



South African Reserve Bank
From the Office of
the Registrar of Banks

C3/2010

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To: All banks, branches of foreign institutions, controlling companies and auditors of banks or controlling companies

Circular 3/2010 issued in terms of section 6(4) of the Banks Act, 1990:

Regulations relating to Banks and related matters

Executive summary

Since the commencement of the sub-prime and financial market crisis, and the subsequent worldwide economic crisis, various international standard-setting bodies announced comprehensive initiatives and strategies, and issued various new or amended requirements or standards, in respect of a wide range of key focus areas to comprehensively respond to the fundamental weaknesses revealed by the crisis.

In order to ensure that the regulatory framework for banks and banking groups in South Africa remains relevant and current, the Bank Supervision Department (BSD) of the South African Reserve Bank hereby gives notice to banks, controlling companies and branches of foreign institutions that the BSD has commenced with a process to comprehensively amend the regulatory framework.

On 15 March 2010 and 30 June 2010 the BSD respectively issued for comment draft 1 and draft 2 of the proposed amended Regulations relating to Banks. In accordance with international agreement regarding the implementation of specified amended requirements, the amended Regulations relating to Banks will be implemented in South Africa on 1 January 2012.

On 12 September 2010, the Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements and the introduction of global liquidity standards. The phase-in period for these further requirements will begin on 1 January 2013.

1. Introduction

1.1 Since the commencement of the sub-prime and financial market crisis in 2007, and the subsequent worldwide economic crisis, various international standard-setting bodies such as the G-20, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (Basel Committee) and the Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee, announced comprehensive initiatives and strategies, and issued various new or amended requirements or standards, in respect of a wide range of key focus areas to comprehensively respond to the fundamental weaknesses revealed by the international financial market and economic crisis.

1.2 In this regard, on 13 July 2009, the Basel Committee issued three finalised documents, the requirements of which will be implemented worldwide on 1 January 2012, namely:

1.2.1 enhancements to the Basel II framework;

1.2.2 revisions to the Basel II market risk framework; and

1.2.3 guidelines for computing capital for incremental risk in the trading book.

1.3 On 12 September 2010, the GHOS announced a substantial strengthening of existing capital requirements and the introduction of global liquidity standards, which are often being referred to as Basel III.

Internationally the implementation of specific requirements related to the strengthening of existing capital requirements and the global liquidity standards will be phased in during predefined periods that will commence on 1 January 2013.

2. A new regulatory landscape

2.1 On 22 September 2010, as part of his opening remarks at the 16th International Conference of Banking Supervisors (ICBS) held in Singapore, Mr Nout Wellink, the Chairman of the Basel Committee and President of De Nederlandsche Bank provided an overview of the international background to and height of the international financial crisis that required, among other things, specific international reforms to be undertaken, including a need for:

2.1.1 a comprehensive review of various international regulatory and supervisory standards;

- 2.1.2 bank-specific reforms related to matters such as a stronger and more robust definition of capital and improved risk coverage of capital requirements, higher levels of required capital and reserve funds, the introduction of specific capital buffers and a supplemental leverage ratio, and the introduction of internationally agreed minimum liquidity standards, as part of the new Basel III framework;
 - 2.1.3 supervisory guidance on important bank-specific initiatives such as stress testing, valuation, corporate governance, compensation, supervisory colleges, and high level principles for financial instruments accounting; and
 - 2.1.4 broader macroprudential measures to strengthen the resilience of the entire banking system and to address matters such as procyclicality, specified capital buffers, the role of “going concern” and “gone concern” capital instruments, interconnectedness and the perception that some banks are too big to fail.
- 2.2 The opening speech of Mr Wellink regarding the new regulatory landscape:
- 2.2.1 is available at: <http://www.bis.org/speeches/sp100922.pdf>; and
 - 2.2.2 is attached hereto as Annexure A for ease of reference.
- 3. Requirements that will be implemented on 1 January 2012**
- 3.1 As stated in paragraph 1.2, on 13 July 2009, the Basel Committee issued three finalised documents, the requirements of which will be implemented worldwide, including in South Africa, on 1 January 2012.
 - 3.2 The document that deals with the enhancements to the Basel II framework include, among other things:
 - 3.2.1 requirements to strengthen the treatment for certain securitisations in Pillar 1 of the Basel II framework, which deals with minimum capital requirements;
 - 3.2.2 higher risk weights for resecuritisation exposures, often referred to as collateralised debt obligations (CDOs) of asset-backed securities (ABS), to better reflect the risk inherent in these products;
 - 3.2.3 changes to the credit conversion factor for short-term liquidity facilities granted to certain off-balance sheet conduits;
 - 3.2.4 requirements for banks to conduct more rigorous credit analyses of externally rated securitisation exposures;

3.2.5 supplemental guidance under Pillar 2 of the Basel II framework, which deals with the supervisory review process. This guidance addresses the flaws in risk management practices revealed by the crisis and raises the standards for:

3.2.5.1 bank-wide governance and risk management;

3.2.5.2 capturing the risk of off-balance sheet exposures and securitisation activities;

3.2.5.3 managing risk concentrations; and

3.2.5.4 providing incentives for banks to better manage risk and returns over the long term.

The supplemental guidance under Pillar 2 of the Basel II framework also incorporates the Principles for Sound Compensation Practices, issued by the FSB (formerly the Financial Stability Forum) in April 2009.

3.2.6 enhancements to Pillar 3 of the Basel II framework, which deals with market discipline or public disclosure, to strengthen disclosure requirements for securitisations, off-balance sheet exposures and trading activities.

The additional disclosure requirements will help reduce market uncertainties regarding, among other things, the strength of banks' balance sheets related to capital market activities.

3.3 Revisions to the Basel II market risk framework

Since the financial market crisis began in mid-2007, many of the losses that occurred were related to positions held in the banks' trading books.

A main contributing factor was that the current capital framework for market risk, based on the 1996 Amendment to the Capital Accord to incorporate market risk, does not capture some key risks.

In response, the Basel Committee supplemented the current value-at-risk based trading book framework with an incremental risk capital (IRC) requirement, which includes default risk as well as migration risk, for unsecuritised credit products.

For securitised products, the capital requirements of the banking book will apply with a limited exception for certain so-called correlation trading activities, where banks may be allowed, subject to the prior written approval of the Registrar and strict qualitative minimum requirements that include stress testing requirements, to calculate a comprehensive risk capital requirement. These measures will reduce the incentive for regulatory arbitrage between the banking book and the trading book.

An additional response to the crisis is the introduction of a stressed value-at-risk requirement. Losses in most banks' trading books during the financial crisis have been significantly higher than the minimum capital requirements under the Pillar 1 market risk rules. The Basel Committee therefore now requires banks to calculate a stressed value-at-risk (sVaR) taking into account a one-year observation period relating to significant losses, which must be calculated in addition to the value-at-risk (VaR) based on the most recent one-year observation period.

The additional stressed value-at-risk requirement will also help reduce the procyclicality of the minimum capital requirements for market risk.

3.4 Guidelines for computing capital for incremental risk in the trading book

The incremental risk requirement is intended to complement additional standards being applied to the value-at-risk model framework.

The changes address a number of perceived shortcomings in the current VaR framework. Foremost, the current VaR framework ignores differences in the underlying liquidity of trading book positions.

In addition, the VaR calculations are typically based on a 99%/one-day VaR which is scaled up to 10 days. Consequently, the VaR capital requirement may not fully reflect large daily losses that occur less frequently than two to three times per year as well as the potential for large cumulative price movements over periods of several weeks or months.

Moreover, the current framework's emphasis on modelling short-run profit-and-loss volatility allows the use of relatively short data windows for estimating VaR parameters, as short as one year, which can produce insufficient required capital against trading positions following periods of relative calm in financial markets.

As already stated, the IRC represents an estimate of the default and migration risks of unsecuritised credit products over a one-year capital horizon at a 99.9 percent confidence level, taking into account the liquidity horizons of individual positions or sets of positions.

In specified cases it is expected from banks to develop their own models to calculate the IRC for the relevant positions.

The document issued by the Basel Committee during July 2009 provides guidelines on how an IRC model should be developed. It also contains guidance for the BSD to evaluate banks' IRC models.

- 3.5 Furthermore, during April 2009, the FSB issued Principles for Sound Compensation Practices, followed by the publication of the related implementation standards in September 2009.

Compensation at significant financial institutions is one of many factors that contributed to the financial crisis that began in 2007.

Therefore official action to address unsound compensation systems has to be embedded in the broader financial regulatory reform program, built around substantially stronger and more resilient global capital and liquidity frameworks.

The aforesaid documents issued by the FSB are in response to the call by the G20 Finance Ministers and Governors to submit detailed specific proposals on corporate governance reforms, global standards on pay structure and greater disclosure and transparency.

Given the commitment to ensure a level playing field, the implementation standards have to be rigorously and consistently implemented throughout the world.

The aim of the standards is to enhance the stability and robustness of the financial system.

- 3.6 Based on the aforesaid and in accordance with the mission of the BSD to promote the soundness of the banking system through the effective and efficient application of international regulatory and supervisory standards, and in order to ensure that the regulatory framework for banks and banking groups in South Africa remains relevant and current, the BSD issued draft 1 and draft 2 of the proposed amended Regulations relating to Banks on 15 March 2010 and 30 June 2010, respectively, for comment.
- 3.7 The proposed amendments to the Regulations relating to Banks are mainly based on the aforesaid requirements issued by the Basel Committee during July 2009 and by the FSB during April and September 2009.
- 3.8 Furthermore, the BSD:
- 3.8.1 incorporated into the proposed amended Regulations relating to Banks the outcome of certain policy decisions taken to date, as well as certain clarifications, and also made some corrections in the Regulations; and
- 3.8.2 is in the process of finalising various further proposed amendments to some of the BA returns and the related directives.
- 3.9 In accordance with international agreement regarding the implementation of the amended requirements issued by the Basel Committee during July 2009, the amended Regulations relating to Banks will be implemented in South Africa on 1 January 2012.

4. Requirements that will be implemented internationally on 1 January 2013 and thereafter

4.1 On 12 September 2010, following its meeting in Basel, Switzerland, the GHOS announced:

4.1.1 a substantial strengthening of existing capital requirements; and

4.1.2 the introduction of global liquidity standards.

4.2 Among other things, the strengthening of the existing capital requirements includes:

4.2.1 an increase in the minimum common equity requirement, from 2 per cent to 4.5 per cent;

4.2.2 a capital conservation buffer of 2.5 per cent to withstand future periods of stress, bringing the total common equity requirements to 7 per cent;

The aforesaid two requirements reinforce the stronger definition of capital agreed by the GHOS in July 2010, and the higher capital requirements for trading, derivative, securitisation and resecuritisation activities to be implemented on 1 January 2012.

4.2.3 an increase in the Tier 1 or primary capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, from 4 per cent to 6 per cent;

4.2.4 the stated capital conservation buffer of 2.5 per cent, above the specified regulatory minimum requirement, to be met with common equity after the application of specified deductions.

The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress.

While banks will be allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the specified minimum requirement, the greater the constraints on discretionary distributions such as dividend payments, share buybacks and bonuses will be.

4.2.5 a countercyclical buffer within a range of 0 per cent to 2.5 per cent of common equity or other fully loss absorbing capital.

This capital requirement will be implemented according to national circumstances. The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth.

For any given country, this buffer will only be in effect when there is excess credit growth that is resulting in a system wide build up of risk. The countercyclical buffer, when in effect, would be introduced as an extension of the conservation buffer range.

- 4.3 The aforesaid capital requirements will be supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures.

For the past few years the BSD has calculated and monitored banks' leverage multiples and ratios, as part of the BSD's supervisory framework, to monitor the potential build-up of risk.

- 4.4 The GHOS also agreed on transitional arrangements for the implementation of the new standards.

The transitional arrangements will help ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy.

- 4.5 The complete press release of the GHOS:

4.5.1 is available at: <http://www.bis.org/press/p100912.htm>; and

4.5.2 is attached hereto as Annexure B for ease of reference.

- 4.6 Based on the aforesaid, and for ease of reference, a comparison between the Basel II capital framework and the newly released Basel III capital framework is attached hereto as Annexure C.

5. Dedicated website for Basel III

- 5.1 The Secretariat of the Basel Committee has developed a dedicated website for the Basel Committee's reform program, which is available and directly accessible on www.bis.org/bcbs/basel3.htm.

6. Basel III: frequently asked questions

- 6.1 In order to allow the BSD to duly coordinate responses in respect of questions that banks, controlling companies or branches of foreign institutions may have in respect of the Basel III framework, banks, controlling companies, branches of foreign institutions or their auditors are invited to submit their duly formulated and motivated questions with the proposed possible interpretation or answer(s) to: SARB-BASELII@resbank.co.za, for the attention of Mr Hugo Stark, who is responsible for the administration of the BSD's policy process and who will ensure that the relevant questions and proposed possible interpretation or answer(s) are directed to the relevant person in the BSD responsible for the formulation and coordination of the relevant response.

7. Notice of the continuous process to amend the Regulations relating to Banks

7.1 As a member of the Basel Committee, the BSD has been actively involved in developing reforms that promote the safety and soundness of the banking system and continue to support long-term economic growth.

Therefore, the BSD fully supports the package announced by the GHOS.

7.2 In order to ensure that the regulatory framework for banks and banking groups remains relevant and current, the BSD hereby gives notice that it already commenced with its formal processes to amend the regulatory framework in accordance with the latest internationally agreed regulatory and supervisory standards.

7.3 The BSD will in due course issue further circulars, directives and guidance notices to banks, controlling companies, branches of foreign institutions and other interested persons regarding the various matters referred to in this Banks Act Circular.

8. Acknowledgement of receipt

8.1 Two additional copies of this Banks Act Circular are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.



E M Kruger
Registrar of Banks

Encl. 3

The previous circular issued was Banks Act Circular 2/2010, dated 2 June 2010.