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

D1/09

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**To banks, controlling companies and auditors of banks or controlling companies**

**Directive 1/2009 issued in terms of section 6(6) of Banks Act, 1990**

**Matters related to capital floors**


**Executive summary**

**South Africa has implemented the revised Regulations relating to Banks, which contain, among other things, the *International Convergence of Capital Measurement and Capital Standards, A revised Framework* (Basel II) issued June 2006, with effect from 1 January 2008.**

**In view of the irreducible uncertainty inherent in the implementation of Basel II, safeguards have been built in to limit the potential for unintended consequences. The safeguards that deal with the possibility of a large decline in required capital levels are commonly referred to as "capital floors".**

**The purpose of this directive is therefore to elucidate the Bank Supervision Department (BSD) of the South African Reserve Bank's approach to capital floors in respect of the following:**

- **The method of the calculation of capital floors including details with regards to the short-cut method to calculate a Basel I equivalent capital requirement.**
- **The general conditions applicable to capital floors such as the capital floor percentages, the time frame to which capital floors must apply and when the capital floors have to be calculated.**
- **The scope of application (i.e. the entities to which capital floors must apply such as bank or controlling company).**

## 1. Introduction

1.1 In view of the irreducible uncertainty inherent in the implementation of the *International Convergence of Capital Measurement and Capital Standards, A revised Framework* (Basel II) issued June 2006[1], safeguards have been built in to limit the potential for unintended consequences. The safeguards that deal with the possibility of a large decline in required capital levels are commonly referred to as "capital floors".

1.2 The purpose of this directive is therefore to elucidate the BSD's approach to capital floors in respect of the following:

1.2.1 The method of the calculation of capital floors including details with regards to the short-cut method to calculate a Basel I equivalent capital requirement.

1.2.2 The general conditions applicable to capital floors such as the capital floor percentages, the time frame to which capital floors must apply and when capital floors have to be calculated.

1.2.3 The scope of application (i.e. the entities to which capital floors must apply such as a bank or controlling company).

## 2. Banks Act (Act No. 94 of 1990 –the Act)

2.1 Section 4(7) of the Act *inter alia* determines that the Registrar may, from time to time, publicly disclose factors relating to the setting of capital-adequacy ratios that are in excess of the minimum capital-adequacy ratio as prescribed.

2.2 Section 70 of the Act *inter alia* determines that a bank or banking group shall manage its affairs in such a way that the sum of its primary and secondary capital, its primary and secondary unimpaired reserve funds and its tertiary capital in the Republic does not at any time amount to less than an amount which represents a prescribed percentage of the sum of amounts relating to the different categories of assets and other risk exposures and calculated in such a manner as may be prescribed.

## 3. Regulations relating to Banks (the Regulations)

3.1 The Regulations prescribe the manner in which the amounts relating to the different categories of assets and other risk exposures should be calculated. The Regulations, however, do not prescribe the calculation of capital floors. Since capital floors are likely to be of a temporary nature, it should not form part of the Regulations.

3.2 Regulation 38(4) of the Regulations states *inter alia* that when the Registrar is of the opinion that a bank's aggregate risk exposure does not sufficiently reflect the factors external to the bank, the Registrar, among other things,

[1] This document is a compilation of the June 2004 Basel II Framework, the elements of the 1988 Accord that were not revised during the Basel II process, the 1996 Amendment to the Capital Accord to Incorporate Market Risks, and the 2005 paper on the Application of Basel II to Trading Activities and the Treatment of Double Default Effects. No new elements have been introduced in this compilation.

may require the said bank to maintain additional capital as may be specified in writing by the Registrar. The safeguards that deal with the possibility of a large decline in required capital levels as one of the potential unintended consequences of Basel II may be classified as a factor external to the bank.

## 4. Other relevant references

4.1 In terms of Basel II and as part of the transitional arrangements (paragraphs 45 to 49 of Basel II), banks that are using the internal ratings-based (IRB) approaches for credit risk or the advanced measurement approach (AMA) for operational risk need to maintain capital floors, following the implementation of Basel II, for a proposed prescribed period of not less than three years. The text details the manner of the calculation which will be elaborated on further in this directive.

## 5. Factors influencing the final decision

5.1 Capital Adequacy Task Group (CATG)

5.1.1 The CATG (subgroup of the Risk Management Task Group which formed part of the Accord Implementation Forum) also considered the issues relating to capital floors.

5.1.2 The primary issue raised by the CATG was cost benefit analysis. Although the task group agreed that capital floors were necessary to limit unintended consequences, the associated costs for maintaining a dual reporting system were considered unjustifiable. The costs primarily emanated from the maintenance of daily average balances as opposed to month-end balances[2] in a bank's financial reporting structures. It was therefore concluded by the CATG that a short-cut method for the calculation of the capital floors should be implemented.

5.1.3 The BSD in principle agreed with the conclusions of the CATG and the short-cut method therefore forms the basis on which the capital floor percentage would be calculated as detailed in paragraph 6 below.

5.2 Communication with pre-eminent monetary and development Non-Governmental Organisations (NGOs)

5.2.1 As a result of communication between BSD and the pre-eminent monetary and development NGOs, BSD's approach to capital floors was modified to compensate for the shortened parallel run by maintaining the 95-per-cent floor for an additional year. The 95-per-cent floor for an additional year was therefore incorporated in the table of capital floor percentages to be calculated as detailed in paragraph 6 below.

## 6. Directive

6.1 Calculation and application of the capital floor

[2] Note that the use of month-end balances (as opposed to daily average balances) is likely to be more conservative in calculating risk based capital for an increasing balance sheet.

6.1.1 As determined in paragraph 45 of Basel II, banks shall be required to calculate **<u>the difference</u>** between **<u>the floor</u>** as defined in paragraph 46 and **<u>the amount</u>** as calculated according to paragraph 47. If the floor amount is larger, banks shall add the difference to their minimum required capital and reserve funds. The difference is to be included in line 8, column 5 of the form BA 700 (additional bank-specific capital requirement specified by the Registrar – other).

6.1.2 The calculation method is set out in Annexure A.

6.2 Calculation of **the floor** (paragraph 46 of Basel II)

6.2.1 The capital floor defined in paragraph 46 of Basel II stipulates that the calculation shall be based on the application of the 1988 Accord (International Convergence of Capital Measurement and Capital standards, updated to April 1998 – Basel I as contained in the previous Regulations relating to Banks). It is derived by applying an adjustment factor to the following amount:

(i) 10 per cent of the risk-weighted assets,

(ii) plus primary share capital and reserve funds and secondary capital and reserve funds deductions, and

(iii) less the amount of general provisions that may be recognised in secondary capital and reserve funds.

6.2.2 The capital floor percentage for banks using the advanced approaches for credit risk and/or operational risk is 95 per cent from the first year of implementation (2008), 95 per cent for the second year, 90 per cent for the third year and 80 per cent for the fourth year.

6.3 Calculation of **the amount** (paragraph 47 of Basel II)

6.3.1 In the years in which the capital floor applies, banks shall calculate

(i) the prescribed percentage (8 per cent + Pillar 2a + Pillar 2b) of total risk-weighted assets as prescribed in terms of the Regulations relating to Banks,

(ii) less the difference between total provisions and expected loss amount as prescribed in paragraphs 374 to 386 of Basel II (please also refer to regulations 23(21) and 23(22) of the Regulations), and

(iii) plus other primary share capital and reserve funds and secondary capital and reserve funds deductions.

6.3.2 Where a bank uses the standardised approach to credit risk for any portion of its exposures, it also needs to exclude general provisions that may be recognised in secondary capital and reserve funds for that portion from the amount calculated according to the calculation set out above.

6.4 General conditions

6.4.1 The following general conditions shall apply:

(i) Banks shall be subject to capital floors in their first four years of implementing the IRB approaches. In line with the Basel II text, the following capital floor percentages shall apply:

| | 1/1/2008 – 31/12/2008 | 1/1/2009 – 31/12/2009 | 1/1/2010 – 31/12/2010 | 1/1/2011 – 31/12/2011 |
|---|---|---|---|---|
| Foundation IRB approach for credit risk and advanced approaches for credit risk and/or operational risk | 95% | 95% | 90% | 80% |

Please note: The period for the calculation of the capital floor percentages is effective for the four years after Basel II has been implemented (the transitional arrangement period starting 1 January 2008). Banks who obtain approval for the IRB approach for credit risk and/or the AMA approach for operational risk subsequent to 1 January 2008 will be treated on a case-by-case basis.

(ii) The calculation of the capital floor shall be submitted to BSD within 30 business days immediately following the interim financial reporting period and the financial year end reporting period or as and when required by the Registrar.

(iii) The calculation of the capital floor (as described above) shall cease to exist on 1 January 2012, except if instructed otherwise by the Registrar.

(iv) The calculation of the capital floor shall be based on month-end balances.

(v) Capital floors specified above shall not be applicable to banks that solely apply the standardised approach for credit risk and entities subject to the standardised approach for credit risk within a banking group.

(vi) The calculation of the capital floor in terms of paragraph 46 of Basel II shall be based on the prescriptions of the previous Regulations relating to Banks[3].

(vii) The BSD may, however, develop appropriate bank-by-bank capital floors as deemed necessary.

[3] *Government Gazette* No. 6917 dated 8 November 2000.

6.5 Scope of application

6.5.1 Capital floors will only be applicable to the appropriate entities within a banking group (i.e. entities that adopted the IRB approach for credit risk and/or AMA for operational risk). All significant entities that report in terms of the IRB approach should therefore be included. Banks and controlling companies shall therefore comply with the minimum capital floor percentage.

**7. Acknowledgement of receipt**

7.1 Two additional copies of this directive are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt duly completed and signed by the chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the afore-mentioned signatories.

E M Kruger
**Registrar of Banks**

The previous directive issued was Directive 8/2008 dated 29 September 2008.

**Name of Bank:**

**Date:**

| | Amount R'000 | RWA % | RWA | Capital at 10% | Other notes |
|---|---|---|---|---|---|
| Total assets as per BA 100 | | | | | |
| Adjustment: set-off | | | | | 1 |
| **Less:** | | | | | |
| - balances to cash, SARB and govt bonds/sovereigns | | 0% | 0 | | |
| - balances in respect of cash management schemes | | 0% | 0 | | |
| - deferred tax not arising from assessed losses | | 0% | 0 | | |
| - balances with cash pledges | | 0% | 0 | | |
| - balances to group banks | | 0% | 0 | | |
| - balances in relation to trading book (not risk weighted on DI100) | | 0% | 0 | | |
| - balances to public institutions | | 10% | 0 | | |
| - balances to banks | | 20% | 0 | | |
| - balances in respect of residential mortgages (<80% LTV) | | 50% | 0 | | |
| - securitised assets | | | | | 2 |
| - other classifications (including net reclassifications) | | 0% | 0 | | |
| | | 10% | 0 | | |
| | | 20% | 0 | | |
| | | 50% | 0 | | |
| | | 150% | 0 | | |
| - balances remaining at 100% | 0 | 100% | 0 | | |
| - large exposures (>25% of capital) | | 1000% | 0 | | |
| - counterparty risk banking book | | | 0 | | |
| **Total on-balance sheet** | | | 0 | | |
| **Plus: off-balance sheet** | | | | | |
| - indemnities & guarantees | | 10% | 0 | | |
| - indemnities & guarantees | | 20% | 0 | | |
| - indemnities & guarantees | | 50% | 0 | | |
| - indemnities & guarantees | | 100% | 0 | | |
| - committed facilities | | 5% | 0 | | |
| - committed facilities | | 10% | 0 | | |
| - committed facilities | | 20% | 0 | | |
| - committed facilities | | 50% | 0 | | |
| - committed facilities | | 100% | 0 | | |
| - letters of credit | | 5% | 0 | | |
| - letters of credit | | 10% | 0 | | |
| - letters of credit | | 20% | 0 | | |
| - net open currency positions per (old) regulation 33(5) | | 100% | 0 | | |
| - contracted capital expenditure | | 20% | 0 | | |
| - underwriting exposures | | 50% | 0 | | |
| - credit derivatives | | 10% | 0 | | |
| - credit derivatives | | 100% | 0 | | |
| - other contingent liabilities | | 20% | 0 | | |
| - other contingent liabilities | | 50% | 0 | | |
| - other contingent liabilities | | 100% | 0 | | |
| **Total off-balance sheet** | | | 0 | | |
| **Total on-balance sheet plus off-balance sheet** | | | 0 | 0 | |
| **Plus: trading book capital requirements** | | | | | |
| - base requirement | | | | | |
| - counterparty risk | | | | | |
| - position risk | | | | | |
| - large exposure requirement | | | | | |
| **Total capital requirement (@10%) based on the presciptions of the Regulations relating to banks as published in the previous Regulations relating to banks** | | | | 0 | para 46 |
| **Plus** | | | | | |
| - Impairments against primary and secondary capital in terms of previous Regulations relating to banks | | | | | para 46 |
| **Less** | | | | | |
| - General provisions qualifying as capital | | | | | para 46 |

**Name of Bank:**
**Date:**

| | Amount R'000 | RWA % | RWA | Capital at 10% | | Other notes |
|---|---|---|---|---|---|---|
| **Calculated amount per para 46** | | | | 0 | | |
| **Floor percentage** | | | | 95% | | |
| **Capital floor** | | | | | 0 | |
| **Compared to** | | | | | | |
| Capital required per BA700 (line 11, column 6) | | | | | | para 47 |
| **Less** | | | | | | |
| - Difference between total provisions and EL recognised as capital per BA 700 (line 75, column 1) | | | | | 0 | para 47 |
| **Plus** | | | | | | |
| - Deductions against primary and secondary capital per BA 700 (line 14, column 4) | | | | | | para 47 |
| | | | | | 0 | |
| **Additional requirement due to capital floors** | | | | | 0 | |

**General Notes**
- Please refer to the conditions as per the directive

**Additional Notes**
1. **Instances where IFRS netting is different from regulation 13 (reg 12 in the old regulations) set-off.**
2. **Covering instances where IFRS does not permit securitised assets to be derecognised even though in compliance with exemption notice**