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

D3/2013

2013-04-09

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

Directive 3/2013 issued in terms of section 6(6) of the Banks Act, 1990

Matters related to capital floors

<u>Executive summary</u>

South Africa implemented the previous Regulations relating to Banks, 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 4/2011, issued in October 2011, in order to ensure the capital floor calculation is based on the amended Regulations relating to Banks (the Regulations).

1. Introduction

1.1 In view of the irreducible uncertainty inherent in the implementation of the Basel II framework issued in June 2006[1] and the Basel III framework that was implemented with effect from 1 January 2013, 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 The proposed amendment to 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 common equity tier 1 capital, additional tier 1 capital and tier 2 capital and its common equity tier 1 unimpaired reserve funds, additional tier 1 unimpaired reserve funds and tier 2 unimpaired reserve funds 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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[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.

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. Directive

5.1 Calculation and application of the capital floor

5.1.1 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 5, column 6 of the form BA 700 (Additional risk weighted exposure equivalent amounts specified by the Registrar – Other).

5.1.2 The calculation method is set out in Annexure A.

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

5.2.1 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 Basel I Regulations[2] 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

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

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

5.2.2 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.

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

5.3.1 Banks shall calculate

(i) the minimum required capital at the prescribed percentage of total risk-weighted assets as specified in terms of Guidance Note 9/2012 or any related directive issued in terms of section 6(6) of the Banks Act, 1990;

(ii) *less* the difference between eligible provisions and expected loss amount in relation to credit risk 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 deductions specified under common equity tier 1 share capital and reserve funds, additional tier 1 capital and reserve funds and tier 2 capital and reserve funds.

5.3.2 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 tier 2 capital and reserve funds for that portion from the amount calculated according to the calculation set out above.

5.4 General conditions

5.4.1 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 BSD may, however, develop specific capital floors for individual banks if deemed necessary.

5.5 Scope of application

5.5.1 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.

6. Acknowledgement of receipt

6.1 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 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.

MSBlackbeard

Adv. M S Blackbeard
Deputy Registrar of Banks

The previous directive issued was Directive 2/2013 dated 18 March 2012.

Encl. 1

Annexure A

Directive in terms of Section 6(6) of the Banks Act 1990 – The application of capital floors

The calculation of capital floors

1. Purpose

The purpose of this directive is to provide a framework for the calculation of the capital floor introduced under the transitional arrangements as envisaged under the *International Convergence of Capital Measurement and Capital Standards, A Revised Framework* (Basel II) issued in June 2006.

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 Basel I Regulations				0	para 46
Plus					
- Impairments against primary and secondary capital in terms of the Basel I Regulations					para 46
Less					
- General provisions qualifying as capital					para 46
Calculated amount per para 46				0	
Floor percentage				95%	
Capital floor					0

Name of Bank:
Date:

	Amount R'000	RWA %	RWA	Capital at 10%	Other notes
Compared to					
Capital required per BA700 (line 16, column 6)					para 47
Less					
- Difference between total provisions and EL recognised as capital per BA 700 (line 85, column 1)					para 47
Plus					
- Deductions against common equity tier 1, additional tier 1 and tier 2 capital per BA 700 (line items 42 + 55 + 57 + 58 + 59 + 63 +74 + 86)					para 47
				0	
			(BA 700 line 5)		
Additional requirement due to capital floors			0	0	
Capital requirement (line 16 column 3)					

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 previous Regulations) set-off.

2. Covering instances where IRFS does not permit securitised assets to be derecognised even though in compliance with the exemption notice.