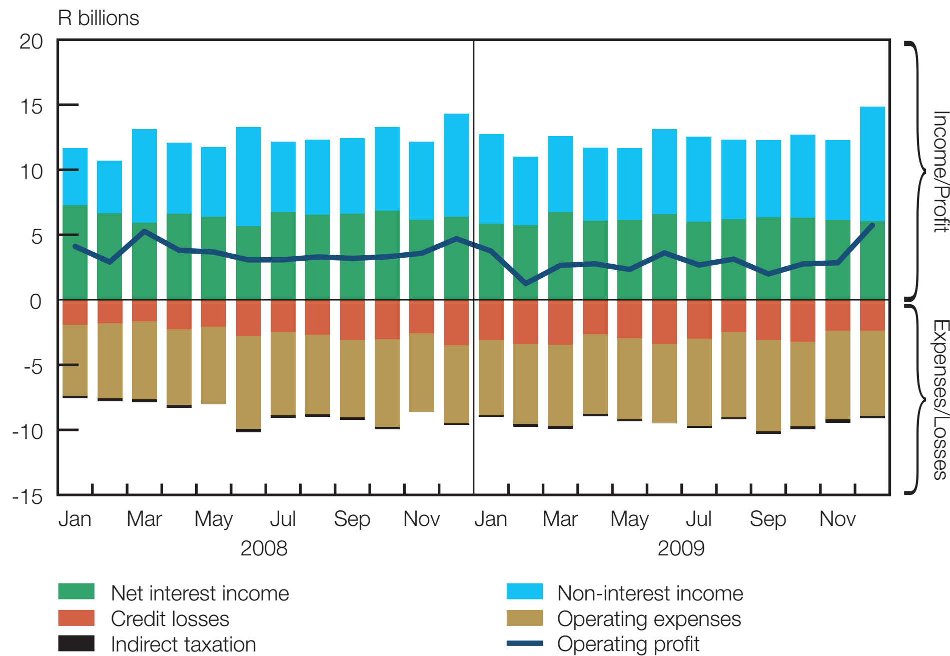
The banking sector's operating profit amounted to R35,5 billion for the year ending December 2009 (December 2008: R44,0 billion). The decline in profitability during 2009 may be ascribed mainly to a rise in credit losses and operating expenses. For the year ending December 2009, credit losses and operating expenses rose to R35,5 billion and R76,5 billion respectively (December 2008: R29,7 billion and R73,4 billion respectively).

credit losses and operating expenses rose to R35,5 billion and R76,5 billion respectively

Gross operating income (i.e., the sum of net interest income and non-interest income) amounted to R149,7 billion for the year ending December 2009 (December 2008: R149,2 billion). Non-interest income increased during the year ended December 2009 to R75,6 billion (December 2008: R71,4 billion) mainly due to higher net fee and commission income and net trading income. Net interest income decreased from R77,8 billion for the year ending December 2008 to R74,1 billion for the year ending December 2009, mainly due to a decline in interest and similar income.

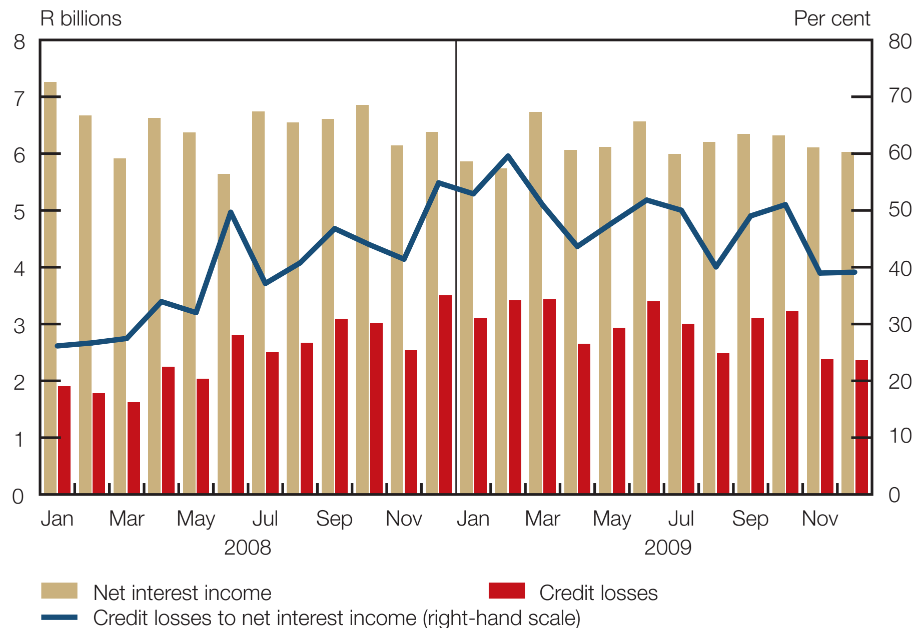
Figure 4.24 provides a breakdown of the income statement on a month to month basis. Operating profit increased from R2,9 billion in November 2009 to R5,7 billion in December 2009 due to an increase in net fee and commission income reported by two of the large banks, and an increase in net trading income from derivative financial instruments reported by one of the large banks. There was a significant decline in operating profit to R1,3 billion in February 2009 mainly due to a decrease in net trading income related to debt securities reported by two of the large banks and a branch of an international bank, as well as a decrease in other gains due to fair value adjustments reported by one of the large banks. This decline in operating profit was further exacerbated by a R318,8 million increase in credit losses to R3,4 billion for February 2009. Credit losses fluctuated between R2,4 billion and R3,4 billion per month during 2009 and amounted to R2,4 billion in December 2009 (December 2008: R3,5 billion). Operating expenses remained in excess of R6 billion per month throughout 2009, ending the year at R6,5 billion for December 2009 (December 2008: R6,0 billion).

Figure 4.24 Composition of the income statement (unsmoothed)



As illustrated in Figure 4.25, credit losses expressed as a percentage of net interest income, remained high – above 40 per cent – reaching a peak of almost 60 per cent at the end of February 2009, mainly due to an increase in credit losses (as also depicted in Figure 4.24). However, the ratio dropped to just below 40 per cent for the last two months of 2009 due to a decline in credit losses (possibly indicating a turning point with regards to the growth rate of credit losses).

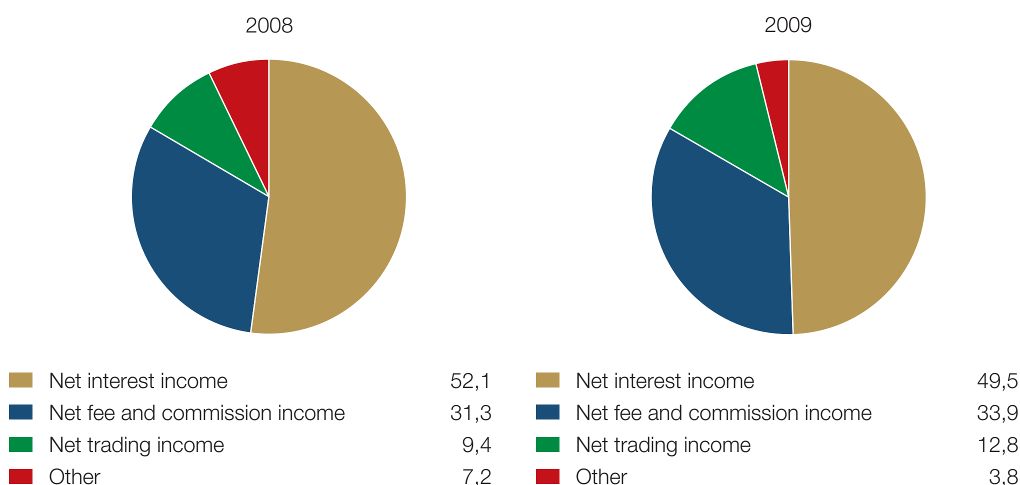
Figure 4.25 Credit losses to net interest income (unsmoothed)



The composition of gross operating income for the years ending December 2008 and December 2009 is reflected in Figure 4.26. For the year ending December 2009, net interest income and net fee and commission income accounted for 49,5 per cent and 33,9 per cent respectively of gross operating income (December 2008: 52,1 per cent and 31,3 per cent respectively). Expressed as a percentage of gross operating income,

net trading income increased from 9,4 per cent for the year ending December 2008 to 12,8 for the year ending December 2009 owing to an increase in income from derivative financial instruments, debt securities and equities. Other income amounted to 3,8 per cent of gross operating income for the year ending December 2009 (December 2008: 7,2 per cent).

Figure 4.26 Composition of gross operating income (per cent)

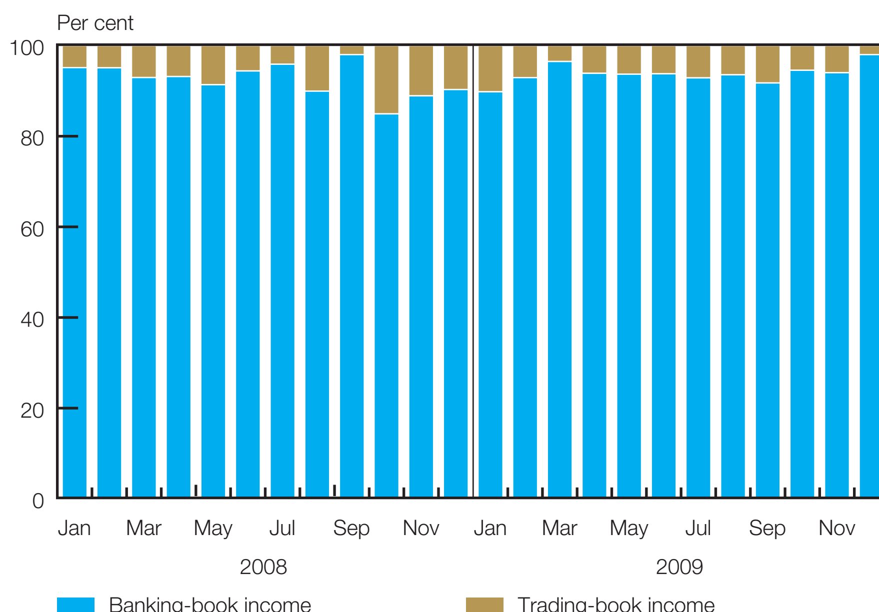


	2008		2009
Net interest income	52,1	Net interest income	49,5
Net fee and commission income	31,3	Net fee and commission income	33,9
Net trading income	9,4	Net trading income	12,8
Other	7,2	Other	3,8

90 per cent income derived from banking-related activities

A split of gross operating income into banking-book and trading-book income is shown in Figure 4.27. The banking sector derived in excess of 90 per cent of its income from banking-related activities during 2009. In respect of December 2009, banking-book income constituted 98 per cent of gross operating income (December 2008: 90,3 per cent).

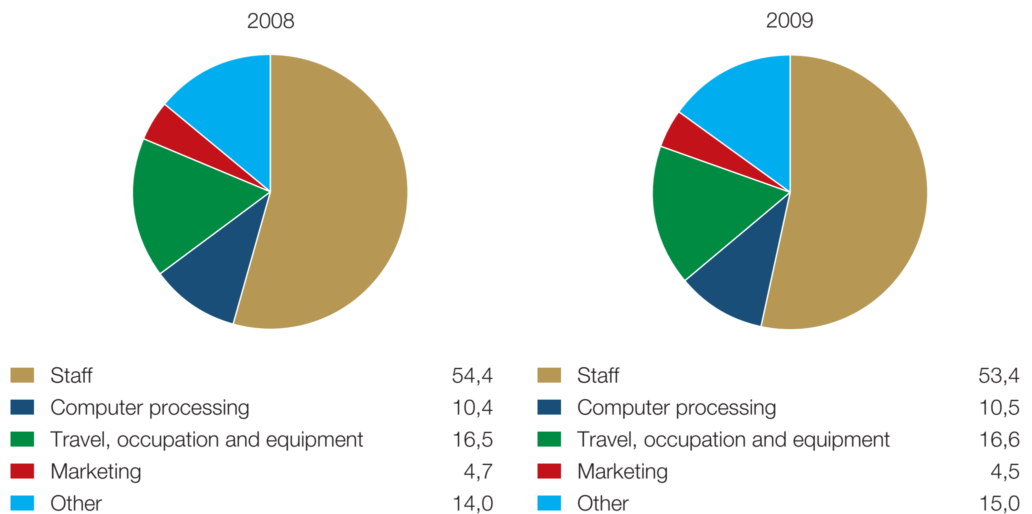
Figure 4.27 Banking-book income versus trading-book income (unsmoothed) (as a percentage of gross operating income)



The composition of operating expenses for the years ending December 2008 and December 2009 is shown in Figure 4.28. For the year ending December 2009, operating expenses amounted to R76,5 billion, of which staff expenses accounted for 53,4 per

cent (December 2008: 54,4 per cent). Travel, occupation and equipment and other expenses constituted 16,6 per cent and 15,0 per cent respectively for the year ending December 2009 (December 2008: 16,5 per cent and 14,0 per cent respectively). Expenses in respect of computer processing represented 10,5 per cent of the banking sector's operating expenses for the year ending December 2009 (December 2008: 10,4 per cent). Finally, marketing expenses remained just below 5 per cent of operating expenses, amounting to 4,5 per cent for the year ending December 2009 (December 2008: 4,7 per cent).

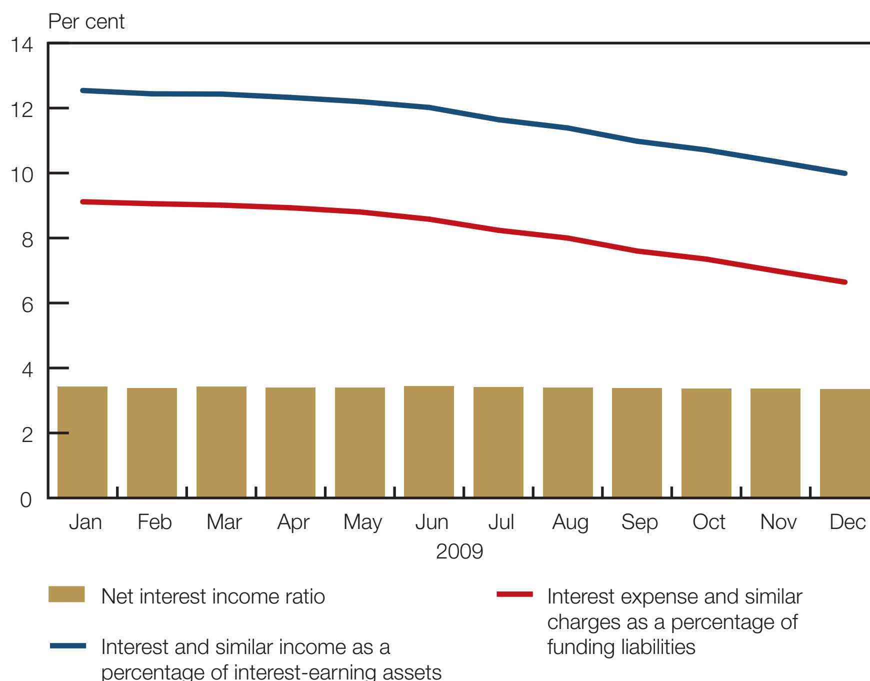
Figure 4.28 Composition of operating expenses (per cent)



net interest income ratio remained fairly stable

The net interest income ratio, as illustrated in Figure 4.29, remained fairly stable at approximately 3,4 per cent throughout 2009 (calculated on a smoothed basis, i.e., 12-month moving average). The ratio is the difference between interest and similar

Figure 4.29 Net interest income ratio (smoothed, i.e., 12-month moving average)

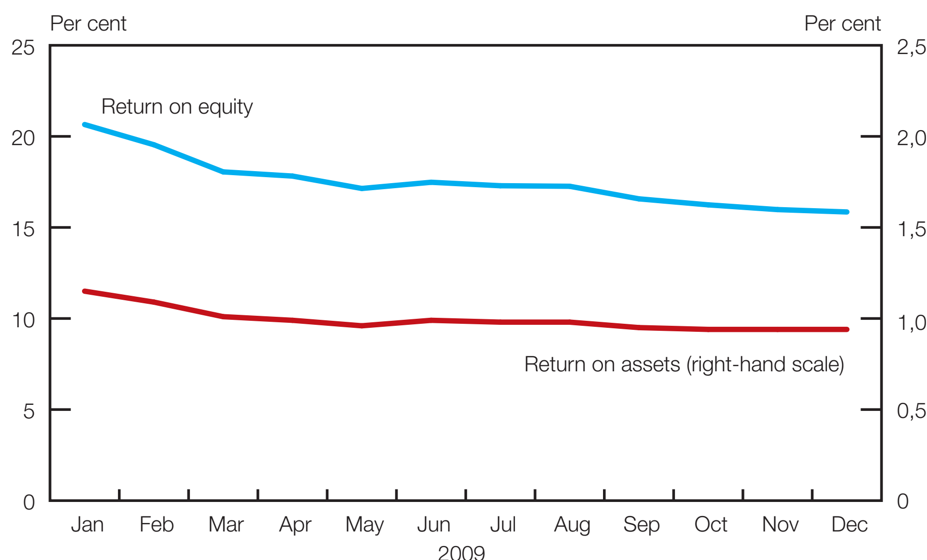


income (expressed as a percentage of interest-earning assets) and interest expenses and similar charges (expressed as a percentage of funding liabilities). Expressed as a percentage of interest-earning assets, interest and similar income declined during 2009, reaching 10,0 per cent at the end of December 2009 compared with 12,5 per cent at the end of January 2009. Interest expenses and similar charges (expressed as a percentage of funding liabilities), also decreased during 2009, from 9,1 per cent at the end of January 2009 to 6,6 per cent at the end of December 2009 due to a decline in interest expenses and similar charges relating to term and other deposits and current accounts. During 2009 the Bank's Monetary Policy Committee reduced the repurchase rate by 450 basis points.

Figure 4.30 sets out the ROE and ROA ratios, calculated on a smoothed basis (i.e., utilising a 12-month moving average), for 2009. The ROE deteriorated during 2009, from 20,7 per cent at the end of January 2009 to 15,9 per cent at the end of December 2009. The decline in ROE during 2009 was the result of a combination of lower operating profit (due to high credit losses and operating expenses) and strong growth in total equity attributable to equity holders (as mentioned in Figures 4.17 and 4.18). The deterioration in ROA from 1,2 per cent at the end of January 2009 to 0,94 per cent at the end of 2009 was due to the increase in operating expenses and high credit losses.

decline in ROE during 2009 due to high credit losses and operating expenses

Figure 4.30 Profitability ratios (smoothed, i.e.,12-month moving average)



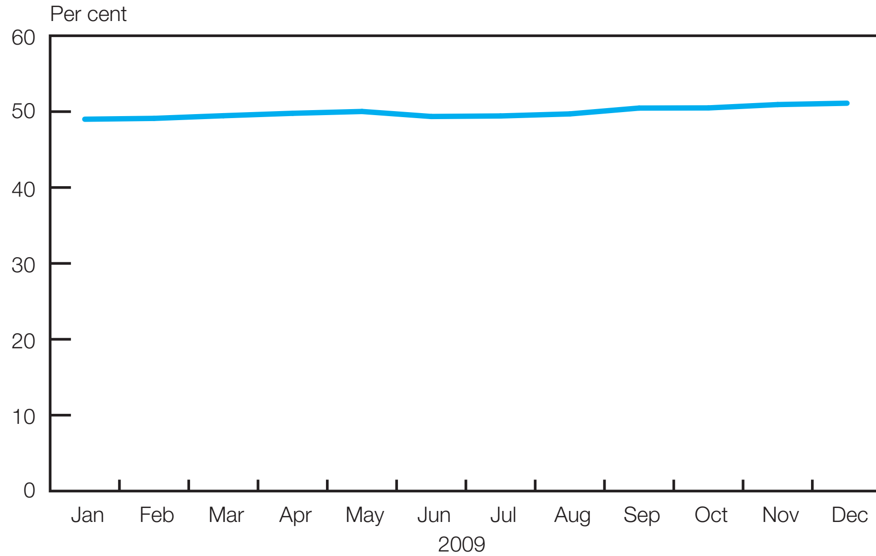
The cost-to-income-ratio, as shown in Figure 4.31 on page 118, deteriorated marginally during 2009, to 51,1 per cent in December 2009 compared with 49,0 per cent at the end of January 2009.

4.6 Capital adequacy

Since the implementation of Basel II (on 1 January 2008), the minimum required capital-adequacy ratios applicable to all banks registered in South Africa have been 7,0 per cent in respect of the Tier 1 ratio and 9,5 per cent for the total capital-adequacy ratio, as calculated for banks on a solo and a consolidated banking group basis. In addition, the Registrar may require banks (and banking groups), as part of the Pillar 2 process, to maintain capital-

adequacy ratios above these minimum requirement levels based on systemic risk and banks' idiosyncratic risk assessments.

Figure 4.31 Cost-to-income ratio (smoothed, i.e.,12-month moving average)



4.6.1 Capital adequacy for banks solo

Tier 1 capital-adequacy ratio improved to 11,0 per cent

The banking-sector capital-adequacy ratio and the Tier 1 capital-adequacy ratio for banks solo are illustrated in Figure 4.32. The total capital-adequacy ratio improved during 2009, increasing to 14,1 per cent at the end of December 2009 (December 2008: 13 per cent). The increase in the ratio was mainly due to the increase in qualifying capital and reserve funds (8,3 per cent year on year, refer to Figure 4.33) and the decline in the rate of asset growth during 2009 (-6,6 per cent year on year). The Tier 1 capital-adequacy ratio also improved to 11,0 per cent at the end of December 2009 (December 2008: 10,2 per cent).

Figure 4.32 Capital-adequacy ratios (solo)

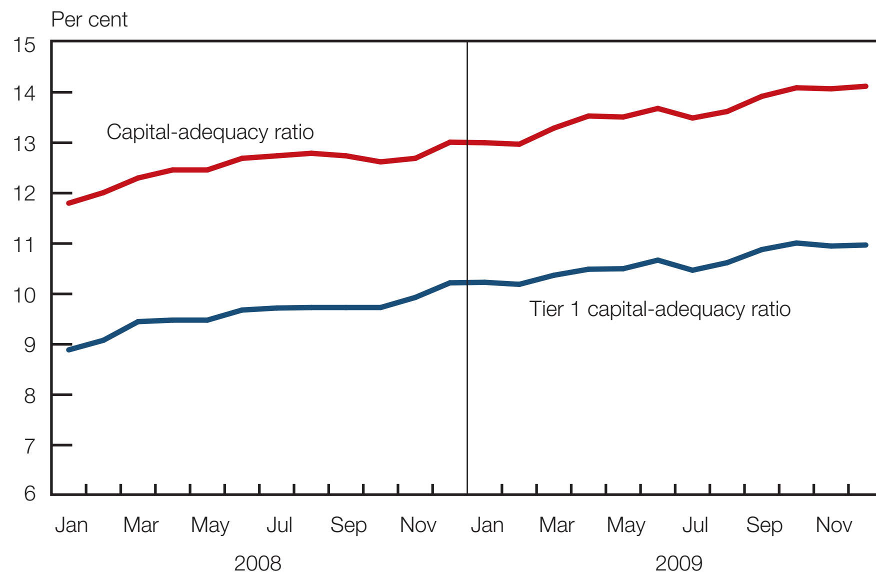
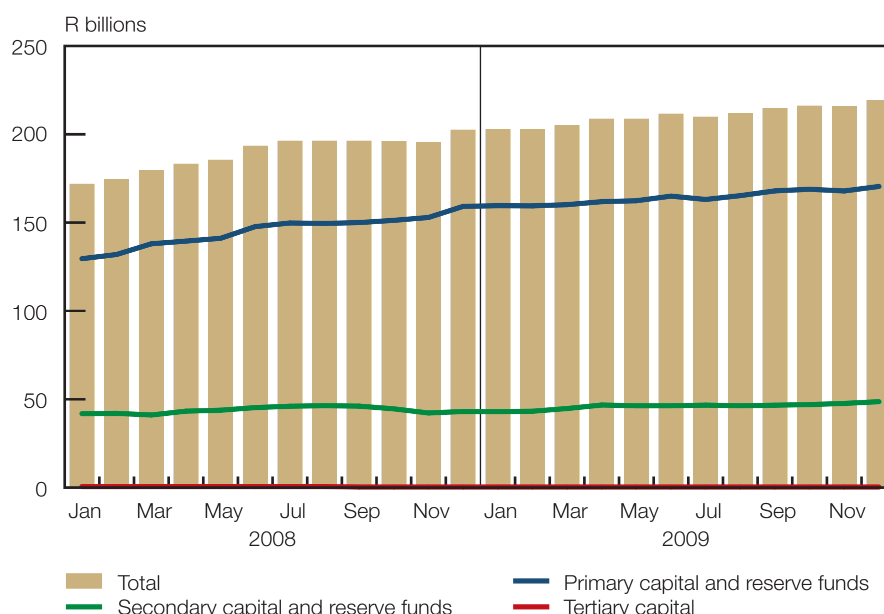


Figure 4.33 reflects the composition of qualifying regulatory capital and reserve funds on a solo basis. Total qualifying regulatory capital and reserve funds amounted to R219,4 billion at the end of December 2009 (December 2008: R202,6 billion), representing an increase of 8,3 per cent year on year. This increase was due to an increase of 7,1 per cent in qualifying primary capital and reserves (mainly due to the appropriation of profits) and an increase of 12,9 per cent in qualifying secondary capital and reserve funds over the period. Total qualifying tertiary capital amounted to only R300 million throughout the period under review.

increase of 7,1 per cent in qualifying primary capital and reserves

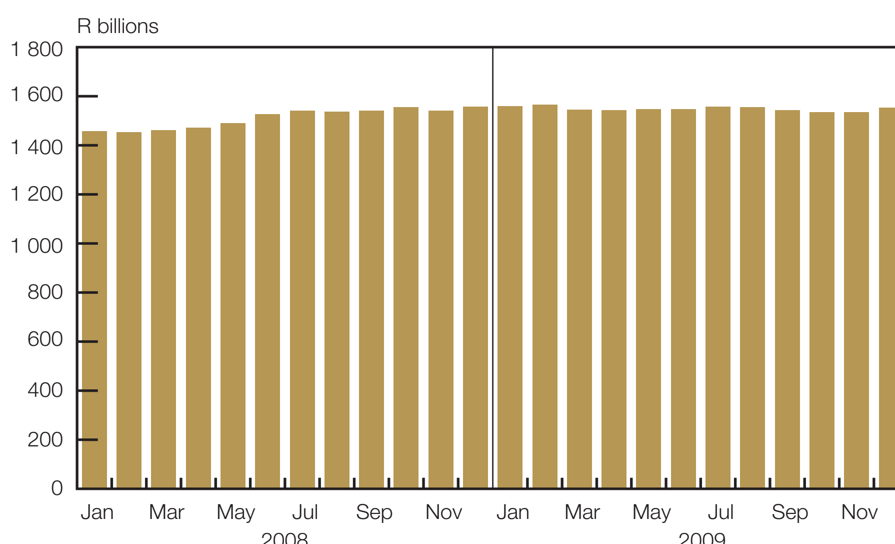
Figure 4.33 Composition of qualifying regulatory capital and reserve funds (solo)



Owing to the negative growth rate in total assets during 2009, the banking sector's total risk-weighted exposure (Figure 4.34) remained fairly stable, amounting to R1 554 billion at the end of December 2009 (December 2008: R1 557 billion).

banking sector's total risk-weighted exposure remained fairly stable

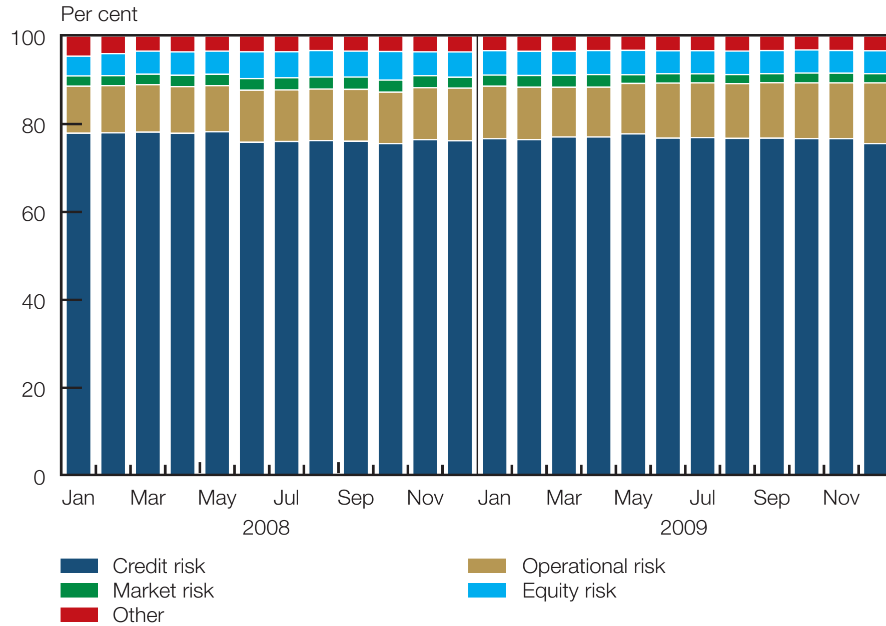
Figure 4.34 Total risk-weighted exposure (solo)



As illustrated in Figure 4.35, the composition of the total regulatory capital requirement remained fairly stable during 2009. At the end of December 2009 credit risk constituted the largest portion of the total regulatory capital requirement, namely 75,6 per cent

(December 2008: 76,2 per cent). Operational risk constituted 13,8 per cent at the end of December 2009 (December 2008: 12 per cent). Equity represented 5,2 per cent at the end of 2009 (December 2008: 5,8 per cent). Other constituted 3,3 per cent at the end of December 2009 (December 2008: 3,6 per cent) and market risk accounted for 2,1 per cent at the end of 2009 (December 2008: 2,5 per cent).

Figure 4.35 Composition of total regulatory capital requirement (solo)



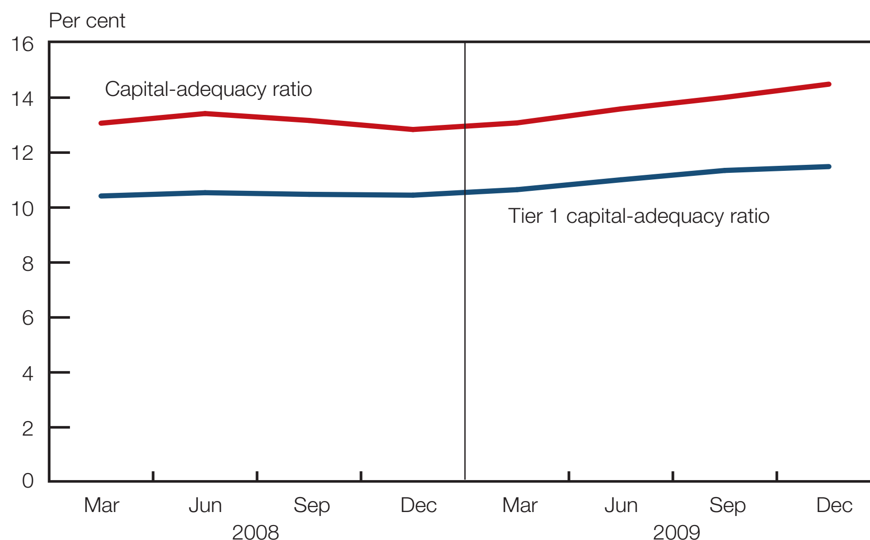
4.6.2 Capital adequacy for total consolidated banking groups

The capital-adequacy ratios for the consolidated banking groups improved as follows (refer to Figure 4.36 and the explanations for banks solo discussed above):

total capital-adequacy ratio increased to 14,5 per cent

- The total capital-adequacy ratio increased to 14,5 per cent at the end of December 2009 (December 2008: 12,8 per cent).
- The Tier 1 capital-adequacy ratio strengthened to 11,5 per cent at the end of December 2009 (December 2008: 10,5 per cent).

Figure 4.36 Capital-adequacy ratios (consolidated banking groups)

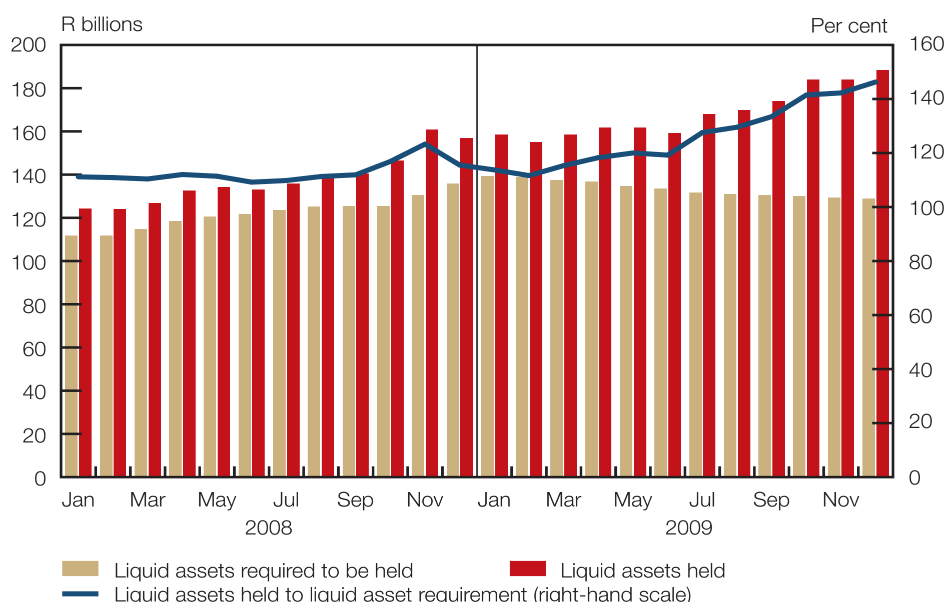


4.7 Liquidity risk

The average daily amount of liquid assets held by banks compared to the minimum requirement is presented in Figure 4.37. The liquid assets held by banks increased by 20 per cent during 2009 as banks increased their investments in instruments qualifying as liquid assets. During this period the statutory liquid assets required declined by 5,2 per cent owing to the decline in funding liabilities towards the end of 2009. At the end of December 2009 banks' statutory liquid asset holdings exceeded the minimum requirement by 46,3 per cent (December 2008: 15,5 per cent) The liquid assets held by banks exceeded the statutory liquid asset requirement throughout 2009.

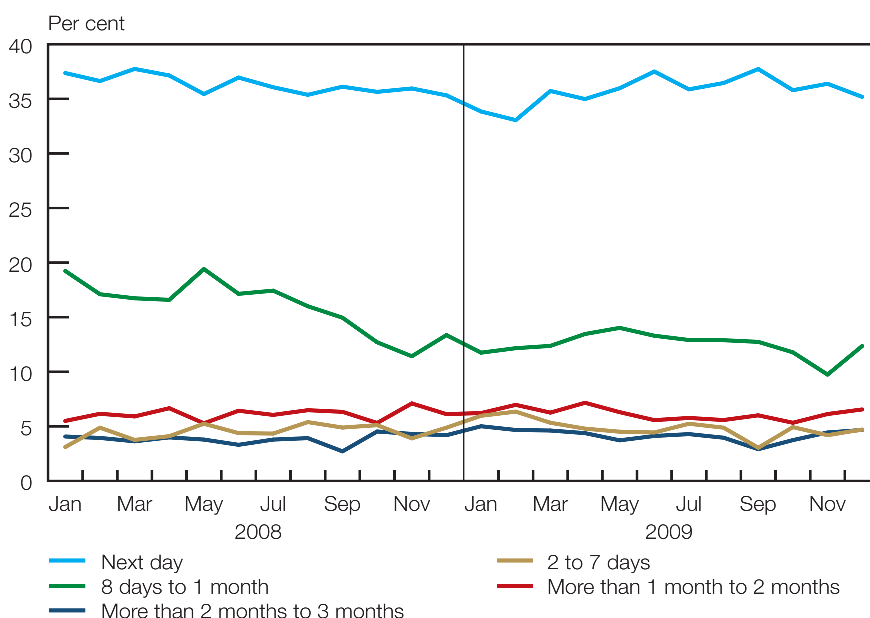
banks' statutory liquid asset holdings exceeded the minimum requirement by 46,3 per cent

Figure 4.37 Statutory liquid assets (actual versus required)



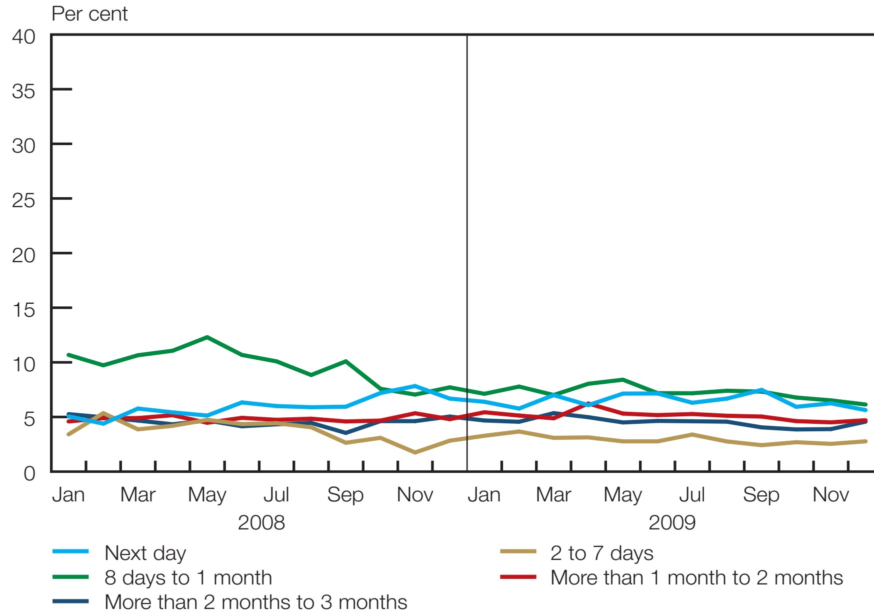
As shown in Figure 4.38, 35,2 per cent of contractual liabilities are classified to mature the "next day" at the end of December 2009 (December 2008: 35,3 per cent). However, banks reported that these liabilities, if considered on a "business-as-usual" assumptions

Figure 4.38 Contractual maturity of liabilities (as a percentage of total liabilities)



basis (Figure 4.39), only represented 5,6 per cent of total liabilities at the end of December 2009 (December 2008: 6,7 per cent). The substantial improvement in the ratio based on the "business-as-usual" assumptions is attributable to the ability of banks to retain funding or deposits on maturity or roll-over dates, notwithstanding the contractual arrangements pertaining to such funding or deposits.

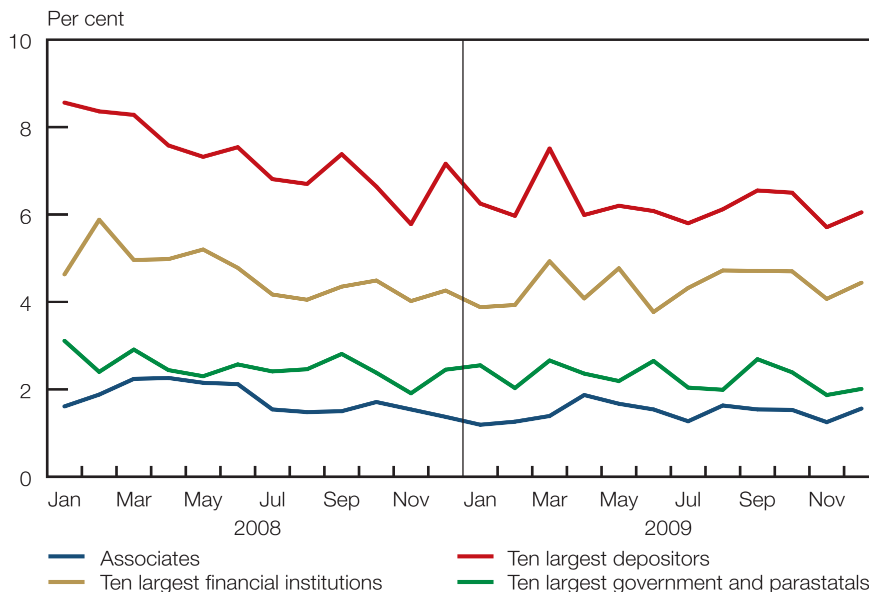
Figure 4.39 "Business-as-usual" maturity of liabilities (as a percentage of total liabilities)



short-term funding from banks' ten largest depositors decreased

Figure 4.40 illustrates the concentration of banks' short-term deposit funding. Short-term funding (as a percentage of total liabilities) received from banks' ten largest depositors, and ten largest government and parastatals decreased to 6,1 per cent and 2,0 per cent respectively at the end of December 2009 (December 2008: 7,2 per cent and 2,5 per cent respectively). Short-term funding from associates and the ten largest financial institutions increased to 1,6 per cent and 4,4 per cent respectively at the end of December 2009

Figure 4.40 Concentration of short-term deposit funding (as a percentage of total liabilities)



(December 2008: 1,4 per cent and 4,3 per cent respectively). Overall, short-term deposit funding from the above sources declined to 14,1 per cent of total liabilities at the end of December 2009, from 15,2 per cent at the end of December 2008.

4.8 Credit risk

risk appetites adjusted in line with challenging economic and business cycles

The operating environment of the banking sector continued to be under pressure during 2009 as was evidenced by increased credit impairments and resultant lower profit levels. The banking sector continued to focus on the monitoring and management of asset quality, provisioning levels and providing assistance to highly indebted borrowers. Risk appetites were adjusted in line with more challenging economic and business cycles, and caution was exercised with regard to lending practices, in particular within the retail portfolios, and more specifically banks' residential mortgage portfolios. Traces of the relief brought about by the reduction in interest rates became evident only during the last quarter of 2009 and might support improved cash flows of banks' clients going forward. Segments other than retail appeared to have been impacted to a lesser extent, but it is acknowledged that these segments remain vulnerable.

total risk-weighted exposure of banks remained fairly stable

Table 4.3 provides the highlights in respect of credit risk indicators that are common to all banks, irrespective of the approach adopted for the calculation of the minimum capital requirement for credit risk (i.e., the SA or the IRB). Both gross loans and advances, and gross credit exposures experienced negative annual growth rates of 2,6 per cent and 6,3 per cent respectively at the end of December 2009. However, the total risk-weighted exposure of banks remained fairly stable, declining slightly by 0,6 per cent between December 2008 and December 2009, mainly as a result of banks' credit policies and strategies that were adapted to match the prevailing credit environment.

Table 4.3 Salient banking-sector credit risk information

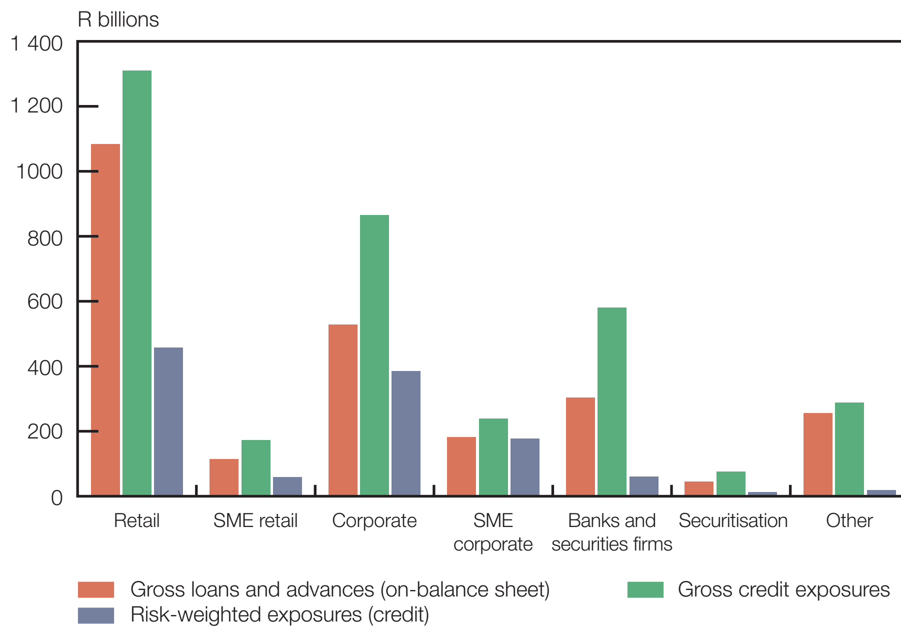
	Dec 2008 (R billions)	Dec 2009 (R billions)	Year-on-year growth (Per cent)
Gross loans and advances (on-balance sheet)	2,316	2,257	-2,55
Gross credit exposures (including on- and off-balance sheet exposures, repurchase or resale agreements and derivative instruments)	3,768	3,532	-6,28
Risk-weighted exposures (credit)	1,178	1,171	-0,56
Impaired advances	91	134	47,5
Specific credit impairments	28	40	38,99

	Dec 2008 (Per cent)	Dec 2009 (Per cent)
Average risk weight of gross credit exposures	31,3	33,2
Impaired advances to gross loans and advances	3,9	5,9
Specific credit impairments to impaired advances	31,4	29,6
Specific credit impairments to gross loans and advances	1,2	1,8

Impaired advances (i.e., advances in respect of which a specific credit impairment has been raised) increased by 47,5 per cent between December 2008 and December 2009 (also refer to Figure 4.42). Owing to, *inter alia*, the impact of the National Credit Act and banks' general attempts to assist or revive struggling borrowers, certain accounts remained in the impaired advances classification category for much longer periods than would have been expected under normal economic conditions. This led to a build-up in impaired advances and, taking into consideration the decline in gross loans and advances during 2009, brought about a significant deterioration in the impaired advances to gross loans and advances ratio.

Figure 4.41 provides a more granular picture in respect of gross loans and advances, gross credit exposures and risk-weighted exposures by providing the information per asset category (which includes retail, small and medium enterprise (SME) retail, corporate, SME corporate, banks and securities firms, securitisation and other). At the end of December 2009 the SME corporate asset category had the highest risk-weighting percentage if measured against its gross credit exposure (or alternatively, against its gross loans and advances), followed by the corporate category. The categories securitisation and other had the lowest risk-weightings.

Figure 4.41 Credit exposures per asset category and respective risk-weighted exposures

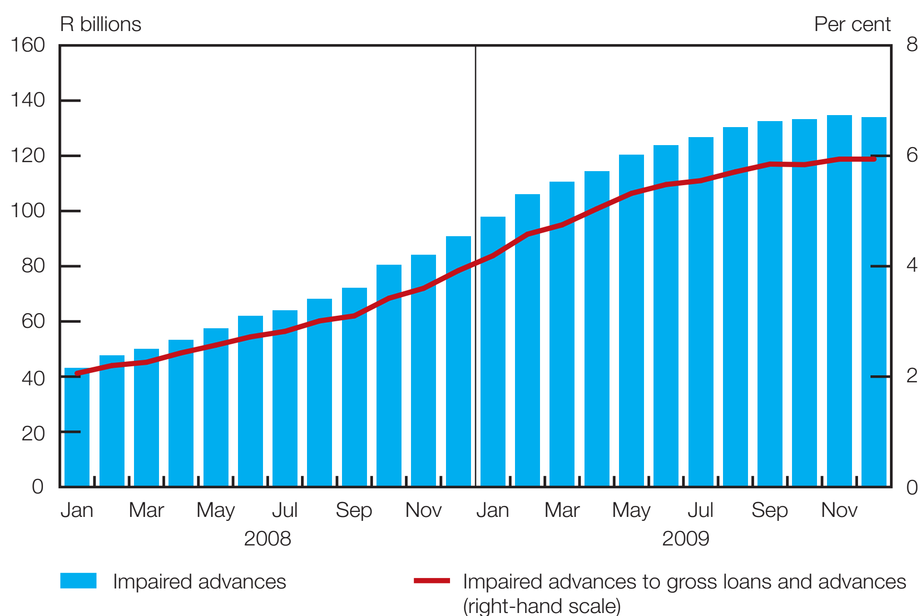


4.8.1 Total impaired advances

impaired advances increased by 47,5 per cent

Impaired advances and the impaired advances to gross loans and advances ratio are set out in Figure 4.42. As mentioned above, impaired advances increased by 47,5 per cent during the period under review and amounted to R134,0 billion at the end of December 2009 (December 2008: R90,8 billion). Impaired advances to gross loans and advances deteriorated to 5,9 per cent at the end of December 2009 (December 2008: 3,9 per cent) due to the substantial increase in impaired advances and the negative rate of growth reported for gross loans and advances during the last quarter of 2009. During the period November 2009 to December 2009 impaired advances declined by 0,5 per cent, the first decline since the commencement of the credit down-cycle.

Figure 4.42 Impaired advances to gross loans and advances



4.8.2 Credit impairments

Figure 4.43 illustrates the increase in specific and portfolio credit impairments by 39,0 per cent and 10,3 per cent respectively, to R39,6 billion and R12,5 billion at the end of December 2009 respectively (December 2008: R28,5 billion and R11,3 billion). Specific credit impairments peaked at the end of October 2009, after which it declined slightly. Portfolio credit impairments have been relatively stable throughout 2009.

specific credit impairments peaked at the end of October 2009

Figure 4.43 Specific and portfolio credit impairments

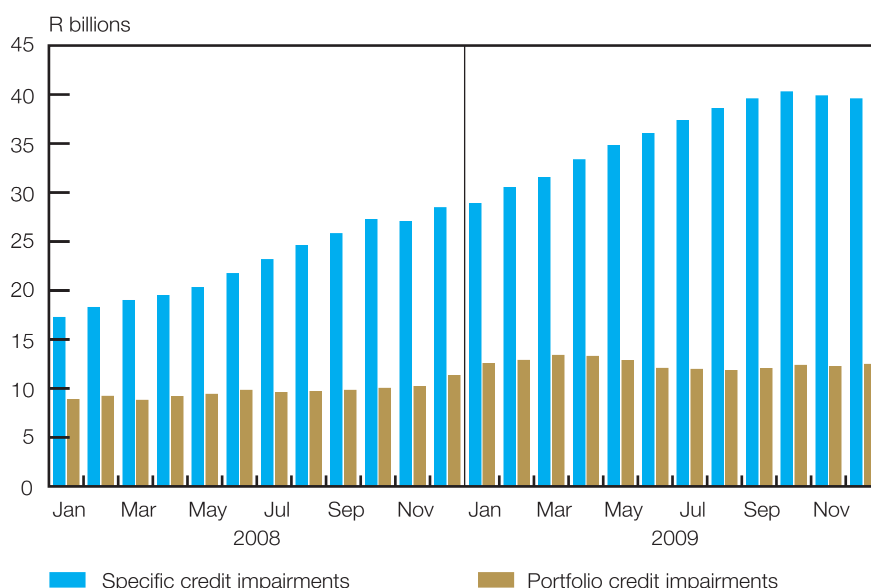
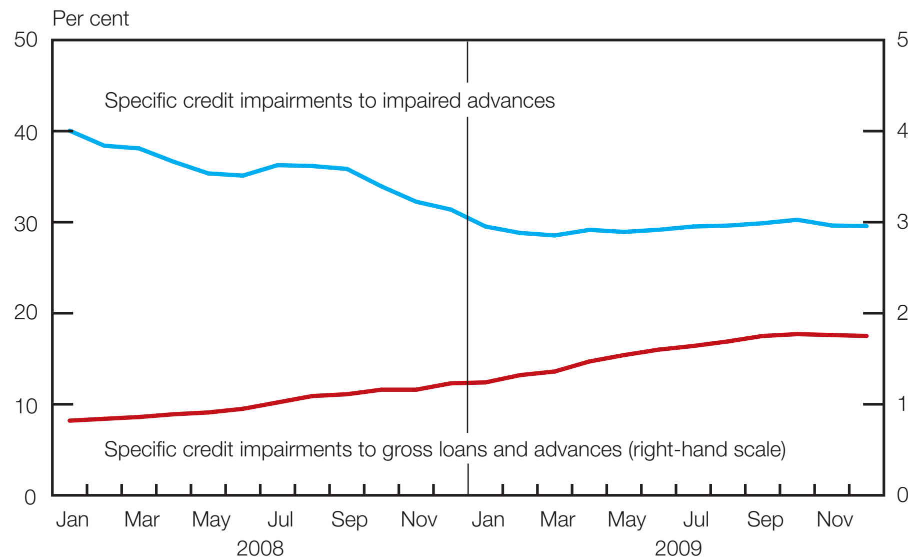


Figure 4.44 provides the ratios specific credit impairments to impaired advances and specific credit impairments to gross loans and advances. Specific credit impairments as a percentage of impaired advances decreased to 29,6 per cent at the end of December 2009 (December 2008: 31,4 per cent) and were stable for the last three quarters of 2009. Specific credit impairments as a percentage of gross loans and advances increased to 1,75 per cent at the end of December 2009 (December 2008: 1,23 per cent), mainly as a result of the decline in the rate of growth in gross loans and advances.

Figure 4.44 Specific credit impairment ratios



4.8.3 The standardised approach banks

SA banks represented 15,7 per cent of the total banking-sector's gross loans and advances

The SA banks represented 15,7 per cent of the total banking-sector's gross loans and advances at the end of December 2009 (December 2008: 15,6 per cent). The risk-weighting distribution in respect of SA banks that is presented in Figure 4.45 on page 127 has been stable during the period December 2008 to December 2009. The average risk weighting increased from 43 per cent at the end of December 2008 to 48 per cent at the end of December 2009 due to an increase in the 150 per cent risk-weighting category. This was largely caused by an increase in overdue advances which was not covered sufficiently by specific credit impairments.

4.8.4 The standardised approach banks: Classification of credit risk exposures

Credit risk exposures are classified as either "standard", "special mention", "sub-standard", "doubtful" or "loss" by SA banks and reported on a quarterly basis. As shown in Figure 4.46, there was a substantial increase in exposures classified as "special mention" between December 2008 and March 2009 due to one of the banks reclassifying its significant exposures to the financial and automotive sectors from "standard" to "special mention" at the height of the international financial market crisis.

Figure 4.45 Risk-weighting distribution of credit exposures under the standardised approach

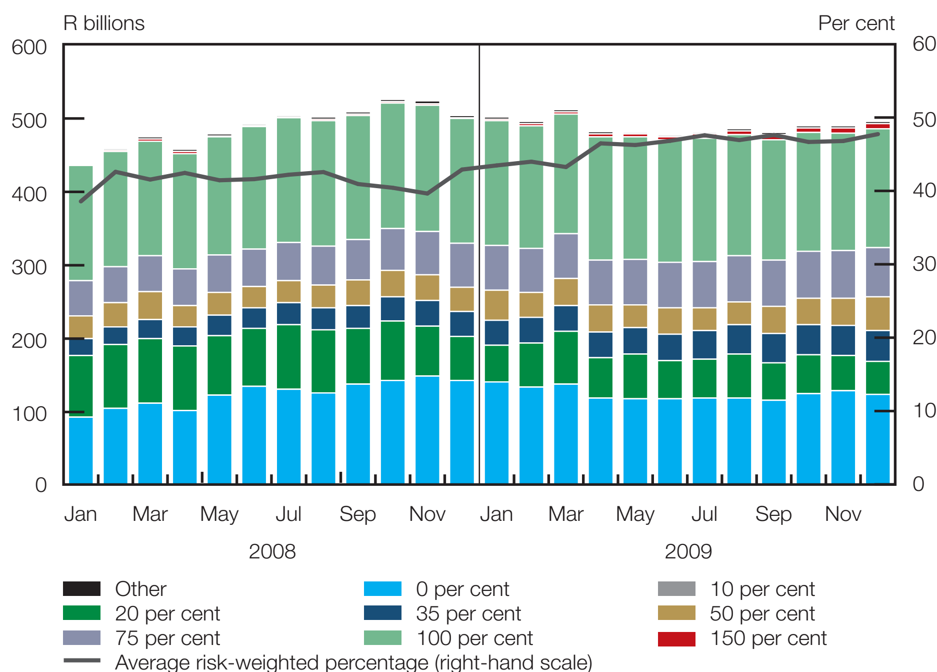


Figure 4.46 Classification of credit risk exposures under the standardised approach

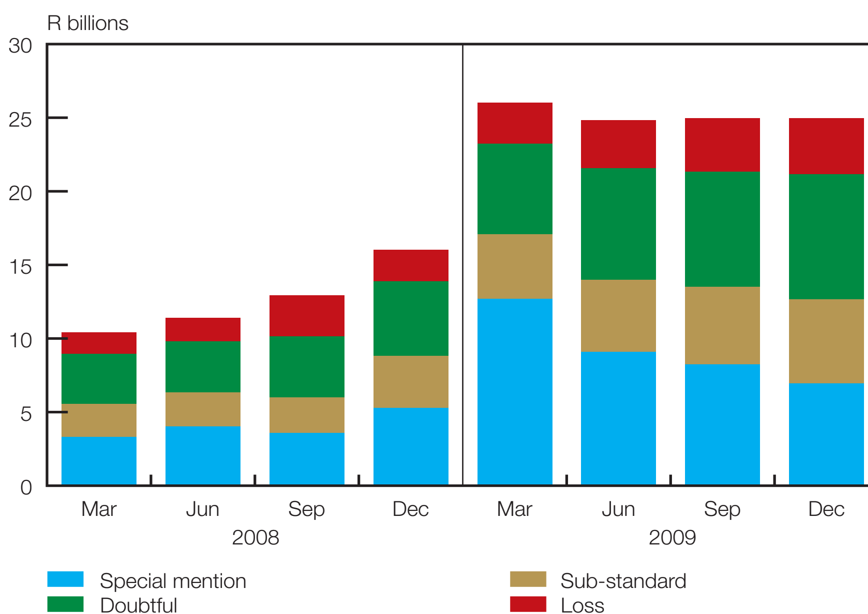
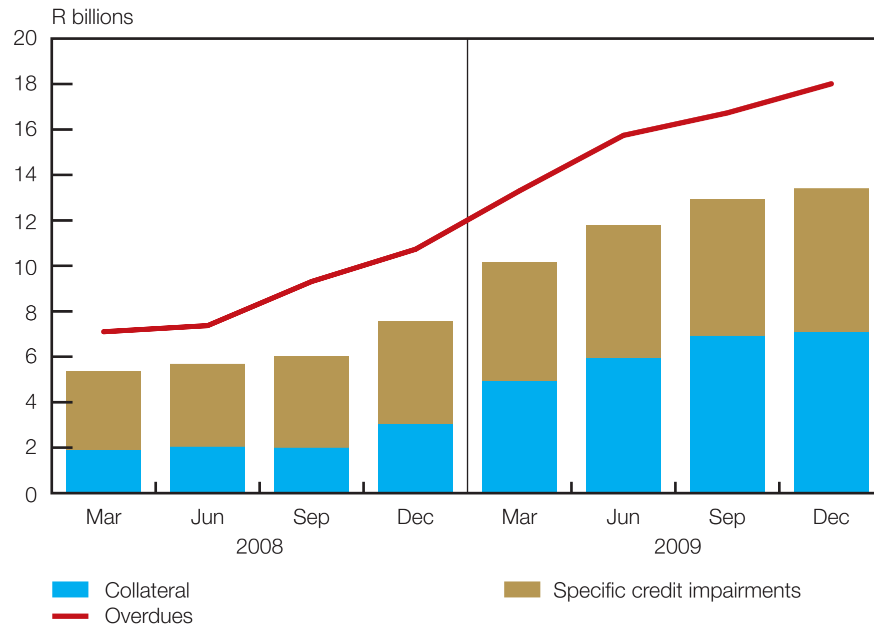


Figure 4.47 combines the classifications "sub-standard", "doubtful" and "loss", named "overdues", which are then measured against the collateral held and specific credit impairments raised. The "gap" or shortfall can be attributed, *inter alia*, to unsecured lending in which instances banks may be required by the Registrar to adhere to higher minimum capital-adequacy ratios.

Figure 4.47 Overdues (includes classifications "sub-standard", "doubtful" and "loss") measured against specific credit impairments and collateral



4.8.5 Internal ratings-based banks

Box 4.1 Calculation of expected loss for internal ratings-based banks

As set out in the Basel Committee document, *An Explanatory Note on the Basel II IRB Risk Weight Functions*,[34] issued in July 2005, banks can estimate expected losses based on three key drivers:

- Probability of default (PD) per rating grade, which gives the average percentage of obligors that default in this rating grade in the course of one year
- Exposure at default (EAD), which gives an estimate of the amount outstanding (drawn amounts plus likely future drawdowns of yet undrawn lines) in case the borrower defaults
- Loss given default (LGD), which gives the percentage of exposure the bank might lose in case the borrower defaults.

The expected loss is calculated as follows:

$$EL = PD * EAD * LGD$$

These risk drivers are converted into risk weights and regulatory capital requirements by means of risk weight formulas specified by the Basel Committee and incorporated accordingly into the Regulations relating to Banks.

IRB banks represented 84,3 per cent of the banking sector's gross loans and advances

Banks that utilised the IRB approach for calculating minimum capital requirements for credit risk represented 84,3 per cent of the banking sector's gross loans and advances at the end of December 2009 (December 2008: 84,4 per cent). Table 4.4 provides a summary of the key drivers of credit risk, as primary inputs to the capital calculation, reported by IRB banks. EAD increased by 0,7 per cent between December 2008 and December 2009 and is utilised in conjunction with the PD and the average LGD to calculate an expected loss in respect of defaulted exposures and the capital requirement through the calculation of an average risk weighting (refer to Box 4.1 for definitions and explanations):

34 www.bis.org/bcbs/irbriskweight.htm.

- The average PD increased to 7,4 per cent at the end of December 2009 (December 2008: 5,8 per cent) due to increases in the retail and corporate asset categories. The retail PD ended 2009 at 12,4 per cent (December 2008: 10,0), and the corporate PD at 3,6 per cent (December 2008: 2,5 per cent); in other words, it is expected that 12,4 per cent of the value of retail borrowers will be in default over the following 12-month period, and 3,6 per cent of the value of corporate borrowers. As a result, fairly high levels of credit losses are still expected for 2010.

average PD increased to 7,4 per cent

- In the event of retail and corporate borrowers actually defaulting, it is estimated that the average LGD would amount to 24,2 per cent and 34,6 per cent respectively of defaulted exposures (December 2008: 24,4 per cent and 34,8 per cent respectively). The LGD for both retail and corporate asset categories improved slightly during 2009 due to banks' increased focus on credit risk mitigation.

LGD for both retail and corporate asset categories improved slightly during 2009

- Applying the PDs, LGDs and EADs, the expected loss as a ratio of the value of defaulted exposures for the IRB banks amounted to 2,0 per cent at the end of December 2009 (December 2008: 1,6 per cent). IRB banks had to make provision for these additional expected losses of defaulted exposures, which impacted negatively on profitability. Banks will therefore still be expected to set profits aside to cover these expected losses during 2010.
- The increase in defaulted exposures forced banks to absorb higher expected credit losses. This, coupled with the absence of growth in new loans, which is normally riskier than more mature loans, resulted in an improved average risk weighting of 34,7 per cent at the end of December 2009 (December 2008: 35,6 per cent).

Table 4.4 Key features reported by internal ratings-based banks

	Dec 2008	Dec 2009
Exposure at default (R billions)	2,578	2,597
Average probability of default (per cent)	5,8	7,4
Of which:		
Retail	10,0	12,4
Corporate	2,5	3,6
Average loss given default (per cent)	27,8	28,4
Of which:		
Retail	24,4	24,2
Corporate	34,8	34,6
Expected loss as a percentage of exposure at default (per cent)	1,6	2,0
Risk-weighted exposure as a percentage of exposure at default (per cent)	35,6	34,7
Advances in default as a percentage of exposure at default (per cent)	3,1	4,6

The EAD for the majority of credit exposures subject to the IRB approach is reported in standard PD bands. Of these, total retail and total corporate form the main components. Figures 4.48 and 4.49 provide the total retail and total corporate distributions of EAD in the standard PD bands, and how they migrated during the period December 2008 to the end of December 2009. From the retail and corporate PD distributions it is evident that the "in default" PD band increased as borrowers over-extended themselves. The impact of this was reduced by the migration of more mature loans to higher quality PD bands.

Figure 4.48 Distribution of retail exposures at default over the probability of default bands

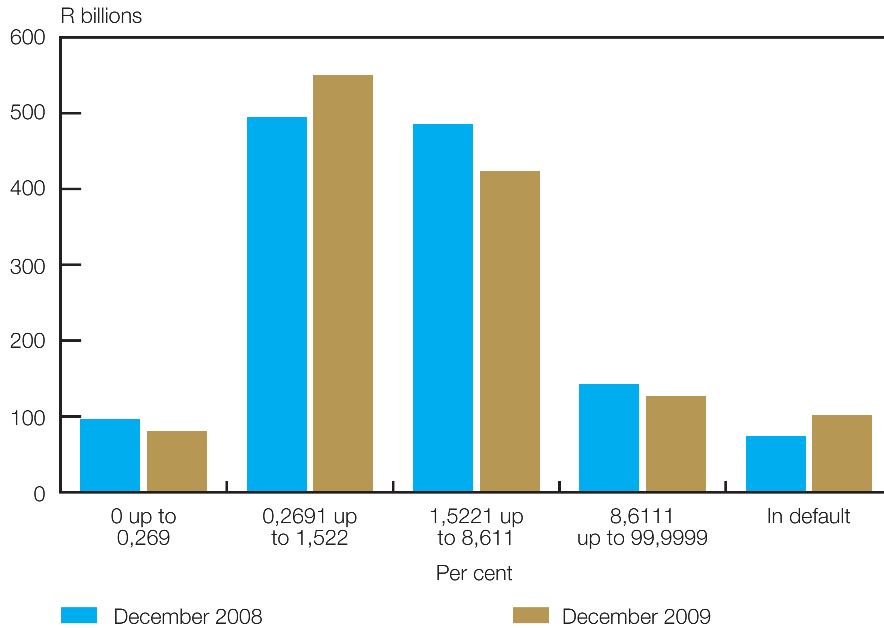
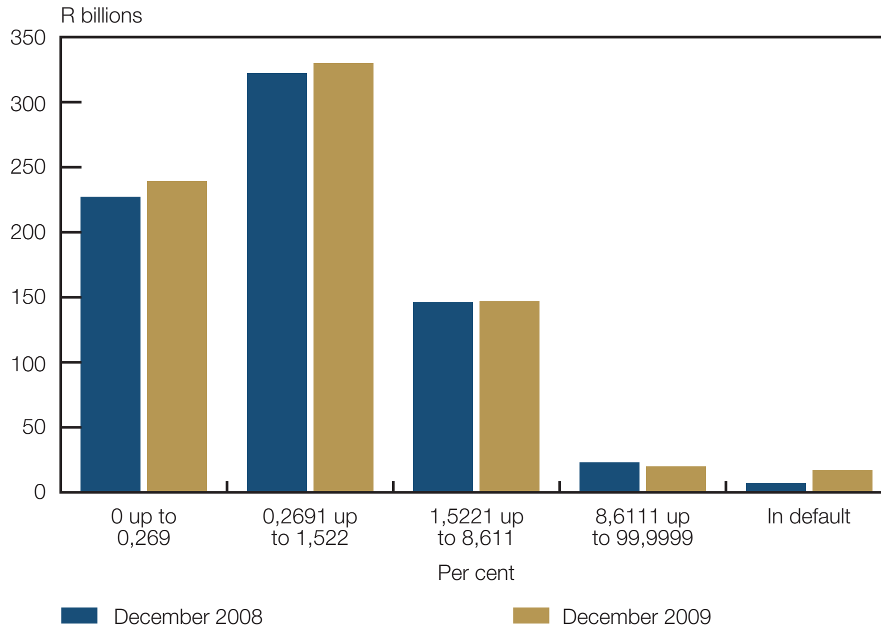


Figure 4.49 Distribution of corporate exposures at default over the probability of default bands



4.8.6 Exposure at default

total default exposures increased by 48,1 per cent

Credit exposure (i.e., EAD) per asset category is presented in Figure 4.50, followed by the default exposure and the respective default ratios (Figure 4.51). Total credit exposure (as reflected in the standard PD bands) declined by 1,8 per cent to R2 533 billion at the end of December 2009 (December 2008: R2 578 billion) in a trend similar to that of gross loans and advances reported on balance sheet. The retail credit exposures accounted for 50,7 per cent of total credit exposure. Total default exposures increased by 48,1 per cent and amounted to R119,6 billion at the end of December 2009 (December 2008: R80,8 billion). The retail default exposures, following an increase of

38,7 per cent during 2009, contributed 85,5 per cent of the total default exposures, amounting to R102,3 billion at the end of December 2009 (December 2008: R73,8 billion). Total corporate default exposures (which includes corporate, specialised lending, SME corporate and purchase receivables-corporate) increased by 156,7 per cent to R17,2 billion at the end of December 2009 (December 2008: R6,7 billion). The default ratios for the total credit exposure, the retail exposure and the corporate exposure deteriorated substantially to 4,7 per cent, 8,0 per cent and 2,3 per cent respectively at the end of December 2009 (December 2008: 3,1 per cent, 5,7 per cent and 0,9 per cent respectively). In general, it would seem that the default ratios flattened out during the final quarter of 2009.

default ratios flattened out during the final quarter of 2009

Figure 4.50 Total exposure at default

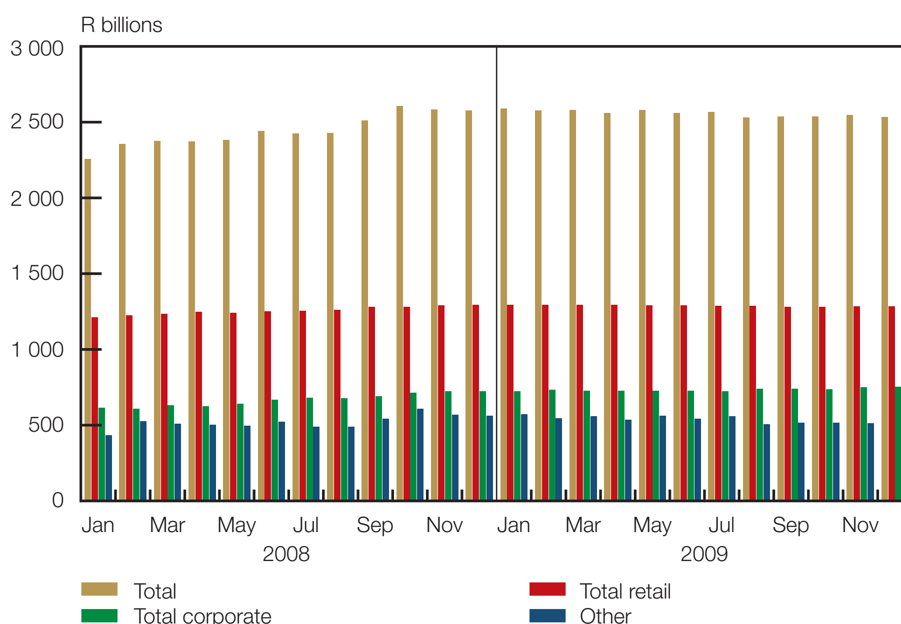
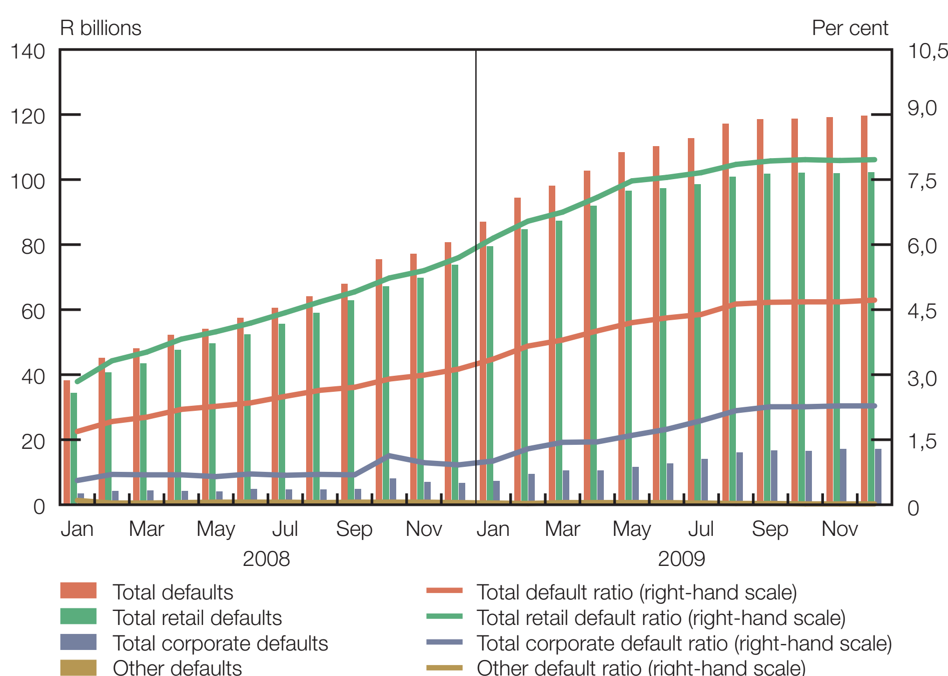
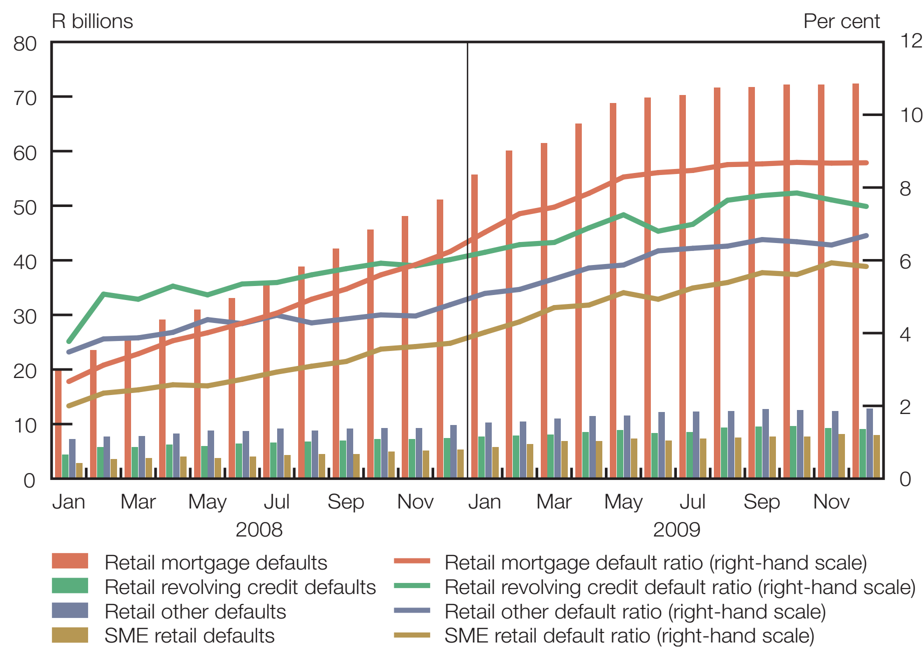


Figure 4.51 Total default exposure and default ratio per asset class



A breakdown of the respective retail defaults and retail default ratios is provided in Figure 4.52. During the first half of 2009 default ratios increased at a strong pace, but this trend slowed down during the second half of 2009. Retail mortgages contributed 70,7 per cent of total retail default exposures at the end of December 2009 (R72,4 billion mortgages in default). The default ratios for retail mortgages, retail revolving credit, retail other and SME retail increased to 8,7 per cent, 7,5 per cent, 6,7 per cent and 5,8 per cent respectively at the end of December 2009 (December 2008: 6,2 per cent, 6,0 per cent, 4,8 per cent and 3,7 per cent respectively) indicating a material deterioration in asset quality in these portfolios during 2009.

Figure 4.52 Composition of retail default exposures and their respective default ratios



Corporate and SME corporate default exposures (excluding specialised lending), and their default ratios, are presented in Figure 4.53 on page 133. Corporate defaults (excluding specialised lending) lagged retail defaults during 2008, but increased by 215,9 per cent during 2009 to R9,1 billion at the end of December 2009 (December 2008: R2,9 billion). The default ratios for corporate (excluding specialised lending) and SME corporate increased to 1,6 per cent and 5,6 per cent respectively at the end of December 2009 (December 2008: 0,6 per cent and 3,0 per cent respectively).

4.8.7 Credit concentration risk: Sectoral and geographic distribution of credit exposures

advances to private households, and finance and insurance represented 62,1 per cent of the banking sector's total credit exposure

Tables 4.5 and 4.6 provide the sectoral and geographic distribution of credit exposures for the years ending December 2008 and 2009. Advances to private households, and finance and insurance represented more than half of the banking sector's total credit exposure and amounted to 39,4 per cent and 22,7 per cent respectively of the total credit exposure at the end of 2009 (December 2008: 36,5 per cent and 25,4 per cent respectively). Advances to the real-estate sector and other amounted to 5,5 per and 5,6 per cent respectively at the end of December 2009. The banking sector's credit exposure to the remaining sectors of the economy was less than 5 per cent at the end of 2009. As reflected in Table 4.6, approximately 91 per cent of the banking sector's total credit exposure remained within the borders of South Africa, while exposure to Europe and Northern America amounted to 7 per cent and 1,3 per cent respectively at the end of 2009. Advances to other parts of the world represented less than 1 per cent of the banking sector's total credit exposure at the end of December 2009.

Figure 4.53 Composition of corporate default exposures (excluding specialised lending) and small and medium corporate enterprises default exposures, and respective default ratios

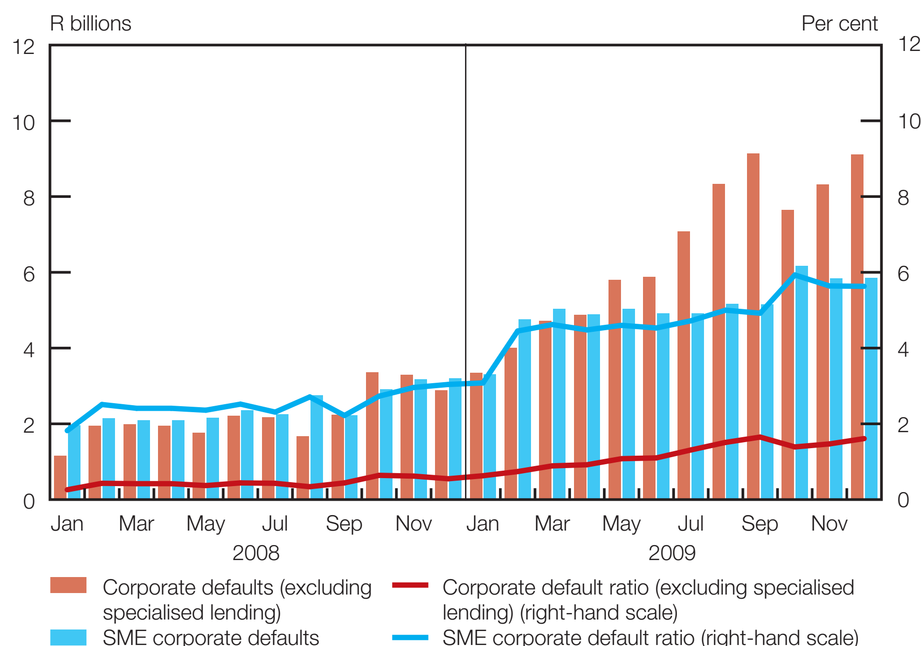


Table 4.5 Sectoral distribution of credit exposures (as a percentage of total credit exposure)

	Dec 2008	Dec 2009
Agriculture	1,21	1,62
Mining	2,70	3,21
Manufacturing	4,42	3,69
Electricity	0,71	0,70
Construction	1,29	1,31
Wholesale and retail trade	3,60	3,85
Transport and communication	2,36	2,90
Finance and insurance	25,37	22,70
Real estate	4,83	5,49
Business services	5,67	4,68
Community and personal services	4,14	4,83
Private households	36,46	39,41
Other	7,25	5,62
Total	100,00	100,00

Table 4.6 Geographic distribution of credit exposures (as a percentage of total credit exposure)

	Dec 2008	Dec 2009
South Africa	89,06	90,67
Other African countries	0,51	0,50
Europe	8,35	7,03
Asia	0,16	0,31
North America	1,61	1,27
South America	0,11	0,11
Other	0,21	0,12
Total	100,00	100,00

4.9 Market risk

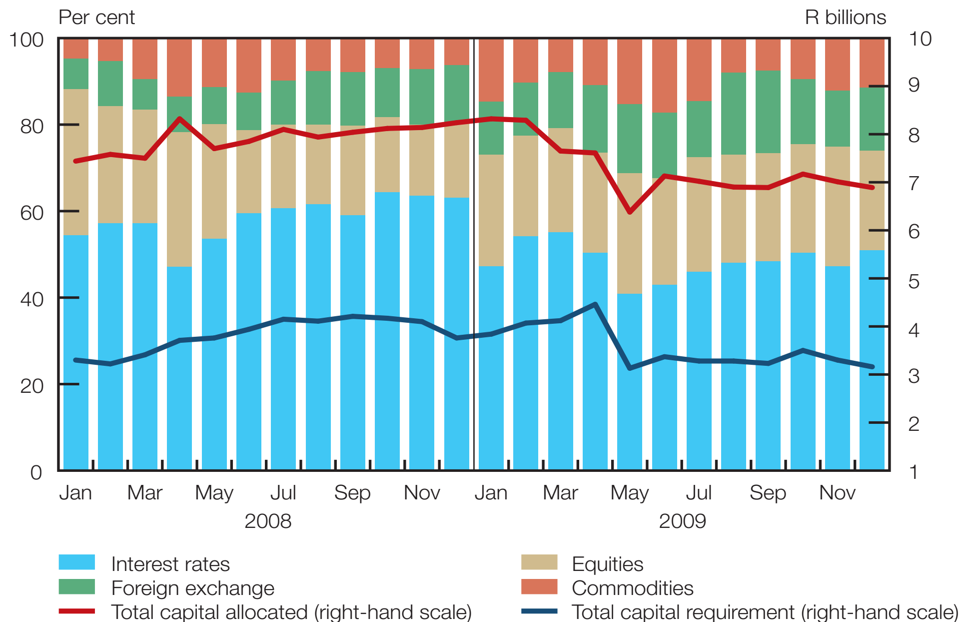
4.9.1 Regulatory capital requirement in respect of market risk

total capital allocated for market risk amounted to R6,9 billion

The composition of market risk regulatory capital requirement is illustrated in Figure 4.54. The total capital requirement for market risk increased from R3,8 billion at the end of January 2009 to R4,1 billion at the end of February 2009 and remained slightly above R4 billion for two successive months before declining to R3,2 billion at the end of December 2009 (December 2008: R3,8 billion). The total capital allocated for market risk amounted to R6,9 billion at the end of December 2009 (December 2008: R8,2 billion). The total allocated capital for market risk fluctuated between R6,4 billion and R8,3 billion during 2009. On average banks utilised 49,0 per cent of capital allocated for market risk during 2009.

The capital requirement in respect of interest rate contracts represented more than 40 per cent of the total market risk capital requirement during 2009. By the end of 2009 interest rate contracts amounted to 50,4 per cent of the market risk capital requirement (December 2008: 63,2 per cent). The capital requirement in respect of equity positions reached a high of 28,2 per cent at the end of November 2009, whereafter the ratio declined slightly to 26,1 per cent at the end of 2009 (December 2008: 17,3 per cent). The capital requirement for foreign exchange contracts and commodities constituted 14,0 per cent and 9,6 per cent respectively of total market risk capital at the end of 2009 (December 2008: 13,3 per cent and 6,2 per cent respectively).

Figure 4.54 Composition of regulatory capital requirement in respect of market risk



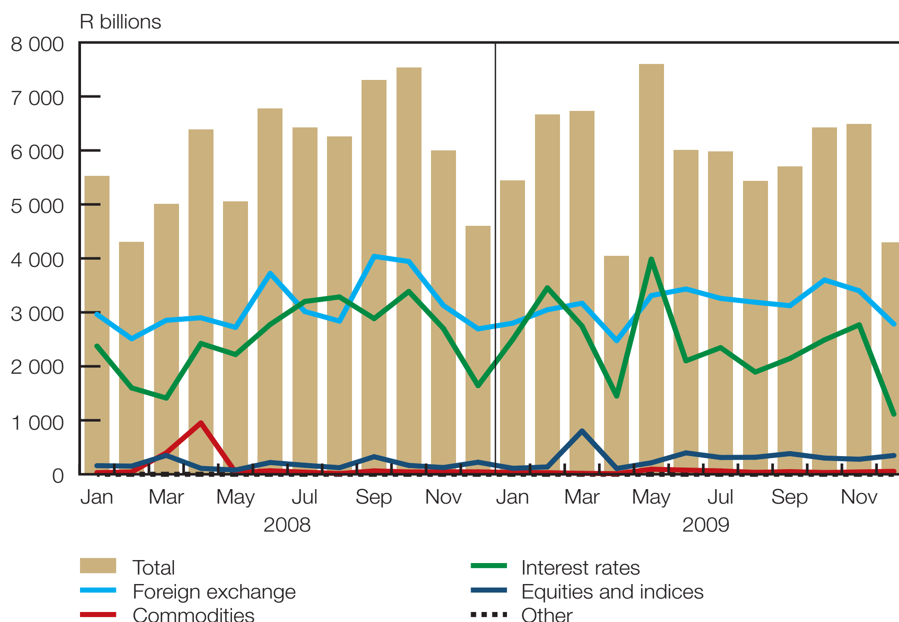
4.9.2 Derivative instruments

turnover in derivative instruments fluctuated between R4 billion and R7,6 billion per month

Figure 4.55 shows the monthly turnover in derivative contracts and their composition. The turnover is calculated by aggregating the gross notional values of all derivative purchases and sales that occurred during a specific month. The turnover in derivative instruments fluctuated between R4 billion and R7,6 billion per month throughout 2009. Monthly notional gross turnover dropped to R4 billion and R4,3 billion respectively at the end of April 2009 and December 2009, due to a decline in turnover of interest rate and foreign exchange contracts, reported by the larger banks and a few branches of

international banks. Interest rate and foreign exchange contracts constituted the major part of the turnover in derivative contracts during 2009. At the end of 2009 interest rate and foreign exchange contracts amounted to R1 114 billion and R2 783 billion respectively (December 2008: R1 642 billion and R2 694 billion respectively). Equities and commodities represented a small portion of the derivative turnover during 2009.

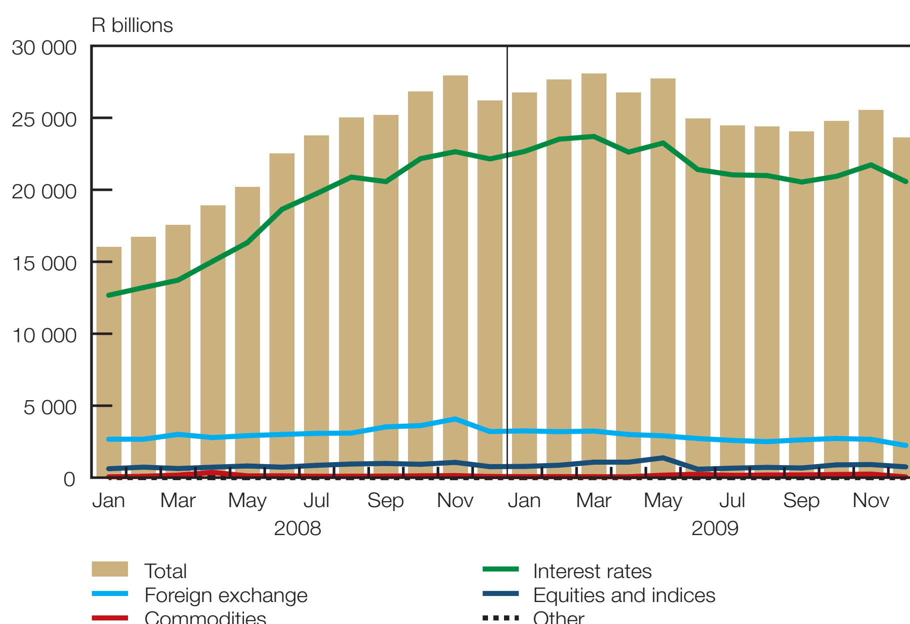
Figure 4.55 Composition of monthly turnover in derivative contracts (gross notional value)



The gross notional value of the total unexpired derivative contracts and the composition thereof are depicted in Figure 4.56. The gross notional value of the total unexpired derivative contracts amounted to R23 612 billion at the end of December 2009 (December 2008: R26 194 billion). Unexpired interest rate derivative contracts accounted for approximately 85 per cent of the total unexpired derivative contracts

interest rate derivative contracts accounted for approximately 85 per cent of the total unexpired derivative contracts

Figure 4.56 Composition of unexpired derivative contracts at month-end (gross notional value)



during 2009, amounting to R20 572 billion at the end of December 2009 (December 2008: R22 144 billion).

OTC-traded unexpired derivative transactions represented 95,6 per cent of the total unexpired derivative contracts

As already mentioned, Figure 4.56 illustrates the unexpired gross notional value of derivative contracts at month-end. Figures 4.57 and 4.58 present identical information to that of Figure 4.56, differentiating between exchange-traded (Figure 4.57) and OTC-traded derivative transactions (Figure 4.58). OTC-traded unexpired derivative transactions represented 95,6 per cent of the total unexpired derivative contracts at the end of December 2009 (December 2008: 96,8 per cent). Interest rate derivative contracts contributed to 89,6 per cent of the total unexpired OTC-traded derivative contracts at the end of December 2009 (December 2008: 86,9 per cent).

Figure 4.57 Composition of unexpired derivative contracts at month-end: exchange traded (gross notional value)

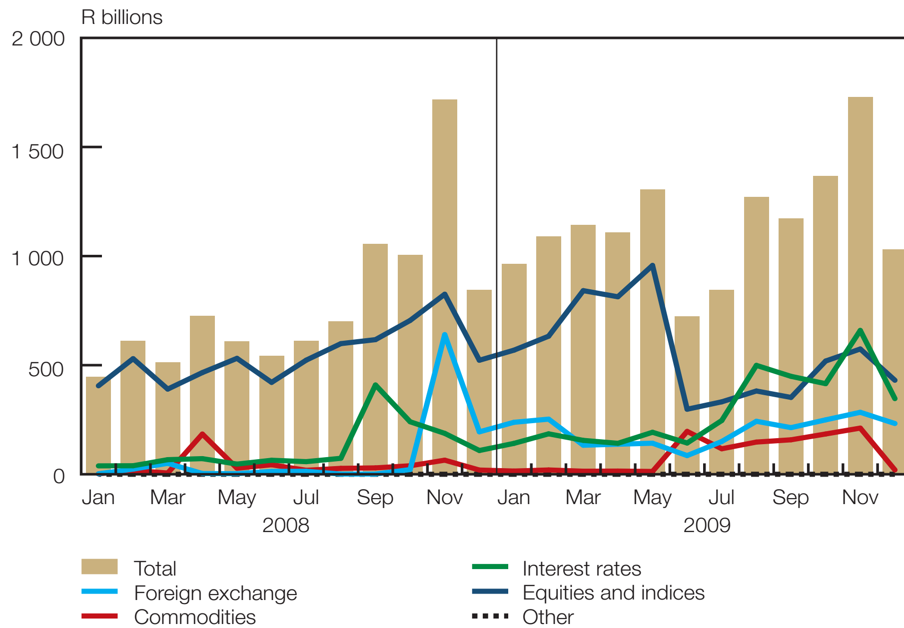
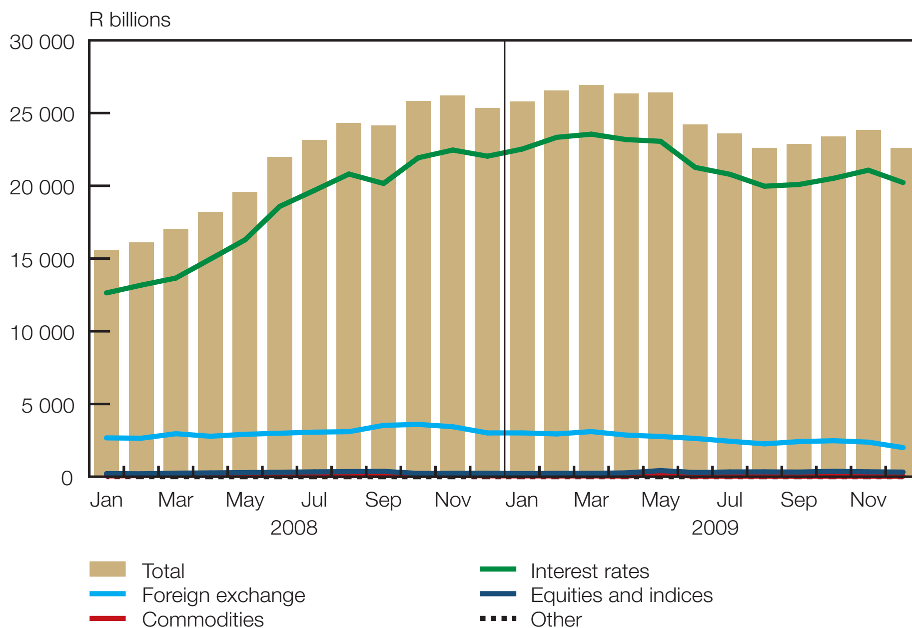


Figure 4.58 Composition of unexpired derivative contracts at month-end: over-the-counter traded (gross notional value)



4.9.3 Currency risk

aggregated FX NOP remained below US$300 million during 2009

Figure 4.59 depicts the aggregated effective net open foreign-currency position (FX NOP) which is calculated by the netting of foreign-currency assets, foreign-currency liabilities, commitments to purchase foreign currency and commitments to sell foreign currency. The aggregated FX NOP remained below US$300 million during 2009 and amounted to US$177 million at the end of December 2009 (December 2008: US$101 million). Expressed as a percentage of qualifying regulatory capital and reserve funds, the aggregated FX NOP remained below 1 per cent throughout 2009, except at the end of February 2009 and November 2009, when it increased in excess of 1 per cent, due to the depreciation of the US dollar. The composition of the aggregated FX NOP is reflected in Figure 4.60. The US dollar was the main contributor to the aggregated FX NOP and influenced most of the fluctuations during 2009.

Figure 4.59 Aggregated effective net open foreign-currency position (as a percentage of qualifying regulatory capital)

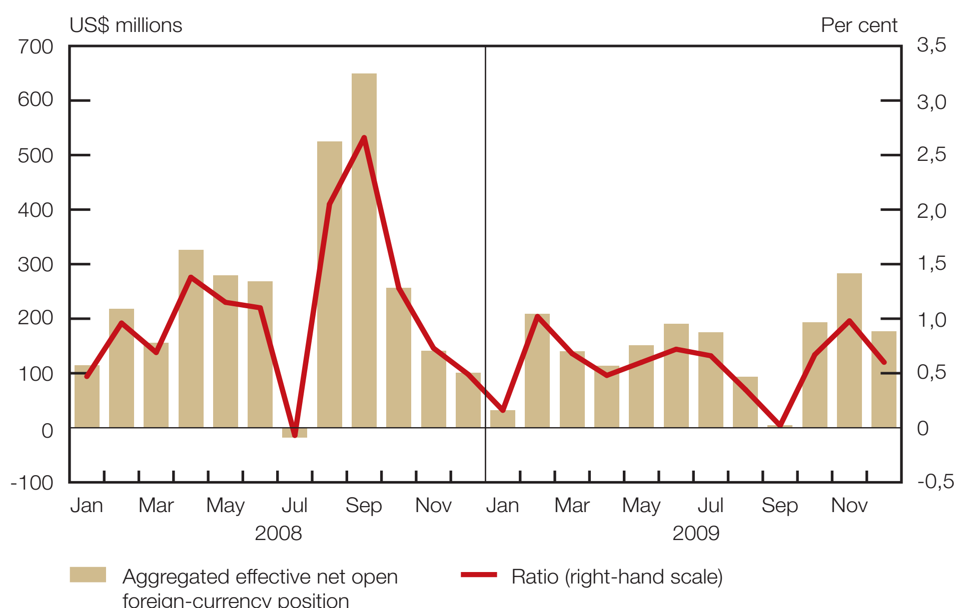
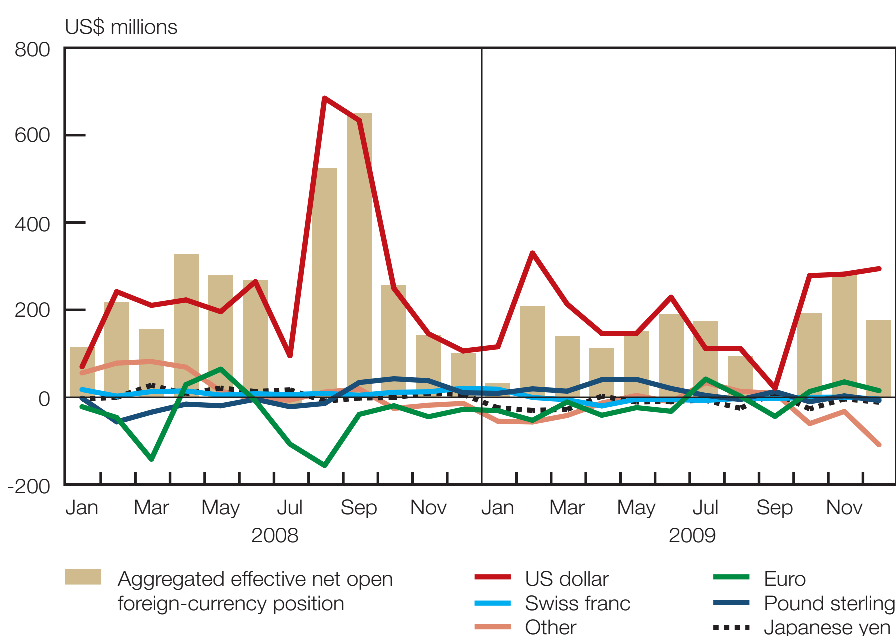
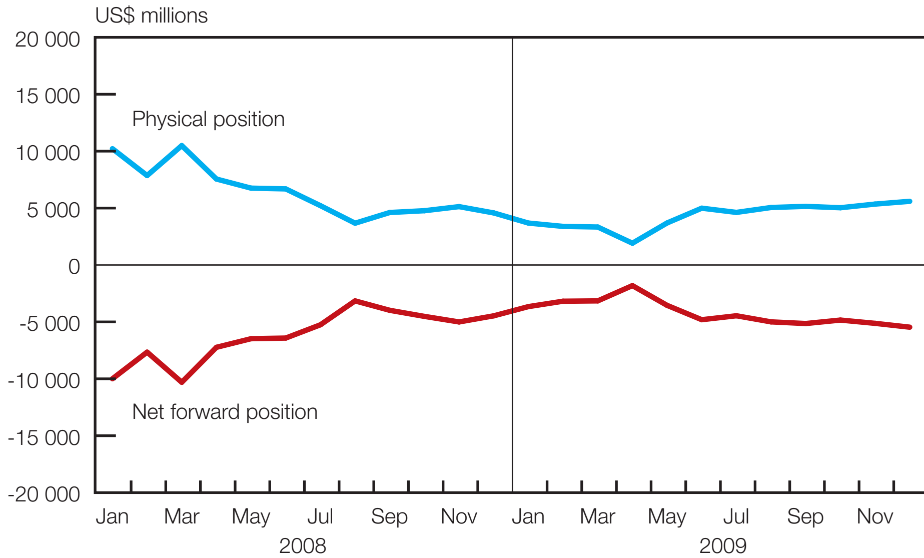


Figure 4.60 Aggregated effective net open foreign-currency position per currency



The position in foreign-currency instruments is illustrated in Figure 4.61. The physical position is the difference between foreign-currency assets and foreign-currency liabilities, while the net forward position is the difference between commitments to sell foreign currency and commitments to purchase foreign currency. The physical position declined from US$3,7 billion at the end of January 2009 to US$1,9 billion at the end of April 2009, before increasing to US$5,6 billion at the end of December 2009 (December 2008: US$4,6 billion). The net forward position decreased from US$3,7 billion at the end of January 2009 to US$1,8 billion at the end of April 2009 and thereafter increased to US$5,5 billion at the end of December 2009 (December 2008: US$4,5 billion).

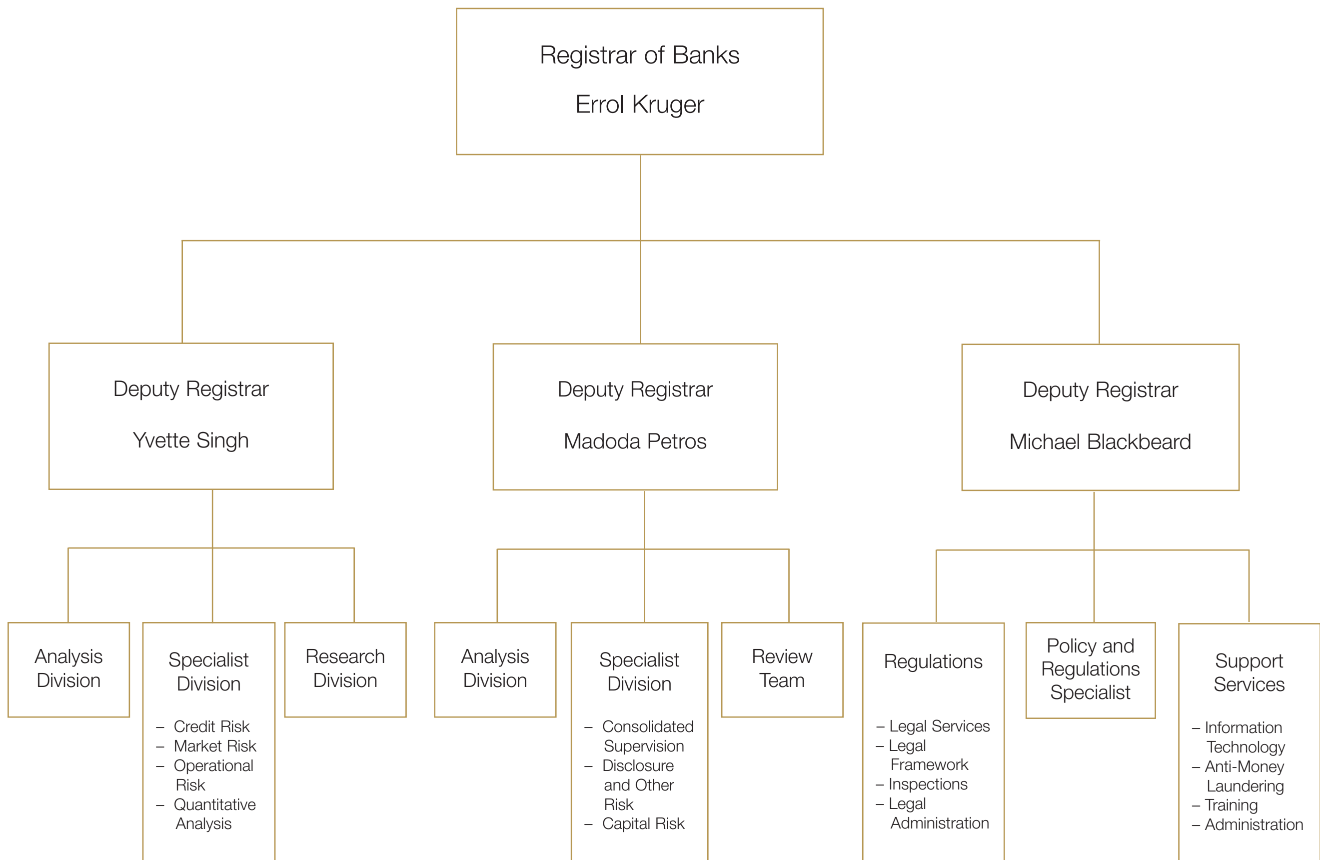
Figure 4.61 Position in foreign-currency instruments



Appendices

Appendix 1

Organisational structure of the Bank Supervision Department



Total staff complement, vacancies and employment equity numbers

	31 December 2008	31 December 2009
Total job register (permanent positions)	108	109
Total employed	94	101
Total vacancies	14	8
Employment equity: Race (target group – per cent)		
General management	44	39
Other staff	51	64
Employment equity: Gender (target group – per cent)		
General management	33	39
Other	55	69

Appendix 2

Registered banks, mutual banks and local branches of foreign banks as at 31 December 2009

Registered banks

	Institution	Address	Total assets at 31 December 2008 (R million)	Total assets at 31 December 2009 (R million)	Annual growth (Per cent)
1	Absa Bank Limited	P O Box 7735, Johannesburg, 2000	707 828	649 142	-8,29
2	African Bank Limited	Private Bag X170, Halfway House, 1685	17 370	24 191	39,27
3	Albaraka Bank Limited	P O Box 4395, Durban, 4000	1 869	2 365	26,51
4	Bidvest Bank Limited	P O Box 185, Johannesburg, 2000	1 509	1 726	14,40
5	Capitec Bank Limited	P O Box 12451, Die Boord, Stellenbosch, 7613	4 554	8 620	89,30
6	FirstRand Bank Limited	P O Box 650149, Benmore, 2010	607 766	548 333	-9,78
7	Grindrod Bank Limited	P O Box 3211, Durban, 4000	1 893	2 119	11,97
8	Habib Overseas Bank Limited	P O Box 62369, Marshalltown, 2107	647	751	16,04
9	HBZ Bank Limited	P O Box 1536, Wandsbeck, 3631	1 853	1 957	5,59
10	Imperial Bank Limited	P O Box 6093, Rivonia, 2128	47 245	54 510	15,38
11	Investec Bank Limited	P O Box 785700, Sandton, 2146	170 528	181 663	6,53
12	Mercantile Bank Limited	P O Box 782699, Sandton, 2146	5 930	5 829	-1,71
13	Nedbank Limited	P O Box 1144, Johannesburg, 2000	506 359	509 739	0,67
14	Sasfin Bank Limited	P O Box 95104, Grant Park, 2051	1 407	1 536	9,12
15	Teba Bank Limited	Private Bag X101, Sunninghill, 2157	3 116	3 365	8,00
16	The South African Bank of Athens Limited	P O Box 7781, Johannesburg, 2000	1 356	1 268	-6,51
17	The Standard Bank of South Africa Limited	P O Box 7725, Johannesburg, 2000	861 396	803 028	-6,78

Appendix 2

Registered banks, mutual banks and local branches of foreign banks as at 31 December 2009 (continued)

Registered mutual banks

	Institution	Address	Total assets at 31 December 2008 (R million)	Total assets at 31 December 2009 (R million)	Annual growth (Per cent)
1	GBS Mutual Bank	P O Box 114, Grahamstown, 6140	718	758	5,6
2	VBS Mutual Bank	P O Box 3618, Makhado, 0920	235	242	3,2

Registered local branches of foreign banks

	Institution	Address	Total assets at 31 December 2008 (R million)	Total assets at 31 December 2009 (R million)	Annual growth (Per cent)
1	ABN AMRO Bank NV	P O Box 78769, Sandton, 2146	19 099	5 328	-72,10
2	Bank of Baroda	Premises No.14, 2nd floor, Sandton City Twin Towers (East Wing), Sandton, 2196	324	415	28,02
3	Bank of China Limited Johannesburg Branch (trading as Bank of China Johannesburg Branch)	P O Box 782616, Sandton, 2146	2 281	4 599	101,60
4	Bank of Taiwan South Africa Branch	P O Box 1999, Parklands, 2121	673	645	-4,23
5	Calyon (trading as Calyon Corporate and Investment Bank – South Africa Branch)	P O Box 527, Melrose Arch, 2076	18 449	15 804	-14,34
6	China Construction Bank Corporation – Johannesburg Branch	Private Bag X10007, Sandton, 2146	4 418	5 174	17,10
7	Citibank NA	P O Box 1800, Saxonwold, 2132	71 388	43 610	-38,91
8	Deutsche Bank AG	Private Bag X9933, Sandton, 2146	20 127	30 110	49,60
9	JPMorgan Chase Bank, NA (Johannesburg Branch)	Private Bag X9936, Sandton, 2146	49 075	23 201	-52,72
10	Société Générale	P O Box 6872, Johannesburg, 2000	8 907	9 205	3,34
11	Standard Chartered Bank (Johannesburg Branch)	P O Box 782080, Sandton, 2146	11 679	14 418	23,45
12	State Bank of India	P O Box 2538, Saxonwold, 2132	1 710	1 801	5,29
13	The Hongkong and Shanghai Banking Corporation Limited (HSBC)	Private Bag X785434, Sandton, 2146	15 329	11 007	-28,19

Appendix 2

Registered banks, mutual banks and local branches of foreign banks as at 31 December 2009 (continued)

Banks under curatorship

Institution		Curator	Date of order
1	None		

Banks in final liquidation

Institution		Liquidator	Date of order
1	Islamic Bank Limited	Mr A D Wilkens of Deloitte & Touche	13 January 1998
2	Regal Treasury Private Bank Limited	Mr T A P du Plessis of D&N Trust and Mr J Pema of Sekela Antrust (Pty) Limited	10 February 2004

Appendix 3

Name changes and cancellation of registration of banks and branches of foreign banks during the period 1 January 2009 to 31 December 2009

Name changes

Previous name		New name	Date of change
1	None		

Cancellation of registration

Institution		Date of cancellation
1	Commerzbank Aktiengesellschaft	31 July 2009
2	Meeg Bank Limited	16 September 2009

Appendix 4

Registered controlling companies as at 31 December 2009

	Institution	Address
1	Absa Group Limited	P O Box 7735, Johannesburg, 2000
2	African Bank Investments Limited	Private Bag X170, Halfway House, 1685
3	Bidvest Bank Holdings Limited	P O Box 185, Johannesburg, 2000
4	Capitec Bank Holdings Limited	P O Box 12451, Die Boord, Stellenbosch, 7613
5	FirstRand Bank Holdings Limited	P O Box 650149, Benmore, 2010
6	Grindrod Financial Holdings Limited	P O Box 3211, Durban, 4000
7	Investec Limited	P O Box 785700, Sandton, 2146
8	Mercantile Bank Holdings Limited	P O Box 782699, Sandton, 2146
9	Nedbank Group Limited	P O Box 1144, Johannesburg, 2000
10	Sasfin Holdings Limited	P O Box 95104, Grant Park, 2051
11	Standard Bank Group Limited	P O Box 7725, Johannesburg, 2000
12	Teba Bank Controlling Company Limited	Private Bag X101, Sunninghill, 2157

The following institutions are deemed to be controlling companies in terms of section 42 of the Banks Act, 1990:

	Institution	Address
1	Albaraka Banking Group (in respect of Albaraka Bank Limited)	P O Box 1882, Manama, Kingdom of Bahrain
2	National Bank of Greece (in respect of The South African Bank of Athens Limited)	86 Eolou Street, Athens TT 121, Greece
3	Pitcairn’s Finance (in respect of Habib Bank Limited)	121, Avenue de la Faiencerie, L-1511 Luxemburg, RCS Luxemburg, B nr 33-106

Appendix 5

Foreign banks with approved local representative offices

	Institution	Address
1	AfrAsia Bank Limited	Block F, Dale House, The Terraces, Steenberg Office Park, Cape Town, 7945
2	Banco BPI, SA	P O Box 303, Bruma, 2026
3	Banco Espirito Santo e Comercial de Lisboa	P O Box 749, Bruma, 2026
4	Banco Privado Português, SA	P O Box 78407, Sandton, 2146
5	Banco Santander Totta SA	P O Box 309, Bruma, 2026
6	Bank Leumi Le-Israel BM	Private Bag X41, Saxonwold, 2132
7	Bank of Cyprus Group	P O Box 652176, Benmore, 2010
8	Bank of India	P O Box 653589, Benmore, 2010
9	BNP Paribas Johannesburg	P O Box 52897, Saxonwold, 2132
10	Barclays Bank plc	P O Box 1542, Saxonwold, 2132
11	Barclays Private Clients International Limited	P O Box 1542, Saxonwold, 2132
12	Bayerische Hypo- und Vereinsbank AG	P O Box 1483, Parklands, 2121
13	Commerzbank AG Johannesburg	5 Keys Avenue, Rosebank, 2195
14	Credit Suisse AG	Private Bag X9911, Sandton, 2146
15	Credit Suisse Securities (Europe) Limited	Private Bag X9911, Sandton, 2146
16	Ecobank	4th Floor, Sandown Valley Crescent, Sandton, 2196
17	Export-Import Bank of India	Suite 117, Aldrovande Palace, 6 Jubilee Grove, Umhlanga Rocks, Durban, 4320
18	Fairbairn Private Bank (Isle of Man) Limited	P O Box 787549, Sandton, 2146
19	Fairbairn Private Bank (Jersey) Limited	P O Box 787549, Sandton, 2146
20	First Bank of Nigeria	P O Box 784796, Sandton, 2146
21	Fortis Bank (Nederland) NV	P O Box 652065, Benmore, 2010
22	Hellenic Bank Public Company Limited	P O Box 783392, Sandton, 2146
23	HSBC Bank International Limited	Private Bag X785434, Sandton, 2146
24	Icici Bank Limited	P O Box 78261, Sandton, 2146
25	JSCB IMEX Bank	P O Box 31262, Tokai, 7966
26	KFW Ipex-Bank GMBH	P O Box 2402, Saxonwold, 2132
27	Lloyds TSB Offshore Limited	Private Bank X25, Northlands, 2116
28	Millenium BCP	P O Box 273, Bruma, 2026
29	Natixis Southern Africa Representative Office	Postnet Suite 352, Private Bag X1, Melrose Arch, 2076
30	National Bank of Egypt	P O Box 55402, Northlands, 2116
31	Société Générale Representative Office for Southern Africa	P O Box 2805, Saxonwold, 2132
32	Sumitomo Mitsui Banking Corporation	Building Four, 1st floor, Commerce Square, 39 Rivonia Road, Sandhurst, Sandton, 2196
33	The Bank of New York, Mellon	Postnet Suite 100, Private Bag X43, Sunninghill, 2157
34	The Bank of Tokyo-Mitsubishi, UFJ Limited	P O Box 78519, Sandton, 2146

Appendix 5

Foreign banks with approved local representative offices (continued)

	Institution	Address
35	The Mauritius Commercial Bank Limited	P O Box 3009, Parklands, 2121
36	The Representative Office for Southern and Eastern Africa of the Export-Import Bank of China	Postnet Suite 158, Private Bag X91-BE, Benmore, 2010
37	Royal Bank of Scotland International Limited	3 Merchant Place, 1 Fredman Drive, Sandton, 2196
38	UBS AG	P O Box 652863, Benmore, 2010
39	Union Bank of Nigeria plc	P O Box 653125, Benmore, 2010
40	Vnesheconombank	P O Box 413742, Craighall, 2024
41	Wachovia Bank, NA	P O Box 3091, Saxonwold, 2132
42	Zenith Bank plc	P O Box 782652, Sandton, 2146

As at 31 December 2009 there were 42 approved representative offices of foreign banks operating in South Africa, emanating from 22 countries.

During the year under review the following representative offices were registered and deregistered:

1. Registrations

   a. Commerzbank AG
   b. AfrAsia Bank Limited
   c. Ecobank

2. Deregistration

   a. Dresdner Bank AG
   b. Dresdner Kleinwort Limited
   c. Westdeutsche Landesbank Girosentrale (WestLB)
   d. ING Bank (Switzerland) Limited

The Regulations relating to Representative Offices of Foreign Banking Institutions ("the Regulations"), issued under Government Notice No. 1370, in *Government Gazette* No. 22939 dated 13 December 2001, seek to ensure constant oversight by the Department of the activities of representative offices of foreign banking institutions operating in the Republic of South Africa.

In order to fulfil the above-mentioned oversight responsibility, the Department follows the following supervisory approach:

- Regular interaction with the chief representative officers of the representative offices.
- Visits to the offices of representative offices.
- Analysis of returns submitted by the representative offices in terms of the Regulations and the follow-up of any issues identified.
- Analysis of the internal control reports submitted by representative offices on an annual basis in terms of Banks Act Circular 3/2004.

During the year under review the Department also implemented a new electronic submission system to facilitate the timely submission and accuracy of returns submitted by representative offices.

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Selected information on South African banks

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Table 1

Composition of total assets (R millions)

	Cash and balances with central bank	Short-term negotiable securities	Loans and advances to customers	Investment and trading securities	Derivative financial instruments	Other assets	Total assets
2008: January	55 351	92 549	2 076 991	118 280	228 497	91 495	2 663 162
February	57 345	101 472	2 147 428	109 250	257 215	85 260	2 757 970
March	60 244	95 199	2 181 815	108 985	295 407	85 693	2 827 343
April	59 135	101 139	2 165 794	111 712	262 444	90 569	2 790 794
May	56 660	103 142	2 212 037	117 026	286 693	85 004	2 860 562
June	58 740	102 995	2 249 718	130 972	314 633	97 597	2 954 656
July	60 145	107 409	2 238 573	137 166	268 339	86 301	2 897 934
August	60 259	115 336	2 229 424	140 328	235 292	78 662	2 859 302
September	64 218	112 031	2 287 747	135 288	244 678	91 768	2 935 730
October	63 156	122 146	2 317 724	139 279	507 322	90 584	3 240 211
November	62 320	131 882	2 300 563	154 045	492 131	84 287	3 225 228
December	66 929	124 031	2 276 371	163 730	455 474	90 735	3 177 269
2009: January	61 417	134 361	2 296 705	169 336	455 183	89 660	3 206 661
February	58 765	140 668	2 272 686	167 440	416 779	86 211	3 142 548
March	63 325	145 592	2 284 151	165 011	396 921	90 560	3 145 560
April	65 669	147 094	2 222 197	166 032	390 716	82 322	3 074 030
May	60 357	147 749	2 219 255	161 216	401 639	86 843	3 077 058
June	64 779	149 221	2 209 475	155 690	356 820	84 788	3 020 773
July	63 398	149 195	2 236 154	166 082	328 473	81 685	3 024 987
August	64 865	153 975	2 234 131	161 131	321 992	83 320	3 019 414
September	66 219	159 784	2 214 190	167 583	308 777	83 684	3 000 236
October	61 037	166 406	2 227 932	170 584	293 744	76 769	2 996 472
November	67 688	164 725	2 213 848	180 433	289 429	81 402	2 997 524
December	65 839	163 824	2 205 299	186 182	265 341	80 933	2 967 418

Table 2

Composition of loans and advances to customers (R millions)

	Homeloans	Commercial mortgages	Credit cards	Lease and instalment debtors	Overdrafts	Term loans	Other	Less: Credit impairments	Loans and advances to customers
2008: January	693 453	168 060	55 950	238 860	122 070	284 469	540 322	26 194	2 076 991
February	701 629	167 289	56 689	241 891	118 362	330 047	559 139	27 618	2 147 428
March	709 506	170 069	56 452	244 240	119 641	332 840	576 990	27 922	2 181 815
April	711 686	173 857	57 381	246 708	115 949	314 382	574 671	28 840	2 165 794
May	719 939	177 401	57 584	248 273	116 654	328 805	593 150	29 770	2 212 037
June	726 158	182 022	57 504	249 523	122 590	344 314	599 070	31 461	2 249 718
July	735 082	187 999	57 613	250 342	113 581	327 505	599 127	32 675	2 238 573
August	741 140	192 049	58 060	251 043	111 679	341 892	567 796	34 235	2 229 424
September	746 452	196 865	58 041	252 679	116 653	356 019	596 712	35 675	2 287 747
October	755 991	201 239	58 085	253 644	110 587	383 799	591 722	37 342	2 317 724
November	761 424	206 711	57 967	253 628	107 168	368 515	582 662	37 512	2 300 563
December	763 503	208 588	57 345	252 725	106 860	377 853	549 246	39 750	2 276 371
2009: January	766 458	206 874	57 719	251 702	120 876	385 238	549 155	41 318	2 296 705
February	770 993	210 251	57 925	250 197	122 407	380 491	523 714	43 291	2 272 686
March	776 894	211 317	57 170	249 005	119 352	402 757	512 522	44 866	2 284 151
April	777 334	211 910	57 493	247 122	118 831	374 902	480 813	46 206	2 222 197
May	778 148	212 583	57 713	245 657	112 649	381 305	478 662	47 460	2 219 255
June	779 262	213 136	56 428	243 785	117 457	365 515	481 927	48 036	2 209 475
July	779 636	212 585	56 253	242 207	117 680	374 537	502 440	49 184	2 236 154
August	781 539	213 375	56 701	240 432	111 653	382 178	498 472	50 218	2 234 131
September	782 944	213 695	56 881	239 471	107 749	369 609	495 205	51 363	2 214 190
October	784 901	214 565	56 864	238 900	108 109	374 995	502 043	52 445	2 227 932
November	785 698	216 419	55 953	237 979	107 116	381 049	481 507	51 873	2 213 848
December	786 715	218 202	55 736	237 594	106 578	378 437	473 820	51 782	2 205 299

Table 3

Composition of other loans (R millions)

	Loans granted/ deposits placed under resale agreement	Redeemable preference shares	Trade, other bills and bankers' acceptances	Factoring accounts	Bank intra-group balances	Other	Total
2008: January	94 926	50 389	4 055	1 905	147 264	241 783	540 322
February	96 592	49 794	5 047	2 106	157 394	248 204	559 139
March	99 907	49 520	4 680	2 558	150 776	269 549	576 990
April	91 780	48 228	5 515	2 345	158 168	268 636	574 671
May	115 780	47 975	5 847	2 525	155 548	265 475	593 150
June	110 469	47 855	5 552	2 365	154 534	278 295	599 070
July	114 711	50 813	5 204	2 357	163 453	262 590	599 127
August	99 204	51 885	5 835	2 688	173 696	234 488	567 796
September	113 871	56 315	6 652	2 625	177 090	240 158	596 712
October	98 671	56 062	8 464	2 588	195 866	230 072	591 722
November	96 040	56 112	7 809	2 745	200 870	219 087	582 662
December	92 705	55 617	4 937	2 453	172 351	221 184	549 246
2009: January	99 296	56 201	4 439	2 165	180 364	206 690	549 155
February	85 813	55 421	4 245	2 274	178 474	197 487	523 714
March	85 229	54 072	3 427	2 533	168 702	198 559	512 522
April	76 082	54 575	2 943	2 228	154 385	190 600	480 813
May	81 081	54 697	2 955	2 150	145 198	192 581	478 662
June	86 129	54 793	3 877	1 974	143 936	191 219	481 927
July	90 624	55 884	3 808	1 827	149 872	200 425	502 440
August	93 775	57 014	3 470	3 732	150 732	189 749	498 472
September	88 852	56 841	3 537	3 806	149 479	192 689	495 205
October	87 093	57 632	3 302	4 293	160 502	189 220	502 043
November	79 009	57 346	3 328	4 064	142 852	194 909	481 507
December	79 819	57 126	3 801	3 689	143 680	185 705	473 820

Table 4

Composition of total liabilities (R millions)

	Deposits, current accounts and other creditors	Derivative financial instruments and other trading liabilities	Term debt instruments	Other	Total liabilities
2008: January	2 107 501	271 429	62 535	67 341	2 508 806
February	2 162 887	307 009	64 650	67 480	2 602 026
March	2 193 368	343 321	65 414	67 280	2 669 382
April	2 202 310	300 433	65 346	64 292	2 632 381
May	2 237 372	329 862	66 400	66 386	2 700 020
June	2 294 885	353 658	66 896	76 014	2 791 454
July	2 294 840	305 509	68 230	62 444	2 731 022
August	2 288 782	271 171	68 716	62 931	2 691 599
September	2 354 406	286 599	69 201	57 578	2 767 784
October	2 400 292	535 948	68 129	65 019	3 069 389
November	2 381 293	537 723	66 611	62 315	3 047 941
December	2 386 135	491 610	67 234	51 194	2 996 173
2009: January	2 393 828	496 338	67 784	64 352	3 022 302
February	2 381 514	451 698	67 355	58 806	2 959 374
March	2 418 152	420 015	67 491	59 291	2 964 949
April	2 359 798	408 546	68 085	54 481	2 890 910
May	2 362 834	405 539	67 626	56 877	2 892 877
June	2 356,363	355 167	67 006	55 905	2 834 441
July	2 374 389	333 934	71 449	57 002	2 836 774
August	2 373 195	327 755	73 525	56 853	2 831 328
September	2 367 922	313 159	72 626	55 436	2 809 142
October	2 382 842	294 389	73 387	53 136	2 803 754
November	2 378 999	292 087	83 206	48 951	2 803 243
December	2 365 862	273 141	84 647	45 535	2 769 185

Table 5

Composition of selected liabilities (R millions)

	Deposits, current accounts and other creditors							
	Current accounts	Savings deposits	Call deposits	Fixed and notice deposits	Negotiable certificates of deposit	Other deposits and loan accounts	Deposits received under repurchase agreements	Total
2008: January	403 392	92 143	466 876	532 943	336 958	183 063	92 125	2 107 501
February	394 030	95 665	480 425	543 838	332 739	226 123	90 066	2 162 887
March	412 327	90 528	497 515	552 053	331 356	215 288	94 301	2 193 368
April	394 048	93 797	496 298	542 206	338 500	243 525	93 936	2 202 310
May	385 498	96 126	498 758	570 946	342 263	235 986	107 795	2 237 372
June	422 604	99 007	504 109	547 412	337 707	268 002	116 045	2 294 885
July	389 808	102 220	507 844	577 172	355 545	243 745	118 505	2 294 840
August	396 443	103 011	496 508	580 708	364 813	230 653	116 645	2 288 782
September	400 249	104 951	520 366	583 818	367 728	235 633	141 660	2 354 406
October	402 097	109 511	554 337	607 770	371 137	236 168	119 272	2 400 292
November	394 616	112 578	537 879	612 018	392 175	223 207	108 820	2 381 293
December	414 813	113 226	525 465	593 339	387 492	242 831	108 970	2 386 135
2009: January	388 627	112 110	518 452	605 983	414 460	253 285	100 911	2 393 828
February	380 625	113 793	506 585	596 527	434 029	246 435	103 520	2 381 514
March	402 013	114 984	516 611	606 064	427 675	237 683	113 121	2 418 152
April	385 683	116 553	524 898	594 592	427 414	216 969	93 688	2 359 798
May	380 088	117 107	545 073	595 448	412 119	217 545	95 454	2 362 834
June	403 025	117 578	531 844	564 944	409 339	226 809	102 825	2 356 363
July	398 592	118 969	519 554	593 136	403 483	224 465	116 189	2 374 389
August	397 305	118 436	435 603	677 092	405 017	223 290	116 451	2 373 195
September	394 829	117 367	424 320	666 361	410 865	234 481	119 699	2 367 922
October	395 598	118 457	427 620	655 181	417 358	248 233	120 395	2 382 842
November	400 285	120 482	432 234	644 402	416 540	250 542	114 514	2 378 999
December	398 082	120 250	424 499	648 965	426 487	247 608	99 971	2 365 862

	Derivative financial instruments and other trading liabilities			Term debt instruments		
	Derivative financial instruments	Other trading liabilities	Total	Qualifying as capital	Other	Total
2008: January	236 348	35 081	271 429	47 175	15 360	62 535
February	267 106	39 903	307 009	49 073	15 577	64 650
March	306 772	36 548	343 321	48 691	16 722	65 414
April	271 194	29 239	300 433	50 588	14 759	65 346
May	294 579	35 284	329 862	51 605	14 795	66 400
June	322 745	30 913	353 658	52 333	14 564	66 896
July	270 214	35 295	305 509	52 890	15 340	68 230
August	238 479	32 691	271 171	53 284	15 432	68 716
September	250 511	36 088	286 599	53 620	15 581	69 201
October	510 233	25 715	535 948	52 024	16 105	68 129
November	493 832	43 891	537 723	49 886	16 724	66 611
December	452 499	39 110	491 610	49 456	17 778	67 234
2009: January	457 031	39 307	496 338	50 187	17 597	67 784
February	418 659	33 039	451 698	50 169	17 186	67 355
March	389 925	30 090	420 015	51 001	16 489	67 491
April	381 003	27 543	408 546	52 437	15 649	68 085
May	384 409	21 131	405 539	52 156	15 470	67 626
June	335 567	19 600	355 167	52 041	14 965	67 006
July	312 005	21 929	333 934	53 211	18 238	71 449
August	303 716	24 039	327 755	53 386	20 139	73 525
September	293 517	19 642	313 159	53 050	19 576	72 626
October	274 214	20 175	294 389	53 787	19 600	73 387
November	271 666	20 420	292 087	56 620	26 586	83 206
December	250 624	22 517	273 141	57 663	26 984	84 647

Table 6

Sources of deposits (R millions)

	Sovereigns including central banks	Public-sector entities	Local authorities	Banks	Securities firms	Corporate customers	Retail customers	Other	Total
2008: January	103 632	105 552	33 587	315 476	142 316	823 706	467 965	123 925	2 116 159
February	74 673	98 534	40 791	388 925	149 528	851 174	459 835	108 512	2 171 972
March	76 489	114 984	41 106	347 020	171 834	875 138	463 434	113 797	2 203 802
April	72 093	106 901	35 919	328 061	177 761	898 195	471 396	122 986	2 213 312
May	63 072	108 365	33 620	353 939	179 726	897 109	492 673	120 695	2 249 201
June	95 635	117 406	34 532	315 342	182 462	955 218	482 000	122 307	2 304 903
July	74 483	113 168	39 384	313 746	186 566	987 845	484 285	104 745	2 304 222
August	73 467	122 306	34 373	308 569	172 603	989 690	482 093	107 227	2 290 327
September	88 134	132 152	31 829	403 855	160 087	1 016 953	419 014	102 939	2 354 962
October	85 070	135 259	31 349	373 562	168 628	1 002 003	496 838	113 419	2 406 127
November	70 278	135 201	32 609	325 732	165 680	1 028 809	502 886	120 097	2 381 293
December	83 814	133 404	30 333	352 445	158 469	995 501	505 419	126 750	2 386 136
2009: January	81 569	136 646	28 712	361 032	159 878	990 872	508 002	127 118	2 393 828
February	64 904	137 699	39 142	352 462	162 011	998 990	510 610	115 831	2 381 649
March	75 242	136 702	34 668	393 155	163 486	984 217	512 265	118 417	2 418 151
April	66 809	133 669	31 498	344 592	165 374	987 247	515 066	115 544	2 359 798
May	65 114	136 109	30 593	392 800	174 270	1 003 277	436 805	123 865	2 362 833
June	76 427	135 845	27 846	314 869	174 689	988 949	518 442	119 296	2 356 363
July	66 979	125 472	31 478	338 133	174 643	1 001 083	520 645	115 955	2 374 389
August	62 796	125 867	28 337	324 213	183 424	1 017 741	519 304	111 514	2 373 195
September	69 421	131 758	27 630	314 210	181 064	1 010 881	520 697	112 261	2 367 922
October	66 162	123 347	25 263	345 048	172 628	1 021 994	518 904	109 497	2 382 842
November	66 460	122 830	26 499	331 381	173 320	1 028 884	522 805	106 821	2 378 999
December	63 466	120 025	25 639	323 614	188 328	1 006 637	526 758	111 394	2 365 862

Table 7

Composition of total equity (R millions)

	Share capital	Retained earnings	Other reserves	Preference shareholders' equity	Total equity
2008: January	73 183	66 451	14 269	453	154 357
February	74 210	68 180	13 101	453	155 944
March	79 050	63 505	13 461	1 944	157 960
April	79 145	64 608	12 717	1 944	158 413
May	79 221	67 192	12 186	1 944	160 543
June	79 225	69 814	12 219	1 944	163 202
July	80 235	71 756	12 977	1 944	166 912
August	81 690	72 900	11 169	1 944	167 702
September	83 456	72 306	10 181	2 004	167 947
October	84 352	73 482	10 985	2 004	170 823
November	87 207	76 289	11 787	2 004	177 287
December	87 617	79 605	11 871	2 004	181 097
2009: January	87 608	82 812	11 935	2 004	184 359
February	82 967	82 340	11 220	6 648	183 175
March	83 495	79 551	10 918	6 648	180 611
April	85 481	80 254	10 738	6 648	183 120
May	85 481	81 214	10 838	6 648	184 180
June	86 319	82 957	10 402	6 648	186 325
July	86 282	84 274	11 010	6 648	188 213
August	85 842	84 634	10 962	6 648	188 086
September	87 592	85 926	10 928	6 648	191 094
October	87 740	87 392	10 937	6 648	192 718
November	87 760	88 908	10 966	6 648	194 282
December	87 760	92 849	10 976	6 648	198 233

Table 8

Composition of off-balance-sheet items (R millions)

	Guarantees on behalf of clients	Letters of credit	Committed undrawn facilities	Credit derivative instruments	Other	Total
2008: January	103 223	182 713	20 655	11 764	22 473	340 828
February	102 518	186 340	21 181	12 106	22 706	344 852
March	104 915	196 950	21 829	12 096	23 354	359 143
April	106 697	199 072	22 070	12 578	22 738	363 155
May	103 795	201 239	22 886	12 537	27 253	367 709
June	110 633	193 761	24 889	10 532	27 151	366 967
July	105 005	186 453	25 309	12 542	27 585	356 894
August	111 463	185 309	25 801	14 206	25 736	362 515
September	115 955	194 665	28 003	14 623	21 236	374 481
October	116 029	194 152	31 204	15 510	18 494	375 390
November	112 360	192 357	27 007	15 507	18 479	365 711
December	107 879	194 820	25 112	18 281	20 293	366 385
2009: January	109 084	196 255	22 765	19 509	23 033	370 646
February	110 413	196 702	22 896	16 709	22 434	369 153
March	112 463	195 233	22 234	14 933	21 403	366 266
April	106 042	187 699	20 487	15 783	25 091	355 101
May	105 850	195 164	20 020	16 127	25 318	362 478
June	102 664	205 688	19 438	13 480	27 968	369 239
July	101 485	206 934	21 219	16 283	26 306	372 227
August	103 470	211 536	21 438	17 321	27 043	380 808
September	103 284	214 059	22 621	12 915	28 630	381 509
October	104 831	207 417	21 862	12 545	28 883	375 539
November	107 123	216 623	22 348	13 214	27 080	386 388
December	103 506	235 370	21 430	12 386	25 591	398 283

Table 9

Composition of the income statement (R millions)

	Income		Expenses			Operating profit/(loss)
	Net interest income	Non-interest income	Credit losses	Operating expenses	Indirect taxation	
2008: January	7 264	4 414	1 900	5 484	180	4 114
February	6 670	4 032	1 780	5 786	226	2 911
March	5 913	7 233	1 624	6 018	234	5 271
April	6 633	5 452	2 252	5 815	206	3 812
May	6 370	5 351	2 039	5 931	73	3 678
June	5 636	7 636	2 799	7 102	300	3 071
July	6 740	5 403	2 503	6 373	187	3 080
August	6 555	5 758	2 672	6 123	213	3 305
September	6 607	5 822	3 092	5 919	229	3 190
October	6 848	6 408	3 012	6 756	176	3 312
November	6 138	6 012	2 542	6 054	-23	3 577
December	6 383	7 927	3 501	5 996	109	4 704
2009: January	5 863	6 879	3 103	5 767	122	3 751
February	5 744	5 256	3 421	6 087	238	1 254
March	6 726	5 854	3 426	6 273	228	2 654
April	6 064	5 649	2 647	6 113	184	2 770
May	6 125	5 528	2 927	6 254	129	2 342
June	6 560	6 548	3 399	6 029	72	3 607
July	5 987	6 544	2 995	6 661	193	2 683
August	6 202	6 091	2 484	6 525	156	3 128
September	6 343	5 937	3 110	6 995	181	1 995
October	6 319	6 367	3 223	6 495	205	2 763
November	6 113	6 169	2 382	6 789	260	2 851
December	6 028	8 819	2 359	6 538	211	5 739

Table 10

Composition of interest and similar income (R millions)

	Short-term negotiable securities	Homeloans	Commercial mortgages	Credit cards	Lease and instalment debtors	Overdrafts	Term loans	Other	Government and other dated securities	Less: Interest income on trading assets allocated to trading revenue	Interest and similar income
2008: January	912	7 774	1 790	908	2 745	1 363	2 925	4 948	681	1 794	22 253
February	868	6 976	1 710	964	2 662	1 122	2 523	5 237	419	526	21 956
March	999	7 549	1 846	911	2 983	1 338	2 756	3 968	621	835	22 136
April	929	7 527	1 900	902	2 983	1 289	2 363	4 691	608	396	22 796
May	932	8 026	2 011	979	3 114	1 350	2 720	4 463	602	763	23 435
June	1 187	7 869	2 020	939	3 076	653	3 588	5 098	246	1 099	23 576
July	1 297	8 379	2 226	974	3 177	1 317	4 507	3 570	1 832	869	26 410
August	1 257	8 488	2 275	1 003	3 154	1 371	3 652	4 761	903	1 213	25 650
September	1 192	8 274	2 194	946	3 098	2 141	3 666	3 870	861	454	25 788
October	1 153	8 570	2 420	986	3 212	1 348	4 060	3 995	242	1 543	24 443
November	1 280	8 105	2 323	956	3 060	1 546	4 618	3 845	1 989	736	26 986
December	1 789	8 777	2 477	954	3 175	778	4 858	2 728	2 377	520	27 393
2009: January	1 375	8 459	2 374	971	3 142	1 411	3 790	4 075	146	654	25 089
February	1 335	7 089	2 063	903	2 756	1 244	2 938	3 889	-373	641	21 204
March	1 307	7 773	2 189	889	2 932	1 571	3 668	3 009	859	660	23 537
April	888	7 055	2 072	834	2 693	1 368	3 340	2 922	891	696	21 368
May	1 178	6 710	2 003	796	2 606	1 101	3 029	3 116	600	235	20 903
June	786	6 217	1 897	778	2 397	1 369	2 830	3 252	455	668	19 313
July	436	6 114	1 862	766	2 431	1 093	3 031	1 502	866	336	17 766
August	1 073	5 900	1 796	766	2 355	1 046	3 171	3 330	996	484	19 949
September	844	5 605	1 748	729	2 235	1 082	2 645	776	525	457	15 733
October	1 166	5 860	1 785	727	2 317	1 108	2 974	1 810	324	488	17 584
November	741	5 644	1 759	726	2 269	1 082	2 886	2 284	967	365	17 994
December	983	5 919	1 838	699	2 314	1 600	2 482	2 280	655	365	18 404

Table 11

Composition of interest expense and similar charges (R millions)

	Current accounts	Savings deposits	Term and other deposits	Negotiable certificates of deposit	Other deposits and loans	Other liabilities	Term debt instruments	Less: Interest expense on trading liabilities allocated to trading revenue	Interest expense and similar charges
2008: January	3 020	441	7 221	3 033	1 755	154	465	1 100	14 989
February	3 027	435	7 796	2 668	1 980	481	341	1 442	15 285
March	3 285	482	7 778	3 049	2 943	538	476	2 328	16 222
April	2 562	497	7 842	2 792	3 776	11	423	1 740	16 163
May	3 324	540	7 956	3 054	-370	425	608	-1 529	17 065
June	3 568	562	8 540	3 662	1 903	179	476	951	17 940
July	3 322	618	9 122	4 044	1 359	546	1 341	681	19 670
August	3 213	640	9 031	3 981	2 639	383	546	1 338	19 096
September	2 516	635	9 321	3 729	2 311	398	943	673	19 180
October	3 472	674	9 175	3 912	959	275	620	1 491	17 595
November	3 289	673	9 260	4 333	2 545	489	1 209	951	20 848
December	3 297	700	9 460	4 813	1 798	589	1 201	849	21 009
2009: January	3 386	692	11 707	1 599	1 966	155	463	742	19 226
February	2 542	581	4 508	6 667	1 621	135	203	797	15 460
March	2 672	613	8 197	4 135	1 401	166	458	831	16 810
April	2 458	414	7 691	3 571	1 706	19	668	1 224	15 305
May	2 227	514	7 258	3 696	1 374	-8	581	862	14 779
June	1 824	420	6 025	3 036	1 160	502	431	644	12 753
July	1 895	440	6 052	2 737	1 134	-16	659	1 122	11 779
August	1 853	423	6 101	3 080	1 137	-27	724	-456	13 748
September	1 706	371	5 314	2 655	943	268	432	2 299	9 390
October	1 757	434	5 421	2 703	892	-3	666	604	11 265
November	1 736	391	5 355	2 752	1 512	-61	638	442	11 881
December	1 734	386	5 539	3 276	2 116	50	652	1 377	12 377

Table 12

Profitability ratios (12-month moving average) (per cent)

2009	Return on equity	Return on assets	Cost-to-income ratio	Net interest income to assets	Non-interest revenue to assets	Operating expenses to assets	Interest and similar income to interest-earning assets	Interest expense and similar charges to funding liabilities	Net interest income ratio*
January	20,65	1,15	49,00	3,24	2,48	2,47	12,54	9,12	3,42
February	19,54	1,09	49,11	3,18	2,50	2,46	12,44	9,06	3,38
March	18,05	1,01	49,46	3,20	2,43	2,44	12,43	9,01	3,42
April	17,82	0,99	49,78	3,16	2,42	2,43	12,33	8,93	3,40
May	17,14	0,96	50,02	3,15	2,41	2,43	12,20	8,80	3,40
June	17,48	0,99	49,36	3,19	2,37	2,39	12,02	8,58	3,44
July	17,29	0,98	49,43	3,15	2,40	2,39	11,64	8,24	3,40
August	17,26	0,98	49,70	3,13	2,40	2,40	11,39	8,00	3,39
September	16,57	0,95	50,47	3,12	2,40	2,43	10,98	7,60	3,38
October	16,24	0,94	50,49	3,10	2,41	2,43	10,71	7,35	3,36
November	15,98	0,94	50,93	3,11	2,43	2,47	10,35	6,99	3,37
December	15,85	0,94	51,11	3,10	2,48	2,50	9,99	6,64	3,35

* ‘Interest and similar income to interest-earning assets’ less ‘interest expense and similar charges to funding liabilities’

Table 13

Composition of gross operating income (R millions)

	Net interest income	Net fee and commission income	Net trading income	Other	Gross operating income
2008: January	7 264	3 325	806	283	11 678
February	6 670	3 447	544	41	10 703
March	5 913	3 960	1 116	2 157	13 146
April	6 633	3 677	1 359	415	12 086
May	6 370	3 835	2 243	-727	11 721
June	5 636	3 921	1 832	1 883	13 272
July	6 740	3 912	-285	1 776	12 143
August	6 555	3 759	1 198	800	12 312
September	6 607	3 851	1 317	654	12 429
October	6 848	4 191	1 796	421	13 256
November	6 138	3 960	1 225	827	12 150
December	6 383	4 915	835	2 177	14 310
2009: January	5 863	3 833	2 793	254	12 742
February	5 744	3 661	1 867	-271	11 000
March	6 726	4 458	1 270	126	12 581
April	6 064	3 970	1 210	469	11 713
May	6 125	3 970	1 510	47	11 652
June	6 560	4 191	1 324	1 032	13 108
July	5 987	4 095	1 543	906	12 531
August	6 202	4 068	1 335	688	12 293
September	6 343	4 108	1 657	173	12 281
October	6 319	4 455	1 269	643	12 686
November	6 113	4 309	1 094	766	12 282
December	6 028	5 584	2 314	921	14 847

Table 14

Composition of gross operating expenses (R millions)

	Staff	Computer processing	Travel, occupation and equipment	Marketing	Other	Operating expenses
2008: January	3 018	586	928	200	752	5 484
February	3 367	582	947	265	625	5 786
March	3 339	596	960	299	824	6 018
April	3 302	598	952	281	683	5 815
May	2 984	641	1 062	304	939	5 931
June	3 731	576	1 079	321	1 395	7 102
July	3 405	630	1 057	285	996	6 373
August	3 491	609	949	318	756	6 123
September	3 345	597	983	267	727	5 919
October	3 394	718	1 066	350	1 229	6 756
November	3 357	715	977	256	749	6 054
December	3 146	817	1 136	314	584	5 996
2009: January	3 076	665	1 017	206	804	5 767
February	3 117	673	1 135	213	950	6 087
March	3 490	638	1 030	287	828	6 273
April	3 260	631	1 030	288	903	6 113
May	3 326	677	1 054	249	948	6 254
June	3 123	671	1 017	292	925	6 029
July	3 648	649	1 033	274	1 056	6 661
August	3 578	592	1 064	267	1 025	6 525
September	3 837	676	1 001	338	1 143	6 995
October	3 572	692	1 057	266	908	6 495
November	3 602	703	1 059	391	1 036	6 789
December	3 240	749	1 177	393	978	6 538

Table 15

Composition of qualifying capital and reserve funds (R millions)

	Primary capital and reserve funds	Secondary capital and reserve funds	Tertiary capital and reserve funds	Total
2008: January	129 567	41 849	593	172 009
February	131 958	42 024	585	174 567
March	138 009	41 083	600	179 692
April	139 528	43 262	600	183 391
May	141 124	43 793	600	185 517
June	147 738	45 284	600	193 622
July	149 793	46 047	600	196 440
August	149 535	46 345	600	196 480
September	150 018	46 103	300	196 421
October	151 281	44 564	300	196 145
November	152 915	42 224	300	195 439
December	159 187	43 062	300	202 549
2009: January	159 583	43 006	300	202 889
February	159 482	43 214	300	202 996
March	160 146	44 742	300	205 188
April	161 859	46 729	300	208 889
May	162 376	46 304	300	208 981
June	164 987	46 308	300	211 594
July	163 111	46 667	300	210 078
August	165 273	46 316	300	211 889
September	167 966	46 630	300	214 896
October	168 872	46 978	300	216 150
November	167 919	47 644	300	215 863
December	170 457	48 616	300	219 373

Table 16

Composition of risk-weighted exposure (R millions)

	Credit risk	Operational risk	Market risk	Equity risk	Other risk	Total
2008: January	1 135 536	155 751	33 967	65 428	66 673	1 457 355
February	1 133 947	156 069	33 062	72 952	57 813	1 453 843
March	1 141 948	157 675	34 943	76 624	49 854	1 461 044
April	1 146 779	156 214	38 060	78 215	52 827	1 472 096
May	1 165 054	156 265	38 614	78 361	50 741	1 489 035
June	1 157 734	180 679	40 372	92 732	54 668	1 526 186
July	1 172 225	180 619	42 547	91 240	55 005	1 541 636
August	1 171 208	180 061	42 131	92 460	50 433	1 536 292
September	1 173 119	181 963	43 221	90 752	52 641	1 541 696
October	1 174 214	181 814	42 727	101 012	54 474	1 554 241
November	1 177 490	182 067	42 085	83 571	55 234	1 540 447
December	1 186 524	186 572	38 585	89 501	56 063	1 557 245
2009: January	1 196 153	186 526	39 416	86 629	51 583	1 560 307
February	1 196 138	186 675	41 776	85 969	54 131	1 564 690
March	1 190 092	174 746	42 289	83 922	53 382	1 544 431
April	1 189 328	174 826	44 309	84 256	50 621	1 543 339
May	1 202 983	177 525	30 458	85 923	50 062	1 546 952
June	1 187 620	193 580	32 825	80 738	51 701	1 546 463
July	1 197 849	193 787	32 029	81 859	51 792	1 557 318
August	1 194 450	193 606	32 144	83 029	52 999	1 556 227
September	1 185 547	194 575	31 765	81 370	50 697	1 543 954
October	1 176 339	194 460	34 397	80 590	48 330	1 534 116
November	1 176 125	194 638	33 834	79 126	50 274	1 533 997
December	1 173 837	214 585	32 431	81 001	51 923	1 553 777

Table 17

Contractual maturity of liabilities (composition) (R millions)

	Next day	2 to 7 days	8 days to 1 month	More than 1 month to 2 months	More than 2 months to 3 months	More than 3 months to 6 months	More than 6 months to 1 year	More than 1 year	Non-contractual
2008: January	937 297	78 114	482 555	137 949	101 986	145 863	235 866	386 840	200 573
February	953 043	126 855	445 076	160 094	102 603	168 779	246 280	433 631	203 428
March	1 007 395	100 489	446 701	157 667	97 012	175 691	271 128	477 615	194 066
April	977 706	107 995	436 630	175 401	105 036	177 256	265 393	461 641	191 061
May	956 786	141 611	524 200	142 539	102 260	169 047	258 554	481 469	191 314
June	1 031 389	122 172	478 412	179 472	92 409	155 964	301 079	502 587	193 214
July	984 805	118 611	476 104	165 339	103 436	161 355	313 725	468 624	195 593
August	951 924	145 068	430 747	174 375	105 441	173 804	301 379	463 938	191 428
September	999 536	135 477	413 774	175 240	74 919	221 202	292 737	450 371	188 167
October	1 094 059	156 746	389 661	163 002	139 056	234 554	324 003	558 051	192 425
November	1 095 712	118 827	348 011	216 351	131 250	229 163	311 916	571 876	197 720
December	1 058 155	146 136	400 159	183 328	125 584	212 444	265 625	592 269	201 452
2009: January	1 022 664	180 318	355 083	188 052	151 564	253 623	253 365	600 202	203 325
February	977 947	187 827	359 943	206 288	138 339	245 654	261 543	568 132	202 235
March	1 059 036	158 144	366 709	185 582	136 927	209 605	271 146	563 819	204 693
April	1 011 263	138 590	389 094	207 038	126 619	185 759	281 689	547 007	199 103
May	1 040 682	130 350	405 639	182 371	107 523	199 793	295 372	512 045	205 575
June	1 062 884	125 833	377 091	157 827	116 800	178 449	334 243	485 857	199 929
July	1 017 442	148 630	366 161	163 554	121 801	175 646	352 462	494 576	204 160
August	1 031 887	138 154	365 088	158 039	112 248	178 614	354 224	496 900	203 408
September	1 059 772	85 285	357 766	168 789	81 857	231 998	336 692	491 885	206 937
October	1 003 357	138 301	330 378	149 367	104 879	241 541	340 193	499 602	210 461
November	1 019 912	117 347	273 045	171 821	124 572	237 573	322 070	528 858	222 861
December	974 163	130 437	342 384	181 332	129 227	227 036	276 019	502 715	224 106

Table 18

"Business-as-usual" maturity of liabilities (composition) (R millions)

	Next day	2 to 7 days	8 days to 1 month	More than 1 month to 2 months	More than 2 months to 3 months	More than 3 months to 6 months	More than 6 months to 1 year	More than 1 year	Non-contractual
2008: January	126 764	85 439	268 004	115 114	132 017	262 273	391 205	1 046 678	206 714
February	114 257	139 156	253 248	127 157	129 240	255 285	366 592	1 174 978	222 517
March	154 042	103 371	284 223	130 670	124 531	269 085	375 440	1 198 369	208 690
April	142 567	110 421	291 112	135 703	113 911	282 652	367 062	1 184 843	214 209
May	138 581	128 014	332 102	120 706	126 405	294 897	374 232	1 184 906	210 955
June	176 696	121 355	298 110	137 269	115 978	288 592	416 476	1 231 615	212 856
July	163 944	121 082	275 663	129 392	118 145	272 518	428 099	1 214 151	216 801
August	158 575	109 294	237 969	130 393	119 933	281 103	422 081	1 237 141	212 940
September	164 512	72 989	279 140	127 143	97 944	312 265	411 859	1 263 520	209 719
October	220 593	94 752	232 696	143 380	141 669	317 261	437 936	1 387 171	224 711
November	238 698	53 362	214 856	162 876	140 688	293 530	443 779	1 394 922	226 836
December	200 122	84 909	231 113	143 835	151 129	292 076	418 201	1 397 079	225 544
2009: January	193 246	99 044	215 255	164 025	141 399	310 322	403 768	1 396 354	227 621
February	170 837	108 687	230 264	151 809	135 028	312 699	411 249	1 359 865	225 793
March	207 601	91 724	207 713	144 722	158 589	298 371	418 323	1 368 846	213 413
April	175 891	90 588	232 554	179 970	143 912	286 187	421 851	1 300 087	212 623
May	206 593	80 027	243 369	153 473	130 238	289 036	428 721	1 273 580	220 724
June	202 554	78 447	203 468	146 532	131 460	273 360	408 715	1 330 070	222 584
July	178 741	96 097	203 395	149 424	130 635	273 325	413 722	1 336 435	226 657
August	189 081	78 268	209 587	144 764	129 339	269 482	418 926	1 339 278	225 311
September	210 255	67 956	205 560	141 661	113 817	289 111	412 960	1 320 206	227 373
October	166 378	75 421	190 179	129 523	108 154	255 516	389 409	1 395 589	276 548
November	175 268	71 327	182 687	126 416	109 106	260 940	373 058	1 411 196	280 275
December	156 019	76 660	170 098	130 224	126 606	263 000	352 176	1 405 311	279 723

Table 19

Concentration of short-term funding (composition) (R millions)

	Deposit funding received from:			
	Associates	Ten largest depositors	Ten largest financial institutions	Ten largest government and parastatals
2008: January	40 418	214 789	116 153	78 001
February	48 962	217 500	153 090	62 502
March	59 782	220 938	132 318	77 617
April	59 516	199 425	131 049	64 134
May	58 037	197 532	140 383	62 143
June	59 239	210 451	133 371	71 665
July	42 051	185 887	113 951	65 881
August	39 702	180 326	108 890	66 178
September	41 408	204 159	120 495	77 729
October	52 453	203 750	137 770	73 029
November	46 886	176 150	122 529	58 081
December	41 047	214 453	127 514	73 327
2009: January	35 961	188 780	117 289	76 926
February	37 229	176 723	116 351	60 130
March	41 140	222 707	146 100	78 763
April	54 060	173 067	117 869	68 174
May	48 274	179 367	138 066	63 257
June	43 560	172 417	106 983	75 135
July	36 057	164 395	122 531	57 898
August	46 287	173 180	133 743	56 415
September	43 373	184 060	132 384	75 586
October	42 851	182 234	131 881	67 148
November	35 179	160 097	114 044	52 486
December	43 067	167 656	123 001	55 563

Table 20

Analysis of credit risk

	Impaired advances (R millions)	Gross loans and advances (R millions)	Specific credit impairments (R millions)	Impaired advances as a percentage of gross loans and advances (Per cent)	Specific credit impairments as a percentage of gross loans and advances (Per cent)	Specific credit impairments as a percentage of impaired advances (Per cent)
2008: January	43 234	2 103 185	17 309	2,06	0,82	40,0
February	47 761	2 175 046	18 337	2,20	0,84	38,4
March	50 042	2 209 737	19 068	2,26	0,86	38,1
April	53 374	2 194 634	19 550	2,43	0,89	36,6
May	57 536	2 241 807	20 339	2,57	0,91	35,4
June	61 980	2 281 179	21 761	2,72	0,95	35,1
July	63 941	2 271 249	23 188	2,82	1,02	36,3
August	68 205	2 263 659	24 666	3,01	1,09	36,2
September	72 090	2 323 422	25 845	3,10	1,11	35,9
October	80 516	2 355 066	27 313	3,42	1,16	33,9
November	84 127	2 338 075	27 124	3,60	1,16	32,2
December	90 827	2 316 121	28 499	3,92	1,23	31,4
2009: January	97 972	2 338 023	28 923	4,19	1,24	29,5
February	106 141	2 315 977	30 579	4,58	1,32	28,8
March	110 594	2 329 017	31 569	4,75	1,36	28,5
April	114 429	2 268 403	33 361	5,04	1,47	29,2
May	120 484	2 266 715	34 851	5,32	1,54	28,9
June	123 768	2 257 511	36 096	5,48	1,60	29,2
July	126 747	2 285 338	37 418	5,55	1,64	29,5
August	130 351	2 284 349	38 611	5,71	1,69	29,6
September	132 466	2 265 553	39 579	5,85	1,75	29,9
October	133 232	2 280 377	40 322	5,84	1,77	30,3
November	134 679	2 265 720	39 901	5,94	1,76	29,6
December	133 974	2 257 081	39 609	5,94	1,75	29,6

Table 21

Internal ratings-based banks: Composition of total credit exposure – Exposure at default (R millions)

	Retail			Corporate			Other			Total credit exposure		
	Total exposure	Default	Default ratio (Per cent)	Total exposure	Default	Default ratio (Per cent)	Total exposure	Default	Default ratio (Per cent)	Total exposure	Default	Default ratio (Per cent)
2008: January	1 210 414	34 362	2,84	614 248	3 411	0,56	432 503	450	0,10	2 257 165	38 222	1,69
February	1 224 175	40 659	3,32	607 358	4 275	0,70	525 262	215	0,04	2 356 794	45 149	1,92
March	1 235 878	43 493	3,52	631 734	4 345	0,69	508 189	186	0,04	2 375 802	48 024	2,02
April	1 246 772	47 668	3,82	625 146	4 296	0,69	501 829	252	0,05	2 373 747	52 215	2,20
May	1 243 081	49 648	3,99	642 592	4 152	0,65	496 399	294	0,06	2 382 072	54 094	2,27
June	1 249 791	52 347	4,19	669 328	4 775	0,71	521 841	308	0,06	2 440 960	57 430	2,35
July	1 256 038	55 677	4,43	679 854	4 652	0,68	490 873	294	0,06	2 426 765	60 622	2,50
August	1 262 598	59 046	4,68	676 940	4 734	0,70	490 249	265	0,05	2 429 786	64 045	2,64
September	1 280 534	62 873	4,91	689 616	4 792	0,69	542 507	327	0,06	2 512 657	67 992	2,71
October	1 282 628	67 138	5,23	714 996	8 049	1,13	609 263	352	0,06	2 606 887	75 539	2,90
November	1 291 447	69 771	5,40	724 710	7 047	0,97	567 708	319	0,06	2 583 864	77 137	2,99
December	1 293 278	73 777	5,70	723 529	6 691	0,92	561 445	304	0,05	2 578 253	80 771	3,13
2009: January	1 293 527	79 528	6,15	724 446	7 293	1,01	573 735	244	0,04	2 591 708	87 064	3,36
February	1 295 749	84 730	6,54	735 182	9 490	1,29	546 764	180	0,03	2 577 694	94 399	3,66
March	1 293 995	87 364	6,75	728 516	10 492	1,44	558 232	271	0,05	2 580 742	98 127	3,80
April	1 295 270	91 892	7,09	727 602	10 556	1,45	537 229	280	0,05	2 560 101	102 728	4,01
May	1 292 054	96 547	7,47	726 597	11 596	1,60	560 973	265	0,05	2 579 624	108 408	4,20
June	1 289 896	97 390	7,55	727 131	12 639	1,74	542 103	270	0,05	2 559 130	110 299	4,31
July	1 286 524	98 486	7,66	723 627	14 009	1,94	557 719	247	0,04	2 567 870	112 743	4,39
August	1 286 073	100 934	7,85	739 762	16 016	2,17	505 050	164	0,03	2 530 885	117 115	4,63
September	1 282 635	101 755	7,93	740 353	16 729	2,26	514 742	137	0,03	2 537 731	118 621	4,67
October	1 282 687	102 038	7,96	735 857	16 610	2,26	517 239	127	0,02	2 535 783	118 775	4,68
November	1 283 674	101 984	7,94	750 998	17 118	2,28	512 386	120	0,02	2 547 057	119 222	4,68
December	1 284 660	102 319	7,96	752 418	17 170	2,28	495 570	123	0,02	2 532 648	119 611	4,72

Table 22

Internal ratings-based banks: Composition of total retail credit exposure – Exposure at default (R millions)

	Retail mortgages			Revolving credit			Retail other			SME retail			Total retail credit exposure		
	Total exposure	Default	Default ratio (Per cent)	Total exposure	Default	Default ratio (Per cent)	Total exposure	Default	Default ratio (Per cent)	Total exposure	Default	Default ratio (Per cent)	Total exposure	Default	Default ratio (Per cent)
2008:															
January	743 802	19 846	2,67	118 143	4 454	3,77	208 046	7 248	3,48	140 424	2 814	2,00	1 210 414	34 362	2,84
February	756 378	23 565	3,12	114 602	5 806	5,07	200 259	7 694	3,84	152 935	3 594	2,35	1 224 175	40 659	3,32
March	762 833	26 145	3,43	116 767	5 756	4,93	202 899	7 844	3,87	153 381	3 747	2,44	1 235 878	43 493	3,52
April	769 013	29 183	3,79	118 118	6 252	5,29	204 598	8 232	4,02	155 043	4 001	2,58	1 246 772	47 668	3,82
May	773 015	31 018	4,01	118 673	5 993	5,05	201 977	8 828	4,37	149 416	3 809	2,55	1 243 081	49 648	3,99
June	775 969	33 114	4,27	120 812	6 461	5,35	204 336	8 711	4,26	148 674	4 060	2,73	1 249 791	52 347	4,19
July	781 005	35 559	4,55	122 241	6 592	5,39	205 327	9 211	4,49	147 466	4 314	2,93	1 256 038	55 677	4,43
August	787 040	38 838	4,93	121 973	6 835	5,60	206 487	8 834	4,28	147 099	4 539	3,09	1 262 598	59 046	4,68
September	809 524	42 169	5,21	121 573	7 010	5,77	208 567	9 160	4,39	140 870	4 534	3,22	1 280 534	62 873	4,91
October	814 856	45 666	5,60	122 245	7 240	5,92	206 439	9 283	4,50	139 087	4 949	3,56	1 282 628	67 138	5,23
November	818 119	48 095	5,88	123 860	7 250	5,85	207 088	9 262	4,47	142 380	5 163	3,63	1 291 447	69 771	5,40
December	819 422	51 127	6,24	123 506	7 435	6,02	206 360	9 856	4,78	143 990	5 358	3,72	1 293 278	73 777	5,70
2009:															
January	823 281	55 750	6,77	123 633	7 684	6,22	201 955	10 279	5,09	144 659	5 814	4,02	1 293 527	79 528	6,15
February	825 736	60 083	7,28	122 391	7 870	6,43	200 634	10 437	5,20	146 988	6 340	4,31	1 295 749	84 730	6,54
March	824 190	61 498	7,46	123 976	8 040	6,49	199 834	10 966	5,49	145 994	6 860	4,70	1 293 995	87 364	6,75
April	830 121	65 075	7,84	123 276	8 488	6,89	197 685	11 454	5,79	144 188	6 875	4,77	1 295 270	91 892	7,09
May	829 423	68 769	8,29	123 272	8 941	7,25	196 393	11 532	5,87	142 966	7 306	5,11	1 292 054	96 547	7,47
June	829 885	69 816	8,41	122 523	8 335	6,80	195 668	12 242	6,26	141 820	6 997	4,93	1 289 896	97 390	7,55
July	829 647	70 296	8,47	122 059	8 530	6,99	194 605	12 315	6,33	140 213	7 346	5,24	1 286 524	98 486	7,66
August	830 353	71 667	8,63	122 280	9 358	7,65	193 964	12 388	6,39	139 477	7 521	5,39	1 286 073	100 934	7,85
September	830 144	71 780	8,65	122 337	9 519	7,78	193 632	12 729	6,57	136 522	7 727	5,66	1 282 635	101 755	7,93
October	830 912	72 225	8,69	122 404	9 606	7,85	192 594	12 534	6,51	136 777	7 673	5,61	1 282 687	102 038	7,96
November	832 568	72 183	8,67	121 461	9 308	7,66	192 317	12 349	6,42	137 328	8 145	5,93	1 283 674	101 984	7,94
December	833 700	72 390	8,68	121 167	9 064	7,48	192 679	12 870	6,68	137 114	7 995	5,83	1 284 660	102 319	7,96

Table 23

Turnover in derivative contracts (R millions)

	Interest rate contracts	Foreign-exchange contracts	Equity and indices	Commodities	Other	Total
2008: January	2 375 777	2 963 525	159 099	31 229	0	5 529 630
February	1 600 462	2 511 147	151 402	42 747	0	4 305 758
March	1 411 726	2 852 877	349 336	395 856	0	5 009 795
April	2 423 336	2 900 230	110 058	951 477	0	6 385 101
May	2 218 492	2 721 892	78 983	36 248	6	5 055 620
June	2 775 913	3 721 087	218 234	64 586	6	6 779 825
July	3 202 101	3 015 297	166 201	39 276	6	6 422 882
August	3 285 111	2 838 070	121 895	13 628	6	6 258 711
September	2 884 335	4 036 946	325 170	62 505	0	7 308 957
October	3 386 828	3 942 806	163 910	43 246	0	7 536 790
November	2 700 391	3 126 682	124 755	46 036	0	5 997 864
December	1 641 915	2 693 662	223 253	44 772	0	4 603 602
2009: January	2 497 180	2 799 491	110 481	34 196	0	5 441 348
February	3 453 779	3 047 383	135 862	28 773	0	6 665 796
March	2 746 045	3 168 625	802 074	17 606	0	6 734 349
April	1 450 428	2 475 823	107 477	11 078	15	4 044 820
May	3 986 003	3 310 685	212 703	93 674	0	7 603 065
June	2 102 300	3 432 714	396 416	77 195	0	6 008 625
July	2 346 090	3 258 520	311 235	61 745	0	5 977 591
August	1 893 724	3 187 376	315 013	34 860	0	5 430 972
September	2 144 980	3 123 440	382 897	48 411	0	5 699 727
October	2 490 072	3 600 014	300 604	32 232	0	6 422 923
November	2 768 693	3 399 497	278 397	42 879	0	6 489 467
December	1 113 634	2 782 712	347 758	54 379	0	4 298 483

Table 24

Effective net open foreign-currency position (US$ millions)

	Total foreign-currency assets	Total foreign-currency liabilities	Net spot position	Commitments to purchase foreign currency	Commitments to sell foreign currency	Mismatched forward commitments	Effective net open foreign-currency position
2008: January	29 591	19 375	10 217	288 629	298 624	-9 996	221
February	25 973	18 117	7 857	264 968	272 623	-7 656	201
March	29 112	18 623	10 489	283 088	293 392	-10 304	185
April	27 229	19 678	7 551	277 005	284 237	-7 232	319
May	25 883	19 133	6 750	282 144	288 619	-6 475	275
June	25 097	18 413	6 684	283 898	290 318	-6 420	264
July	23 059	17 847	5 212	280 699	285 953	-5 254	-42
August	22 372	18 701	3 672	290 488	293 642	-3 154	518
September	22 734	18 122	4 611	298 547	302 529	-3 982	629
October	24 695	19 927	4 768	310 970	315 486	-4 516	252
November	25 606	20 480	5 127	323 346	328 350	-5 004	123
December	24 238	19 664	4 574	312 579	317 045	-4 466	108
2009: January	24 428	20 745	3 683	292 143	295 800	-3 657	26
February	24 443	21 052	3 391	293 000	296 182	-3 182	209
March	23 916	20 580	3 336	316 112	319 267	-3 154	135
April	22 940	21 027	1 913	301 503	303 314	-1 811	102
May	23 240	19 547	3 692	265 399	268 944	-3 546	146
June	24 534	19 544	4 990	252 977	257 783	-4 807	183
July	23 418	18 798	4 620	240 341	244 802	-4 461	159
August	24 335	19 285	5 050	229 106	234 104	-4 997	53
September	24 444	19 294	5 150	225 933	231 077	-5 143	7
October	25 021	19 991	5 030	232 978	237 818	-4 840	190
November	25 845	20 494	5 351	237 715	242 842	-5 127	224
December	25 857	20 264	5 593	225 376	230 840	-5 463	130

Appendix 7

Directives sent to banking institutions during 2009

Banks Act Directive 1/2009	Matters related to capital floors
Banks Act Directive 2/2009	Investments, and loans and advances by controlling companies: Section 50 of the Banks Act, 1990
Banks Act Directive 3/2009	Limit in respect of effective net open foreign-currency position, and matters related to the unencumbered assets to be held by branches of foreign institutions

Appendix 8

Exemptions and exclusions from the application of the Banks Act, 1990

Section 1(cc): Exemptions by the Registrar of Banks

Government Gazette		Topic	Expiry
Date	Number		
2006/12/01	29412	A group of persons between which a common bond exists	Indefinite
1994/12/14	16167	Commercial paper	Indefinite
2008/12/19	31716	"Ithala Limited" A wholly owned subsidiary of Ithala Development Finance Corporation Limited	2011/12/31
1994/12/14	16167	Mining houses	Indefinite
1994/12/14	16167	Trade in securities and financial instruments	Indefinite
2008/01/01	30628	Securitisation schemes	Indefinite

Section 1(dd): Exemptions by the Minister of Finance

Government Gazette		Topic	Subparagraph	Expiry
Date	Number			
1991/01/31	13003	Participation bond schemes	(dd)(ii)	Indefinite
1991/01/31	13003	Unit trust schemes	(dd)(ii)	Indefinite
2008/08/22	31342	Financial Service Co-operative	(dd)(i)	Indefinite

Section 1(gg): Exemptions by the Registrar of Banks

Government Gazette		Topic	Expiry
Date	Number		
1998/09/22	19283	Members of the Johannesburg Stock Exchange as persons authorised to accept money as mandatories and to deposit such money into banking accounts maintained by them	Indefinite

Section 2(vii): Exclusions by the Minister of Finance

Government Gazette		Topic	Expiry
Date	Number		
1992/01/24	13744	Post Office Savings Bank	Indefinite
1994/12/14	16167	Industrial Development Corporation of SA Limited	Indefinite

Section 78(1)(d)(iii): Exemptions by the Registrar of Banks

Government Gazette		Topic	Expiry
Date	Number		
1997/05/02	17949	Category of assets of a bank held in the name of a person other than the bank concerned	Indefinite

Appendix 9

Approval of acquisition or establishment of foreign banking interests in terms of section 52 of the Banks Act, 1990, from 1 January 2009 to 31 December 2009

Name of bank/ controlling company	Date of approval	Name of interest (and percentage interest held, if not 100 per cent)	Country
Absa Group Limited	2009/09/08	Absa Representative Office Namibia (Pty) Limited	Namibia
Capitec Bank Limited	2009/12/18	Visa Incorporated (1972 class C common stock shares)	United States of America
Capitec Bank Limited	2009/10/14	MasterCard Incorporated (9116 Class B ordinary shares and 1 Class M ordinary share)	United States of America
FirstRand Bank Holdings Limited	2009/02/24	Kula Gold (Pty) Limited (24,46 per cent)	Australia
FirstRand Bank Holdings Limited	2009/02/24	Lizer Cylinders Limited (≤ 32 per cent)	India
FirstRand Bank Holdings Limited	2009/03/03	Sutter Gold Mining Inc (49,9 per cent)	Canada
FirstRand Bank Holdings Limited	2009/03/10	Interior Works Holdings (Pty) Limited (48 per cent)	Australia
FirstRand Bank Holdings Limited	2009/03/17	Axis Infrastructure Fund Limited (35 per cent)	Mauritius
FirstRand Bank Holdings Limited	2009/05/04	FirstRand Bank Nigeria Representative Office	Nigeria
FirstRand Bank Holdings Limited	2009/07/01	FirstRand Bank Angola Representative Office	Angola
FirstRand Bank Holdings Limited	2009/12/09	Argun Vermogensvermaltung GmbH (1 per cent)	Germany
FirstRand Bank Holdings Limited	2009/12/18	Payment Associate of Lesotho (20 per cent)	Lesotho
Mercantile Bank Limited	2009/05/24	Visa Incorporated (Class C common stock of ordinary shares)	United States of America
Investec Limited	2009/11/19	Central African Gold Ghana Limited (CAGG)	Ghana
Investec plc*	2009/03/09	Investec UK Special Opportunities Fund Limited (19 per cent)	Guernsey
Investec plc*	2009/03/17	Investec Gresham Limited	United Kingdom
Investec plc*	2009/05/21	Abacus Property Group (3 per cent)	Australia
Investec plc*	2009/06/02	Media Innovation Pty Ltd (2,85 per cent)	Singapore
Investec plc*	2009/07/24	Collgar Wind Farm Investment Holdings (Pty) Ltd	Australia
Investec plc*	2009/07/24	Collgar Wind Farm Services (Pty) Ltd	Australia
Investec plc*	2009/08/04	Idatech Cyprus Holding Company	Cyprus
Investec plc*	2009/08/04	Idatech Fuel Cell Systems Cyprus Ltd	Cyprus
Investec plc*	2009/08/04	Idatech Fuel Cell System India Ltd	India
Investec plc*	2009/04/30	Austral Comnia Holdings Pty Ltd (1 per cent)	Australia
Investec plc*	2009/04/30	Azure Mineral Ltd (1 per cent)	Australia
Investec plc*	2009/04/30	Investec Global Aircraft Fund (14 per cent)	Australia
Investec plc*	2009/04/30	Investec Property Opportunity Fund (5 per cent)	Australia
Investec plc*	2009/04/30	Investec Wentworth Private Equity Fund 3 (1 per cent)	Australia
Investec plc*	2009/04/30	Kingsgate Consolidated (1 per cent)	Australia
Investec plc*	2009/04/30	MZL Opportunity Fund (75 per cent)	Australia
Investec plc*	2009/04/30	MZL Inherited Syndicate Fund (49 per cent)	Australia
Investec plc*	2009/04/30	MZL Accrux Syndicate Fund (49 per cent)	Australia
Investec plc*	2009/04/30	MZL Pty Ltd Convertible Note (15 per cent)	Australia
Investec plc*	2009/04/30	Renison Consolidated Mines RL (1 per cent)	Australia
Investec plc*	2009/02/17	EZ Energy USA Inc (13,5 per cent)	United States of America
Investec plc*	2009/03/09	Mannum Powerco (Pty) Ltd	Australia
Investec plc*	2009/03/09	Tungkillo Powerco (Pty) Ltd	Australia
Investec plc*	2009/03/17	Investec Gresham Limited	United Kingdom
Investec plc*	2009/03/25	Mackenzie Tower (Pty) Limited (50 per cent)	Australia
Investec plc*	2009/05/12	Start Funding No 3 Limited	Ireland
Investec plc*	2009/05/12	Gaeta Limited	Ireland
Investec plc*	2009/08/04	Roninvest Holdings LLC	United Kingdom

Appendix 9

Approval of acquisition or establishment of foreign banking interests in terms of section 52 of the Banks Act, 1990, from 1 January 2009 to 31 December 2009 (continued)

Name of bank/ controlling company	Date of approval	Name of interest (and percentage interest held, if not 100 per cent)	Country
Nedbank Limited	2009/03/23	NedProperties (Pty) Limited	Namibia
Nedbank Limited	2009/03/23	NedPlan Insurance Brokers Namibia	Namibia
Nedbank Limited	2009/06/23	Fairbairn Private Bank (Jersey) Limited (29,7 per cent)	Jersey
Nedbank Limited	2009/07/28	Ethanol Acquisition, LLC (8,49 per cent)	United States of America
Nedbank Limited	2009/10/28	Fairbairn Private Bank (IoM) Limited's Representative Office United Arab Emirates	United Arab Emirates
Nedbank Limited	2009/12/22	CBN Nominees (Pty) Limited	Namibia
Standard Bank Group Limited	2008/04/02	Liberty Holdings Namibia Limited	Namibia
Standard Bank Group Limited	2009/12/11	United Funeral Insurance Limited	Namibia
Standard Bank Group Limited	2009/07/23	MasterCard International Incorporated (1 per cent interest)	United States of America
Standard Bank Group Limited	2009/08/07	Visa Incorporated (1 per cent interest)	United States of America
Standard Bank Group Limited	2009/07/20	Troika Dialog Group Limited (37,31 per cent)	Cayman Islands
Standard Bank Group Limited	2009/05/02	The Standard Bank of South Africa Limited – Beijing Representative Office	Peoples Republic of China
Standard Bank Group Limited	2009/05/02	Standard Advisory China Limited	Peoples Republic of China
Teba Bank Limited	2009/12/17	Visa Incorporated (2,446 shares in Class C Common Stock)	United States of America

* Applications in respect of Investec plc to establish or acquire foreign interests or subsidiaries were noted in terms of the conditions of approval of the dually listed company structure.

Appendix 10

Memorandums of understanding concluded between the Bank Supervision Department of the South African Reserve Bank and foreign supervisors as at 31 December 2009

	Domicile of foreign regulator (listed alphabetically)	Foreign banking supervisor	Effective from
1	Argentina	Superintendencia de Entidades Financieras y Cambiarias (The Central Bank of Argentina)	18 August 2007
2	Australia	Australian Prudential Regulation Authority	4 July 2007
3	Germany	Bundesanstalt für Finanzdienstleistungsaufsicht	13 August 2004
4	Hong Kong	Monetary Authority of Hong Kong	12 December 2006
5	Ireland	Irish Financial Services Regulatory Authority	21 July 2004
6	Isle of Man	Financial Supervision Commission of the Isle of Man	13 August 2001
7	Mauritius	Bank of Mauritius	25 January 2005
8	Namibia	Bank Supervision Department of the Bank of Namibia	27 September 2004
9	Nigeria	Central Bank of Nigeria	20 March 2008
10	United Arab Emirates	The Dubai Financial Services Authority	8 August 2009
11	United Kingdom	Financial Services Authority	21 July 2006

The purpose of a memorandum of understanding (MoU) is to provide a formal basis for a bilateral working relationship and co-operation between supervisors, including the exchange of information and investigative assistance.

It should be noted that any MoU entered into by the Department does not modify or supersede any laws or regulatory requirements in force in, or applying to, the Republic of South Africa. Accordingly, an MoU sets forth a statement of intent and does not create any enforceable rights.

In 2009 the Department made a policy decision in future to allow only the acquisition or establishment of local (inward) and cross-border banking operations in instances where an MoU with the cross-border banking supervisor concerned has been concluded. This decision was underpinned by global initiatives to ensure that cross-border activities do not contribute to enhanced risk, as was evidenced by the global crisis.

Appendix 10

Memorandums of understanding concluded between the Bank Supervision Department of the South African Reserve Bank and foreign supervisors as at 31 December 2009 (continued)

During the year under review the Department concluded or signed only one memorandum of understanding (MoU), and that was with the Dubai Financial Services Authority. A further six MoUs were initiated in 2009 bringing the total number of work-in-progress MoUs to 15 at the end of 2009. The 15 pending MoUs are as follows:

	Domicile of foreign regulator (listed alphabetically)	**Regulator**
1	China	The Financial Supervisory Commission of Taiwan
2	Cyprus	Central Bank of Cyprus
3	France	The French Banking Commission
4	India	The Reserve Bank of India
5	Kenya	Central Bank of Kenya
6	Korea	The Financial Supervisory Commission of the Republic of Korea
7	Lesotho	Central Bank of Lesotho
8	The Netherlands	The Netherlands Bank
9	Russian Federation	Central Bank of the Russian Federation
10	The Kingdom of Swaziland	Central Bank of Swaziland
11	Taiwan	The Financial Supervisory Commission of Taiwan
12	Tanzania	Bank of Tanzania
13	The Bolivarian Republic of Venezuela	The Superintendence of Banks and other Financial Institutions of the Bolivarian Republic of Venezuela
14	United Arab Emirates	Central Bank of the United Arab Emirates
15	United States of America	Federal Reserve Bank of New York

Africa

The 14 Heads of State or Government of the Southern African Development Community (SADC) have signed a Protocol on Finance and Investment* (PFI). The PFI, among other things, includes a section that is a framework for co-operation and co-ordination in banking regulatory and supervisory matters. The 14 SADC countries are the Republic of Angola, the Republic of Botswana, the Democratic Republic of Congo, the Kingdom of Lesotho, the Republic of Malawi, the Republic of Mauritius, the Republic of Mozambique, the Republic of Namibia, Republic of Seychelles, the Republic of South Africa, the Kingdom of Swaziland, the United Republic of Tanzania, the Republic of Zambia and the Republic of Zimbabwe.

* http://www.sadc.int/cms/uploads/SADC%20Finance%20and%20Investment%20Protocol%20Brochure%20-%20English.pdf

Abbreviations

ABS	asset-backed security
AIG–TB	Accord Implementation Group–Trading Book
ALM	asset and liability management
AMA	advanced measurement approach
AML	anti-money laundering
ASA	alternative standardised approach
BEICF	business environment and internal control factors
BIA	basic indicator approach
BIS	Bank for International Settlements
BoN	Bank of Namibia
BSD-CBK	Bank Supervision Department of the Central Bank of Kenya
CBA	Co-operative Banks Act, 2007 (Act No. 40 of 2007)
CBDA	Co-operative Banks Development Agency
CBK	Central Bank of Kenya
CBRG	Cross-Border Bank Resolution Group
CBSWCA	Committee of Bank Supervisors in West and Central Africa
CCBG	Committee of Central Bank Governors
CCF	credit conversion factor
CDO	collateralised debt obligation
CDS	credit default swap
CEBS	Committee of European Banking Supervisors
COPAC	Co-operatives and Policy Alternative Centre
CRA	credit-rating agency
CTF	combating the financing of terrorism
EAD	exposure at default
ECAI	external credit assessment institutions
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
EU	European Union
FATF	Financial Action Task Force (on Money Laundering)
FDIC	Federal Deposit Insurance Corporation
FIC	Financial Intelligence Centre
FICA	Financial Intelligence Act, 2008 (Act No. 11 of 2008)
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSDU	Financial Sector Development Unit
FSF	Financial Stability Forum
FSI	Financial Stability Institute
FX NOP	net open foreign-currency position
G-20	Group of Twenty
GDP	gross domestic product
H-index	Herfindahl–Hirschman Index
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAAP	internal capital-adequacy assessment process
ICAEW	Institute of Chartered Accountants of England and Wales
IDRC	incremental default risk charge
IMA	internal models-based approach
IMF	International Monetary Fund

IOSCO	International Organisation of Securities Commission
IRB	internal ratings based
IT	information technology
LDA	loss distribution approach
LDCE	loss data collection exercise
LGD	loss given default
MDA	Mineworkers Development Agency
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MER	Mutual Evaluation Report
MoU	memorandum of understanding
OECD	Organisation for Economic Co-operation and Development
OSFI	Office of the Superintendant of Financial Institutions
OTC	over the counter
PD	probability of default
PIN	Public Information Notice
Remco	remuneration subcommittee
ROA	return on assets
ROE	return on equity
ROP	range of practice
ROSC	Reports on the Observance of Standards and Codes
S&P	Standard & Poor's
SA	standardised approach (credit risk)
SADC	Southern African Development Community
SAPO	South African Post Office
SAPS	South African Police Service
SARS	South African Revenue Service
SBA	scenario-based approach
SCAP	Supervisory Capital Assessment Program
SIG	Standards Implementation Group
SIGOR	Standards Implementation Group Operational Risk
SIGV	Standards Implementation Group Validation Subgroup
SME	small and medium enterprise
SREP	supervisory review and evaluation process
SSBS	Subcommittee of Banking Supervisors
TBG	Trading Book Group
TSA	standardised approach (market risk and operational risk)
UK	United Kingdom
US	United States
VaR	value at risk

Glossary

Basel I	*International Convergence of Capital Measurement and Capital Standards*
Basel II	*International Convergence of Capital Measurement and Capital Standards: A Revised Framework*
Core Principles	Core Principles for Effective Banking Supervision
East AFRITAC	East African Regional Technical Assistance Centre
FinStab	Financial Stability Department of the South African Reserve Bank
Fitch	Fitch Ratings
Meeg	Meeg Bank Limited
Moody's	Moody's Investor Service
New Companies Act	Companies Act, 2008 (Act No. 71 of 2008)
the Basel Committee	the Basel Committee on Banking Supervision
the Bank	South African Reserve Bank
the Banks Act	The Banks Act, 1990 (Act No. 94 of 1990)
the Compensation Principles	FSB Principles for Sound Compensation Practices
the Compensation Standards	FSB Principles for Sound Compensation Practices: Implementation Standards
the Department	Bank Supervision Department of the South African Reserve Bank
the Fed	the United States Federal Reserve System
the Methodology	Compensation Principles and Standards Assessment Methodology
the Registrar	Registrar of Banks
the Staff Report	IMF *2009 Article IV Consultation: Staff Report*