



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

D4/2011

2011-10-19

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

**Directive 4/2011 issued in terms of section 6(6) of the Banks Act, 1990**

**Matters related to capital floors**

**Executive summary**

South Africa implemented the revised Regulations relating to Banks (the Regulations), which contain, among other things, the *International Convergence of Capital Measurement and Capital Standards, A Revised Framework* (Basel II) issued in 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 into Basel II 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 used for the calculation of capital floors, including details with regard to the abbreviated method to calculate the 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 a bank or controlling company).

This directive would replace Directive 1/2009, issued in February 2009, in order to ensure capital floors remain in place beyond the initial three years.

## 1. Introduction

- 1.1 In view of the irreducible uncertainty inherent in the implementation of the Basel II framework issued in June 2006,<sup>1</sup> 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 used to calculate capital floors, including details with regard to the abbreviated method to calculate the 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 they 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, 1990 (Act No. 94 of 1990 – the Act)

- 2.1 Section 4(7) of the Act, *inter alia*, determines that the Registrar of Banks (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 of South Africa (the Republic) does not at any time amount to less than an amount that *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

- 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.

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<sup>1</sup> 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.



- 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 may, *inter alia*, 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) approach 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 Basel II framework details the manner in which the calculation should be done (see Annexure A of this directive).
- 4.2 Subsequently, the Basel Committee on Banking Supervision (Basel Committee) issued a press release, namely "Basel II capital framework enhancements announced by the Basel Committee", dated 13 July 2009, in which it was stated that the Basel Committee agreed to keep in place the Basel I capital floors beyond the end of 2009. Furthermore, during subsequent engagements with the international authorities concerned, it was confirmed that the Basel I capital floors would remain in place at 80 per cent of the Basel I equivalent capital requirement.

#### **5. Factors influencing the final decision**

##### **5.1 Capital Adequacy Task Group**

- 5.1.1 The Capital Adequacy Task Group (CATG), which is a 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 the CATG raised was a cost benefit analysis. Although the task group agreed that capital floors were necessary to limit unintended consequences, the associated costs involved in 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<sup>2</sup> in a bank's financial reporting structures. The CATG therefore concluded that an abbreviated method for calculating the capital floors should be implemented.
- 5.1.3 The BSD, in principle, agreed with the CATG's conclusions. Therefore the abbreviated method forms the basis on which the capital floor percentage would be calculated as detailed in paragraph 6 below.

<sup>2</sup> 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.

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, the 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 that are to be calculated as detailed in paragraph 6 below.

**6. Directive**

6.1 Calculation and application of the capital floor

6.1.1 As determined in paragraph 45 of Basel II, banks shall be required to calculate *the difference* between *the floor* as defined in paragraph 46 and *the amount* 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 in April 1998 to Basel I as contained in the previous Regulations<sup>3</sup> 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, 95 per cent for the second year, 90 per cent for the third year and 80 per cent for the fourth and subsequent years.

<sup>3</sup> Government Gazette No. 6917, dated 8 November 2000.



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

#### 6.3.1 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;
- (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 the years subsequent to the implementation of the IRB approaches. In line with the Basel II framework, the following capital floor percentages shall apply:

|   | First year | Second year | Third year | Fourth year and subsequent years |
|---|------------|-------------|------------|----------------------------------|
| 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 years after Basel II has been implemented (the original transitional arrangement period commenced on 1 January 2008). Banks who obtain approval for the IRB approach for credit risk and/or the AMA 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 reporting periods ending 31 December and 30 June, or as and when required by the Registrar.
- (iii) The calculation of the capital floor shall be based on month-end balances.
- (iv) 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.

- (v) The calculation of the capital floor in terms of paragraph 46 of Basel II shall be based on the prescriptions of the previous Regulations.
- (vi) The BSD may, however, develop specific capital floors for individual banks if deemed necessary.

#### 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 both chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.



Adv M S Blackbeard  
**Registrar of Banks**

Encl. 1

The previous directive issued was Directive 3/2011 dated 4 October 2011.