T T Mboweni: The South African banking sector - an overview of the past 10 years

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the year-end media cocktail function, Johannesburg, 14 December 2004.

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1. Introduction

Over the past decade, South Africa has established a well-developed banking system which compares favourably with those in many developed countries and which sets South Africa apart from many other emerging market countries. At the end of 2004, we find ourselves with a more mature banking sector, with a moderate level of private-sector indebtedness and a respectable and first-rate regulatory and legal framework. South African banks are well managed and utilise sophisticated risk-management systems and corporate-governance structures in conducting the business of a bank.

South Africa's banks are regulated in accordance with the principles set by the Basel Committee on Banking Supervision. Consequently, our banks comply with international sound practice and offer a sophisticated banking system to the public. Customers have online, real-time, nationwide access to bank accounts 24 hours a day, everyday of the year. South Africa's political transformation, together with the relaxation of exchange controls and the liberalisation of African economies, has resulted in South Africa becoming an increasingly important financial centre. South Africa is now also well positioned to provide global services through the international offices of our banks and the presence of international banks in South Africa.

2. Structure of the South African banking sector

Currently, there are 38 registered banks in South Africa. This number consists of 15 South African controlled banks, 6 non-resident controlled banks (subsidiaries), 15 local branches of international banks, and two mutual banks. In addition, 44 international banks have authorised representative offices in South Africa. Representative offices, however, may not take deposits.

Five major groups continue to dominate the South African banking sector. These groups are the Absa group, the Standard Bank group, the FirstRand Bank group, Investec and Nedcor. In 1994, these groups represented 83.8 per cent of the total assets of the banking sector and, currently, they represent 87.4 per cent of the banking sector. The remaining 12.6 per cent of assets in the banking sector are currently held by the other 31 banks, excluding the two mutual banks.

Initially, the number of medium to small local banks increased steadily over the past decade. During, the latter part of 1999, however, these banks faced liquidity pressures, which led to many of these medium to small banks exiting from the banking system. This downward trend reached its lowest point with the placement of Saambou Bank into curatorship in February 2002 and the subsequent integration of BOE Bank into Nedbank. From the last quarter of 1999 to the end of March 2003, some 22 banks exited the South African banking system. It can be said, however, that this phenomenon was due more to a consolidation of the broader banking sector than a failure of the medium to small banking sector. Currently, small local banks constitute 3.1 per cent of the total banking sector assets, in comparison to 21.7 per cent in 1994.

As a result of the political isolation of South Africa in the mid-1980's, international banks terminated their operations in South Africa. Immediately prior to the advent of the democratically elected government in 1994, few international banks were doing banking business in South Africa. Amendments to the Banks Act in 1994, however, allowed not only representative offices and subsidiaries of international banks to be established in South Africa, but also branches of international banks. Following the opening of South Africa's financial system in 1994, international participation in the local banking industry increased significantly, from 3 per cent in 1994 to 9.5 per cent of total banking sector assets by the end of October 2004.

3. Periods of change in the banking sector

Following South Africa's re-entry into international financial markets in 1994, locally registered banks have increasingly been expanding their operations into other countries. At the same time, international banks have been expanding their operations into South Africa. Besides adding further depth and sophistication to the South African market, these foreign banks began to tap into the South African labour market. Consequently, the arrival of these predominantly resourceful and experienced banks posed formidable challenges to local banks. In a quest to survive and excel, South African banks had to devise means to adapt to the new terrain. As a result of the increased competition, lending margins have been placed under greater pressure, and several banks have had to expand their businesses and enter markets with slightly higher credit-risk profiles.

Currently, the major banks offer a wide range of services to both individual and corporate customers. One-stop relationship banking, with an emphasis on universal banking, instead of isolated services, has gained in importance during the past few years. Nevertheless, several banks, especially small local and foreign banks continue to service niche markets, where they hold some form of competitive advantage.

4. Trends in South African banks over the past decade

Generally, the South African banking sector remained fairly stable during the past decade. The first part of the past decade was characterised by global financial turbulence and banking crises in many countries. In general, the South African banking sector showed itself to be remarkably resilient during the crises experienced. The latter part of the decade was characterised by a significant depreciation of the South African currency and, in 2002, we experienced our own banking instability. Fortunately, and owing particularly to the solid foundations upon which our banking system is based, 2003 and 2004 were marked by greater stability.

(i) Balance-sheet structure

The aggregated balance sheet of all banks in the South African banking sector grew from R344.6 billion as at end December 1994 to R724 billion as at end December 1999. By the end of October 2004, total assets had grown to a record high of R1.436 trillion. Loans and advances grew continuously over the past decade, from R270.8 billion as at end Dec 1994 to R 1.104 trillion as at end October 2004. Domestic deposits from the public remained the main source of funding for the banking sector over the past ten years and amounted to R888 billion in October 2004 (as opposed to R241.9 billion as at end December 1994).

(ii) Profitability

The efficiency of the banking sector can be determined by expressing operating expenses as a percentage of total income. Currently, the international benchmark for efficiency is 60 per cent. In the past, South African banks were able to keep this ratio below or close to the international benchmark. The ratio, however, has increased from 60.2 per cent in 1999 to 67 per cent in 2002. The high volatility in efficiency in 2002 indicates that the South African banking sector was indeed experiencing problems with profitability in the first six months of 2002. This deterioration is confirmed by the return on equity of 5.4 per cent (smoothed over 12-months) and the return on assets of 0.4 per cent (smoothed over 12-months) as at the end of June 2002. Since 2002, however, the efficiency ratio has improved and, as at the end of October 2004, the efficiency of the banking sector was 65.2 per cent. By the end of October 2004, the return on equity and the return on assets of the banking sector had similarly improved.

(iii) Capital adequacy

The change in focus of the regulatory authorities from direct controls to a more market-based approach has been accompanied by an emphasis on proper capitalisation, sound risk-management procedures and greater disclosure. South Africa adheres to the capital-adequacy guidelines for banks promulgated by the Basel Committee on Banking Supervision. The requirement to maintain capital equal to the full ratio of 8 per cent of risk-weighted assets was changed to a rate of 10 per cent by the

Registrar of Banks in 2001. By end of October 2004, the banking sector as a whole had a capital-adequacy ratio of 13 per cent (up from 9.5 per cent in December 1994).

(iv) Non-performing loans

Of great significance was a decrease in the growth of total non-performing loans during the past decade. After reaching a peak of R29.2 billion in March 1999, growth in total non-performing loans declined to R23.8 billion as at end December 2003. During 2004, total non-performing loans continued to decrease to a level of R20.9 billion. Provisioning by banks remained adequate throughout the past decade despite non-performing loans being high in the late nineties, as mentioned earlier.

5. Reaction of the regulator to the small to mid-sized banking crises

It is common cause that the South African banking sector experienced certain mini-crises over the past decade. None was more concerning than the instability experienced by small to mid-sized banks during the period of the Saambou problem. Saambou Bank experienced a liquidity crisis, emanating from negative market perceptions, a profit-warning announcement and the sale of Saambou shares by two of the bank's executive directors. At the time, Saambou was the seventh largest South African bank and had both a large retail deposit base and a well-established branch network.

In order to prevent a crisis of confidence in the small to mid-sized banking sector, Saambou was placed under curatorship. Unfortunately, this led to further withdrawals, not only from the smaller banks but also from larger banks. This loss of confidence significantly affected the sixth largest bank at the time, BOE Bank, indicating that the lack of confidence could move up the scale and not only down the scale.

Since such a trend could not be supported, the South African Reserve Bank entered into consultations with the National Treasury, which ultimately issued a guarantee to all depositors that the government would fund their withdrawals. This action sent a signal to the market that the authorities were serious about maintaining the stability of the banking sector.

Several lessons have been learnt from the small to mid-sized banking crises. First, owing to the special nature of banks, all key players, including, for example, external auditors, analysts, the media and rating agencies, should appreciate the nature of banking and act responsibly when dealing with the banking sector.

Second, the regulatory authorities must also be mindful of the fact that all their actions, combined and separately, constitute signals to the market and that greater problems may result if a bank in distress is not handled in a manner that provides certainty.

Third, the regulatory authorities have also learnt to treat with circumspect institutions that apply for a banking licence, but which have only the interests of the individual shareholder and not the interests of the depositor base in mind when making business decisions. An institution can no longer be allowed to be registered to conduct the business of a bank and, then, simply to ride on the coat tails of the name "bank", whilst at the same time not conducting deposit-taking business or not acting responsibly in the interests of the depositor base, but rather in the interests of an unobtainable share price.

Fourth, the Registrar of Banks needs to be mindful of "boutique" banks that are not fulfilling the definition of the "acceptance of deposits form the general public" and, on the asset side of their balance sheet, are not acting "in the interest of the general public".

Fifth, as a result of the problems prevalent in the small to mid-sized banking sector during the past decade, and especially towards the latter part of the decade, the South African Reserve Bank adopted a policy framework for dealing with banks in distress. This policy framework serves to provide clarity on the process in place for not only dealing with banks in distress, but also preventing problems in one bank spreading to other banks. It is, however, only a framework to guide the approach taken, and the particular approach has to be decided on a case-by-case basis, depending on the specific circumstances.

Sixth, in addition to the policy framework for dealing with banks in distress, the Registrar of Banks emphasised the importance of sound corporate governance in banks. In order to investigate the standard of corporate governance within the South African banking sector, the Registrar appointed Adv J F Myburgh SC to conduct a review of the status of compliance with sound corporate-governance practices within the five largest banking groups in South Africa during 2002.

Among Adv Myburgh's findings were that, generally the banks investigated were committed to adherence to and application of high standards of corporate governance; the banks on their own initiative reviewed their corporate-governance principles from time to time; and corporate governance in the banks was generally sound but vigilance was required to ensure continued compliance with the best practice in corporate governance which is evolving in South Africa and internationally.

Myburgh's recommendations were, *inter alia*, that the board of a bank should consist of no more than about 16 members; a bank's board should not have more than about four executive directors; the majority of non-executive directors should be independent directors with immediate effect; and banks should aim for the majority of their directors to be independent directors within not more than five years.

The Registrar of Banks accepted the recommendations made by Adv Myburgh and is dedicated to reviewing the commitment to sound corporate governance in the banking sector on an ongoing basis and is currently reviewing corporate governance in the remaining "non-big five" banks.

It needs to be stressed, however, that the objective of regulatory and supervisory authorities world wide can never be to avoid the failure of financial participants, and, that, in a sound system, there will be failures. Instead, the objective is to strive for an optimal balance between, on the one hand, the cost of controls and intervention in order to address market failures and, on the other hand, the anticipated benefits of regulation and supervision. The need for a sound relationship and proper coordination between the fiscal authorities and the regulator can also not be overemphasised.

6. Emergence of the "four-pillar" policy

The four pillar policy relates to having a minimum number of substantial banks (so called "pillars") on which the domestic banking industry relies and discourages the merger between any of those four banks. The primary reasons for such a policy relate to the maintenance of minimum levels of competition, in the interests of prudential and systemic stability, in order to avoid the spread of risk and to promote reliance on a broader platform of institutions.

Currently, Australia relies heavily on the "four-pillar" policy, which originated in 1990 from its previous "six-pillar" policy. New Zealand, which effectively has the same major banks as Australia, is protected by the Australian policy. The Australian "six-pillar" policy discouraged mergers between any of the four major banks and two major life insurance companies. The Australian government determined that it would be anti-competitive for the four big banks and two big insurance companies to merge.

In 1997, however, the Australian government scrapped its "six-pillar" policy after the Wallis Inquiry concluded that increased competition would achieve lower costs, better services and higher efficiencies for consumers. Nevertheless, the Australian government determined that there was insufficient competition to allow mergers among the big four banks and thus the "six-pillar" policy became the "four-pillar" policy.

According to the South African Minister of Finance, who has responsibility for national financial policy, South Africa also follows a "four-pillar" policy. Recently, the Minister stated that South Africa maintains a "four-pillar" policy of having four big, locally owned banks regulated by the Office for Banks. The "four-pillar" policy in South Africa lay at the heart of considering the Nedcor Bank bid for Stanbic. The arguments advanced and conclusions drawn at the time conformed to that principle.

Current indications are that a number of international banks are interested in acquiring one or two of our four pillars. Even if such interested was approved, it seems important to the Reserve Bank that there still remain four pillars upon which our banking system rests. The presence of internationally-owned banks will most certainly introduce more competition which in theory should benefit consumers.

The authorities will therefore have to examine each application to buy into one of our four pillars on a case by case basis. The world is changing very fast and the regulatory authorities cannot be seen to be standing in the way of globalisation and rapid changes. These changes should be welcome as they are indicative of the increasingly positive outlook for South Africa. The authorities have therefore to face up to the task of anticipating and keeping abreast of changes to meet the new challenges and opportunities. 'Nothing is stable except stability' and progress is measured by 'constantly changing when circumstances change', as the great philosophers of old would say.

7. Current challenges for banking policy, especially in view of international banks' interest in acquiring local banks

Closely related to the consideration of a four-pillar policy in a country is a consideration of whether international ownership of any of those "pillars" should be permitted and, if so, on what conditions. In that regard, the banking system of New Zealand serves as a good example of a country that, whilst having predominantly non-resident owned banks, has maintained a sound financial system for decades.

Should international interest in our local banks culminate in international ownership, the supervisory regime would have to follow the internationally agreed framework of "home-host" banking supervision. This is already in operation in that South African-owned banks have a presence abroad and internationally-owned banks have a presence in South Africa. The success of such a system relies largely on both the home-country and the host-country regulator ensuring compliance with the Basel Core Principles for Effective Banking Supervision and the various guidelines flowing therefrom. In that regard, regulators seek to ensure that their requirements do not obstruct home-country requirements and, consistent with meeting their responsibilities, dovetail as much as possible with those requirements.

Maintenance of a sound and efficient financial system and an ability to respond to a crisis effectively are crucial prerequisites for a country's economic and social welfare. Therefore, host-country supervisory arrangements are essential, as are structures for coordinating home and host supervision. Home-country and host-country supervisors should be able to rely on and support one another at all times.

When banking groups have international shareholders, it is important for the host-country supervisor to be able to rely on the shareholder of reference in times of need.

8. Challenges going forward

Three important challenges face the South African banking system, including bank supervisors, in the forthcoming number of years. These challenges are the implementation of the New Capital Accord, or Basel II, as the Accord is commonly known; the provision of the broader access to banking services; and the full implementation of anti-money laundering measures.

(i) Basel II

The principles of Basel II are intended to align capital-adequacy requirements more closely with the key elements of banking risks and to provide for banks to enhance their risk-measurement and risk-management capabilities. The revised capital framework is furthermore an attempt to adapt to new developments and instruments and to be neutral towards financial innovation. Although the aim is not to stifle innovation, the framework is also not intended to encourage capital arbitrage. Basel II will evidently bring with it a higher supervisory and compliance burden, because of the Accord's greater complexity.

The Office for Banks has embraced the principles contained within Basel II and is of the opinion that Basel II is suitable for application in both G10 and non-G10 countries, since it provides a menu of approaches suitable for both sophisticated and the least sophisticated banks. Implementation of Basel II will be one of the high-priority strategic focus areas of the Registrar of Banks in the forthcoming number of years. Basel II will be implemented within the South African banking sector on 1 January 2008. Parallel runs will take place during 2007. The Office for Banks has and will continue to direct resources towards developing a supervisory framework involving all approaches offered by the new Accord.

Basel II will have a significant impact not only on banks, but also supervisors, who will have to re-engineer their processes and tailor their organisational structures to meet the Basel II standards. In collaboration with other supervisors, the Office for Banks is currently developing its Basel II implementation strategy. This process requires, amongst other things, a thorough understanding of the provisions of Basel II, the design of appropriate supervisory processes and the development of complementary tools to discharge supervisory duties. Ultimately, the new capital-adequacy framework has the potential to improve risk management in banks and to align economic capital more closely with regulatory capital. Co-operation between banks and supervisors, between supervisors of different countries and between different banks is therefore essential for the successful implementation of Basel II.

The Accord Implementation Forum established by the Registrar of Banks and representing banks and various other stakeholders is functioning well and is assisting the banking sector and the regulator with identifying and addressing the risks that may arise prior to and during the implementation of systems designed to ensure compliance with Basel II.

There will be continued amendment of the regulatory framework and the supervisory process and procedures, as well as development of complementary tools, in order to cater for the requirements of Basel II.

(ii) Broader access to banking facilities

One of the most topical issues in the current South African financial landscape is the need to extend access to banking facilities on a wider basis than is currently the case. In South Africa, the regulation and provision of financial services to the poor has largely been based on exemption notices to the Banks Act. The South African Reserve Bank announced through the Bank Supervision Department's 2002, Annual Report, that it envisaged amending the regulatory framework in order to allow for the establishment of different classes of banking institutions, such as second-tier and third-tier banks.

Draft legislation has been published by the National Treasury in the form of the Dedicated Banks Bill and the Co-operative Banks Bill, as a means of providing access to the banking sector to interested participants and thus ensuring a flow-down of banking services to the wider community. It is essential, however, that the new legislation should ensure that the business of such institutions is conducted in a safe and sound manner, conducive to the orderly growth of the financial sector, whilst contributing to poverty reduction in both rural and urban areas. Comment on the Dedicated Banks Bill and the Co-operative Banks Bill may be provided until the end of January 2005.

(iii) Anti-money laundering

The Financial Intelligence Centre Act, 2001 (FIC Act), imposes duties on certain institutions to introduce anti-money-laundering measures, to train their employees, to report suspicious transactions to the Financial Intelligence Centre (FIC) and to retain client information. The banking sector has therefore begun a concerted campaign to comply with the FIC Act and to fulfill the sector's obligations in terms of local legislation and international guidelines.

In May 2002, South Africa applied for membership of the Financial Action Task Force (FATF), an intergovernmental body that develops and promotes policies, nationally and internationally, to combat money laundering. South Africa was granted FATF membership in June 2003.

As from February 2003, banks and several other institutions have been reporting suspicious transactions that may involve money laundering to the FIC. Banks have to make detailed reports of all unusual and/or suspicious transactions to the FIC. In addition, banks have to report the number of such reports to the Registrar of Banks. Although this has been a challenge for banks, resulting in additional system and resource requirements, banks have shown a commitment to comply with their duties.

The Bank Supervision Department has an obligation to monitor compliance by our banks with the FIC Act and other anti-money laundering guidelines. In order to ensure compliance with the requirements of the FIC Act, a circular was issued in December 2002. The circular provided guidelines on the types of measures that banks had to implement in order to prevent them being used to launder the proceeds of crime. In terms of the circular, each bank has to furnish the Bank Supervision Department with a detailed plan, with time frames by which the bank intended to achieve full implementation of and compliance with the FIC Act and the FIC Regulations.

The initial deadline of 30 June 2004 by which banks had to verify the identities of some 17 million clients was extended to a range of new deadlines, starting on 31 October 2004 for high-risk clients and ending on 30 September 2006 for the lowest risk clients.

The Bank Supervision Department, in its role as a supervisory body, will continue to monitor progress with the implementation of anti-money-laundering measures. It is also the intention of the Registrar of Banks to incorporate anti-money-laundering measures into the planned on-site visits to banks.

9. Conclusion

In summary, therefore, the South African banking sector remains stable, and we are convinced that further growth of the industry may be expected in 2005. Such growth, however, will be accompanied by certain challenges. Besides preparing for the implementation of Basel II, South African banks will continue to be encouraged to follow international sound corporate governance practices. Furthermore, the Office for Banks remains mindful of the need for banks to ensure that the objectives of the Financial Services Black Economic Empowerment Charter are met. For the Charter to succeed, co-operation by all stakeholders is a necessity, and the South African Reserve Bank will continue to support and assist banks in meeting their objectives. Taking into account the strengths of our banking sector, we can look forward to a sector that can continue to establish itself as one of the most sophisticated and integrated banking sectors in the world.