



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

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

**Directive 4/2015 issued in terms of section 6(6) of the Banks Act 94 of 1990**

**Amendments to the Regulations relating to Banks, and matters related thereto**

#### **Executive summary**

On 1 January 2008, 1 January 2012 and 1 January 2013, South Africa implemented amended Regulations relating to Banks (Regulations) which incorporated, among other things, the minimum requirements set out in internationally agreed frameworks and standards issued by standard-setting bodies such as the Financial Stability Board and the Basel Committee on Banking Supervision (Basel Committee). The amended Regulations issued on the above-mentioned three dates included the requirements specified in the Basel II, Basel 2.5 and Basel III frameworks respectively.

In order to ensure that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant and current, the Bank Supervision Department (BSD) of the South African Reserve Bank continuously reviews its legal framework to ensure that the framework appropriately reflects local and international market developments, and complies with the ever-evolving international regulatory and supervisory standards, and best practices.

Furthermore, as a member of the Basel Committee, the legal framework in terms of which the BSD regulates and supervises banks and banking groups is subject to ongoing international assessments and reviews, which include matters related to completeness and comparability. Any identified area of incompleteness or non-comparability results in the implementation of an appropriate amendment.

This directive accordingly specifies such identified areas of the legal framework requiring amendment, including specified regulations, circulars, directives or guidance notes.

**Banks and controlling companies (hereinafter collectively referred to as 'banks') are hereby directed to implement the relevant requirements specified in this Directive 4/2015.**

## **1. Introduction**

- 1.1 On 1 January 2008, 1 January 2012 and 1 January 2013, South Africa implemented amended Regulations which incorporated, among other things, the minimum requirements set out in internationally agreed frameworks and standards issued by standard-setting bodies such as the Financial Stability Board and the Basel Committee, including the requirements respectively specified in the Basel II framework, the Basel 2.5 framework and the Basel III framework.
- 1.2 In order to ensure that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant and current, the BSD continuously reviews its legal framework to ensure that the framework appropriately reflects local and international market developments, and continuously complies with the ever-evolving international regulatory and supervisory standards, and best practices.
- 1.3 Furthermore, as a member of the Basel Committee, the legal framework in terms of which the BSD regulates and supervises banks and banking groups is subject to ongoing international assessments and reviews, which include assessments related to completeness and comparability. It is expected of supervisory authorities to appropriately amend any area of incompleteness or non-comparability.
- 1.4 Assessments and reviews conducted by this Office and other persons during the past year in respect of the legal framework in terms of which the BSD regulates and supervises banks and banking groups revealed some areas of incompleteness or non-comparability, the details of which are set out in paragraphs 2 to 12 of this Directive 4/2015.
- 1.5 As a member of the Basel Committee, and in order to ensure a level playing field between South African banks and other internationally active competitive banks, this Office regards the full, timely and consistent implementation of internationally agreed frameworks, requirements and standards as critical.
- 1.6 On 1 October 2014, this Office issued Directive 6/2014, informing all relevant persons of the formal commencement of processes to amend the regulatory and supervisory framework in accordance with the latest internationally agreed regulatory and supervisory standards.

The proposed amendments to the Banks Act 94 of 1990 (the Banks Act), and the Regulations, envisaged in this Directive 4/2015, form an integral part of the aforesaid process of amendments to the regulatory framework in terms of which this Office regulates and supervises banks and banking groups.

## 2. Scope of application

2.1 Currently regulation 36(7)(a)(i) of the Regulations states that "... the Registrar may on prior written application and subject to such conditions as may be specified in writing by the Registrar, allow a bank or controlling company, instead of full consolidation, to apply-

(A) the aggregation method specified ..."

Paragraph 24 of the Basel II framework requires that majority-owned or -controlled banking entities, securities entities (where subject to broadly similar regulation or where securities activities are deemed banking activities) and other financial entities should generally be fully consolidated. However, the Basel II framework is not prescriptive on the required level of detail when working towards full consolidation, or the required level of detail when working towards the calculation of group capital adequacy.

It has accordingly come to this Office's attention that the "instead of" construction as currently reflected in regulation 36(7)(a)(i) of the Regulations may lead to an interpretation that the aggregation method is an alternative to consolidation and not a detailed method towards the calculation of group capital adequacy.

In order to clarify the position and remove any uncertainty, this Office proposes to substitute the words "instead of full consolidation" in regulation 36(7)(a)(i) of the Regulations with the words "in its method towards calculating group capital adequacy, in addition to full consolidation that may be applied in cases such as, for example, the completion of the form BA 700".

## 3. Definition of capital and minimum capital requirements

3.1 Paragraph 33 of the Basel II framework states that "... the capital invested in a majority-owned or controlled insurance entity may exceed the amount of regulatory capital required for such an entity (surplus capital). Supervisors may permit the recognition of such surplus capital in calculating a bank's capital adequacy, under limited circumstances."

The aforesaid recognition of surplus capital from insurance entities as qualifying capital was subsequently superseded by the introduction of the Basel III framework.

Regulation 36(10)(d) of the Regulations still makes provision for the Registrar to grant approval for the surplus amount of capital from insurance entities to be included in the calculation of qualifying capital for the relevant group.

This Office on no occasion approved any amount of surplus capital from insurance entities to be included in the calculation of a banking group's qualifying capital or capital adequacy.

In order to fully align the Regulations with the updated wording specified in the Basel III framework, this Office proposes to delete the current enabling provisions related to surplus capital from insurance entities from regulation 36(10)(d) of the Regulations, and the related wording from all other relevant or related regulations, subregulations or prescribed returns in the Regulations, including any relevant disclosure requirements.

- 3.2 Paragraphs 52 and 53 of the Basel III framework state that for an instrument to be included in common equity tier 1 capital of a joint stock company, the criteria must be met solely with common shares.

Currently regulation 38(13)(a) of the Regulations refers to an “instrument or share”.

The intention of the current wording in the Regulations is not to include in common equity tier 1 capital any instrument or share other than what is permitted in terms of the Basel III framework.

Nevertheless, in order to fully align the wording of regulation 38(13)(a) of the Regulations with the requirement specified in paragraph 53 of the Basel III framework, this Office proposes to delete the word “instrument” from regulation 38(13)(a) of the Regulations.

- 3.3 Paragraph 52 of the Basel III framework lists all the elements that form part of common equity tier 1 capital, and the list includes both shares and reserves.

Section 1 of the Banks Act contains separate definitions for common equity tier 1 capital and common equity tier 1 unimpaired reserve funds.

Currently not all relevant references in regulations 38 and 43 of the Regulations correctly refer to the sum of common equity tier 1 capital and common equity tier 1 unimpaired reserve funds.

Therefore this Office proposes to refine the current wording in regulations 38 and 43 of the Regulations to state clearly that common equity tier 1 refers to the sum of common equity tier 1 capital and common equity tier 1 unimpaired reserve funds.

- 3.4 Paragraph 54 of the Basel III framework lists all the elements that form part of additional tier 1 capital, and the list refers to instruments.

Currently the definition of additional tier 1 capital in section 1 of the Banks Act refers only to “shares”, instead of “shares or debt instruments”.

Therefore this Office proposes to amend the definition of additional tier 1 capital in section 1(1) of the Banks Act by inserting the words “or debt instruments” after the word “shares”.

3.5 Paragraph 90 of the Basel III framework lists certain items, which, under the Basel II framework, were deducted 50 per cent from tier 1 and 50 per cent from tier 2 (or had the option of being deducted or risk weighted). The Basel III framework requires that the items specified below be assigned a risk weight of 1 250 per cent:

- certain securitisation exposures;
- certain equity exposures under the probability of default/loss given default (PD/LGD) approach;
- non-payment/delivery on non-delivery versus payment and non-payment versus payment transactions; and
- significant investments in commercial entities.

Based on the provisions of paragraph 9 of the Basel II framework and other related provisions, which state, *inter alia* “It should be stressed that the revised Framework is designed to establish minimum levels of capital for internationally active banks. As under the 1988 Accord, national authorities will be free to adopt arrangements that set higher levels of minimum capital. Moreover, they are free to put in place supplementary measures of capital adequacy for the banking organisations they charter ...”, and for the sake of prudence, the Regulations currently either require or make provision for specific exposures to be deducted from common equity tier 1 capital, instead of being risk weighted.

However, for the sake of comparability between jurisdictions, and to fully align the requirements of the Regulations with the wording contained in paragraph 90 of the Basel III framework, this Office proposes to amend:

- Table 7 in regulation 23(6)(j) of the Regulations by the deletion of footnote 1, with the consequential updates to the relevant BA forms or other related regulations or subregulations;
- regulation 23(11)(b)(xii)(D)(v) of the Regulations by the deletion of the phrase “...or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds”;
- Table 14 in regulation 23(11)(q) of the Regulations by the deletion of footnote 1, with the consequential updates to the relevant BA forms or other related regulations or subregulations;
- regulation 31(6)(c)(viii) of the Regulations by the deletion of the phrase “...or the relevant imputed percentage equivalent to a deduction from the bank’s capital and reserve funds, provided that instead of adding to the bank’s risk weighted exposure amount the said equity exposure amount, the reporting bank may deduct from its common equity tier 1 capital and reserve funds the relevant equity exposure amount, which amount shall in the case of the said deduction approach be deemed to represent the expected loss amount relating to the said equity exposure...”;

- proviso (ii) of regulation 23(20)(b)(ii) of the Regulations by the substitution of the phrase "...deduct from its common equity tier 1 capital and reserve funds the full amount of value transferred plus any relevant replacement cost until the said second payment or delivery leg is effectively made..." for the phrase "...assign to the full amount of value transferred plus any relevant replacement cost a risk weight of 1 250 per cent...".

#### **4. Credit risk - standardised approach**

- 4.1 Paragraph 64 of the Basel II framework provides for a risk weight that is one category less favourable than that assigned to claims on the sovereign, subject to a floor of 20 per cent for claims on banks of an original maturity of three months or less, denominated and funded in the domestic currency.

In terms of the provisions of Table 7 and Table 8, respectively in regulations 23(6)(j) and 23(8)(a) of the Regulations, a risk weight of 20 per cent may be assigned to specified claims on banks in the RSA, provided the claim has an original maturity of three months or less, excluding any claim on an RSA bank that is renewed or rolled resulting in an effective maturity of more than three months. However, regulations 23(6)(j) and 23(8)(a) of the Regulations do not specify that such a claim has to be denominated and funded in the domestic currency before the preferential risk weight may be applied.

Therefore this Office proposes to amend the provisions of Table 7 in regulation 23(6)(j) and Table 8 in regulation 23(8)(a) of the Regulations to require that the aforesaid claim on a bank has to be denominated and funded in Rand before the preferential risk weight may be applied.

- 4.2 Paragraph 65 of the Basel II framework states that claims on securities firms may be treated as claims on banks provided these firms are subject to supervisory and regulatory arrangements comparable to those under the Basel framework. Claims on securities firms may therefore receive a risk weight that is one category less favourable than the risk weight assigned to claims on the sovereign.

Similarly as for claims on banks as set out in paragraph 4.1 above, Table 7 and Table 8, respectively in regulations 23(6)(j) and 23(8)(a) of the Regulations, make provision for a 20 per cent risk weight to be assigned to specified claims on securities firms in the RSA, provided that such firms are subject to comparable supervisory and regulatory arrangements as banks in the RSA, including, in particular, risk-based capital requirements and regulation and supervision on a consolidated basis, and the claim on the securities firm has an original maturity of three months or less, excluding any claim on a securities firm in the RSA that is renewed or rolled resulting in an effective maturity of more than three months.

However, Table 7 and Table 8, respectively in regulations 23(6)(j) and 23(8)(a) of the Regulations, do not specify that the claim has to be denominated and funded in the domestic currency before the preferential risk weight may be applied.

Therefore this Office proposes to amend the provisions of Table 7 and Table 8, respectively in regulations 23(6)(j) and 23(8)(a) of the Regulations, to require that the aforesaid claim on a securities firm has to be denominated and funded in Rand before the preferential risk weight may be applied.

- 4.3 Paragraph 197 of the Basel II framework states that the materiality thresholds on payments (under the credit protection obtained through guarantees or credit derivatives) below which no payment is made in the event of loss are equivalent to retained first loss positions and must be deducted in full from the capital of the bank purchasing the credit protection.

In contrast, Table 7 in regulation 23(6)(j) of the Regulations requires that such an exposure be risk weighted at 1 250 per cent, and footnote 1 of Table 7 in regulation 23(6)(j) of the Regulations makes provision for banks to apply such imputed percentage that effectively results in a risk-weighted exposure amount equivalent to a deduction against capital and reserve funds.

The risk weighting treatment applied in the Regulations was found to be consistent with the overall approach taken under Basel III to risk weight those exposures that were deducted in terms of the Basel II framework, and will therefore be retained in the Regulations.

However, footnote 1 of Table 7 in regulation 23(6)(j) of the Regulations, which requires exposures to be risk weighted at 1 250 per cent or such imputed percentage that effectively results in a risk-weighted exposure amount equivalent to a deduction against capital and reserve funds, may be regarded as a diversion from the Basel III framework. The Basel III framework does not provide for any adjustment to the 1 250 per cent risk weight.

Therefore in order to fully align the Regulations with the updated wording specified in the Basel III framework, this Office proposes to delete footnote 1 of Table 7 in regulation 23(6)(j) of the Regulations, thus requiring the relevant exposures to be risk weighted at 1 250 per cent.

## **5. Credit risk - internal ratings-based approach**

- 5.1 Paragraph 231 of the Basel II framework specifies requirements in respect of an exposure to be eligible for retail treatment. These requirements include that the relevant loans have to be extended to small businesses and managed as retail exposures, provided that the total exposure of the banking group to the small business borrower, on a consolidated basis, is less than €1 million.

While regulation 23(11)(c)(iv)(A)(i)-(iii) of the Regulations incorporated these requirements substantively, the requirement that the total exposure amount be determined on a consolidated basis may not be sufficiently clear.

In order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to insert in regulation 23(11)(c)(iv)(A)(iii) of the Regulations an explicit requirement that the total exposure of the banking group to the relevant small business borrower shall be determined on a consolidated basis.

- 5.2 Paragraph 234 of the Basel II framework provides the definition of qualifying revolving retail exposures (QRRE). Since the asset correlation assumptions for the QRRE risk weight function are significantly below those for the other retail risk weight function at low PD values, it is required that the use of the QRRE risk weight function be constrained to portfolios that have exhibited low volatility of loss rates, relative to their average level of loss rates, especially within the low PD bands.

Regulation 23(11)(c)(iv)(B)(ii) of the Regulations provides a definition of QRRE. However, regulation 23(11)(c)(iv)(B)(ii)(ee) of the Regulations only requires that the exposures have to exhibit low volatility in loss rates, but does not specify that the low volatility shall be relative to the average level of loss rates.

In order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to insert in regulation 23(11)(c)(iv)(B)(ii)(ee) of the Regulations an explicit requirement that the low volatility in loss rates shall be relative to the average level of loss rates.

- 5.3 Paragraph 274 of the Basel II framework provides supervisors with national discretion to allow banks to substitute total assets of the consolidated group for total sales in calculating the small to medium enterprises (SME) threshold and the firm-size adjustment when total sales are not a meaningful indicator of firm size.

Regulation 23(11)(d)(ii)(C) of the Regulations specifies that a bank is required to use total sales when calculating the SME threshold and makes provision for the Registrar to specify a different threshold, “such as assets instead of sales.” The use of the words “such as” implies that the Registrar may decide to use a threshold other than assets or sales, which is not provided for in paragraph 274 of the Basel II framework.

Therefore in order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to substitute the words “the Registrar may specify in writing a different threshold amount or base, such as assets instead of sales” in regulation 23(11)(d)(ii)(C) of the Regulations with the words “the Registrar may specify in writing a different threshold amount and/or specify in writing to substitute sales for assets as the base”.

- 5.4 Paragraph 386 of the Basel II framework, read with the provisions of paragraph 90 of the Basel III framework, specifies that certain items that were previously deducted 50 per cent from tier 1 and 50 per cent from tier 2 capital are now risk-weighted at 1 250 per cent.

Regulations 23(11)(q) and 23(13)(e) of the Regulations specify that certain exposures are assigned a risk weight of 1 250 per cent, “or such imputed risk weighting that effectively results in a risk weighted exposure amount equivalent to a deduction against capital and reserve funds”.

For the sake of comparability between jurisdictions, and to fully align the requirements of the Regulations with the wording contained in paragraph 90 of the Basel III framework, this Office proposes to amend the provisions of regulations 23(11)(q) and 23(13)(e) of the Regulations to state clearly that the relevant exposures shall be risk weighted at 1 250 per cent.

- 5.5 Paragraph 402 of the Basel II framework specifies risk drivers that banks need to consider when assigning exposures to a pool. The list of risk drivers includes a requirement that “Banks must explicitly address cross-collateral provisions where present”.

Regulation 23(11)(b)(v)(D)(i) of the Regulations provides a list of risk drivers that covers all the relevant requirements specified in paragraph 402 of the Basel II framework, but regulation 23(11)(b)(v)(D)(i) of the Regulations does not specify that banks are required to explicitly address cross-collateral provisions where present.

In order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 23(11)(b)(v)(D)(i) of the Regulations to state clearly that banks are required to explicitly address cross-collateral provisions where present.

- 5.6 Paragraph 406 of the Basel II framework requires that significant concentrations within a single grade or grades must be supported by convincing empirical evidence that the grade or grades cover reasonably narrow PD bands and that the default risk posed by all borrowers in a grade fall within that band.

Regulation 23(11)(b)(v)(B)(i)(aa) of the Regulations requires that a bank shall in the case of concentrations within a single grade have empirical evidence that the grades cover sufficiently narrow PD bands, but the regulation does not specify that if a bank notes concentration within grades it is required to have such convincing empirical evidence.

In order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 23(11)(b)(v)(B)(i)(aa) of the Regulations to require that significant concentrations within a single grade or grades shall be supported by convincing empirical evidence that the grade or grades cover reasonably narrow PD bands and that the default risk posed by all borrowers in a given grade fall within that band.

- 5.7 Paragraph 444 of the Basel II framework requires that where banks do not use the same estimates for both internal ratings-based (IRB) and internal purposes, a bank must document them and demonstrate their reasonableness to the supervisor.

Regulation 23(11)(b)(v)(I)(iii) of the Regulations requires banks to document differences between its IRB estimates and the estimates they use for internal risk management purposes, but the regulation does not specify that banks are required to demonstrate the reasonableness of any differences to this Office.

In order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 23(11)(b)(v)(I) of the Regulations to explicitly state that where banks do not use the same estimates for both IRB and internal purposes, the bank shall not only be required to document such differences but shall also be required to demonstrate their reasonableness to the BSD.

- 5.8 Paragraph 264 of the Basel II framework makes provision for a three-year transition period following the implementation of the Basel II framework on 1 January 2008, during which time period national supervisors had discretion to relax specific minimum IRB requirements.

Provision for the aforesaid discretion to be exercised by the Registrar was incorporated into the provisions of regulations 23(11)(b)(ii) and 23(13)(b)(ii) of the Regulations. However, since the three-year transition period following the implementation of the Basel II framework in South Africa expired on 31 December 2010, it is superfluous to retain the enabling provision for the Registrar to exercise such discretion.

Therefore, in order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to delete the phrase “or such lesser minimum period as may be specified in writing by the Registrar” from the provisions of regulations 23(11)(b)(ii) and 23(13)(b)(ii) of the Regulations.

- 5.9 Paragraph 445 of the Basel II framework requires that a bank using the advanced IRB approach must demonstrate that it has been estimating and employing LGDs and exposure at default (EADs) in a manner that is broadly consistent with the minimum requirements for use of own estimates of LGDs and EADs for at least the three years prior to qualification.

Regulation 23(13)(b)(ii)(F) of the Regulations requires that banks have to be broadly in compliance with the relevant minimum requirements specified in regulation 23(11) of the Regulations, which relate to PD, but the aforesaid regulation omits to state clearly that advanced IRB banks are also required to be broadly in compliance with the relevant minimum requirements specified in regulation 23(13) of the Regulations, which specifically deals with the use of own estimates of LGDs and EADs, for at least the three years prior to qualification.

In order to fully align the provisions of the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 23(13)(b)(ii) of the Regulations to state clearly that in addition to compliance with the relevant minimum requirements specified in regulation 23(11) of the Regulations, advanced IRB banks are also required to be broadly in compliance with the relevant minimum requirements specified in regulation 23(13) of the Regulations, for at least the three years prior to qualification.

- 5.10 Regulation 23(11)(b)(vi)(A)(i)(cc) of the Regulations incorrectly directs banks to comply with the relevant minimum requirements in regulation 23(11)(b)(v)(G) of the Regulations instead of the relevant minimum requirements specified in regulation 23(11)(b)(v)(H) of the Regulations.

This Office proposes to amend the provisions of regulation 23(11)(b)(vi)(A)(i)(cc) of the Regulations to correct this oversight and direct banks to comply with the relevant minimum requirements specified in regulation 23(11)(b)(v)(H) of the Regulations.

## **6. Credit risk - securitisation**

- 6.1 In terms of the provisions of paragraph 559 of the Basel II framework, if a clean-up call, when exercised, is found to serve as a credit enhancement, the exercise of the clean-up call must be considered a form of implicit support provided by the bank and must be treated in accordance with the supervisory guidance pertaining to securitisation transactions.

Paragraphs 4(3) and 5(3) of Government Notice No. 2, *Government Gazette* No. 30628 of 1 January 2008 (the Securitisation Exemption Notice) specify the detailed capital and disclosure requirements relating to implicit support.

Clean-up calls are covered by paragraph 11 of the Securitisation Exemption Notice, and paragraph 11(1)(a)(iv) states that when a clean-up call is found to serve as a credit-enhancement when exercised, the Registrar shall take appropriate action against the institution that acted in a primary role. While paragraph 11(1)(b) of the Securitisation Exemption Notice specifies that such clean-up calls are subject to capital treatment that is consistent with the capital treatment for implicit support, the requirements related to disclosure are not explicit.

In order to remove any uncertainty in this regard, this Office proposes to amend the provisions of paragraph 11 of the Securitisation Exemption Notice, to state clearly that when the exercise of any clean-up call is found to serve as a credit enhancement, and the exercise of the clean-up call therefore constitutes a form of implicit support, the bank shall be subject to the relevant provisions of paragraph 4(3) of the Securitisation Exemption Notice, which sets out the capital and disclosure requirements relating to implicit support in detail.

- 6.2 Paragraphs 567, 573, 609 and 615 of the Basel II framework, read with the provisions of paragraph 90 of the Basel III framework, require that certain securitisation exposures be risk weighted at 1 250 per cent. The Basel framework does not make provision for any adjustment to the 1 250 per cent risk weight.

Currently the regulations that implement the requirements specified in the aforesaid paragraphs of the Basel II and Basel III frameworks require banks to apply a risk weight of 1 250 per cent, or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds.

For the sake of comparability between jurisdictions, and to fully align the requirements of the Regulations with the wording contained in paragraph 90 of the Basel III framework, this Office proposes to amend all the relevant regulations in the Regulations by deleting the phrase “or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds”, to state clearly that the relevant exposures shall be risk weighted at 1 250 per cent.

- 6.3 In terms of the provisions of paragraph 576 of the Basel II framework, in the case of eligible liquidity facilities where the conditions for use of external credit assessments are not met, the risk weight that should be applied to the exposure's credit equivalent amount is equal to the highest risk weight assigned to any of the underlying individual exposures covered by the facility.

Currently regulation 23(6)(h)(vii)(A)(ii) of the Regulations requires that the highest risk weight of the “senior commercial paper” covered by the liquidity facility be applied to such facilities.

In order to fully align the provisions of the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 23(6)(h)(vii)(A)(ii) of the Regulations to state clearly that in the case of eligible liquidity facilities where the conditions for use of external credit assessments are not met, the risk weight that has to be applied to the exposure's credit equivalent amount shall be the highest risk weight assigned to any of the underlying individual exposures covered by the facility.

- 6.4 It has further been noted that regulation 23(11)(f)(v) of the Regulations, which implements the requirements of paragraph 618(d) of the Basel II framework, incorrectly references the requirements for recognition of external ratings to regulation 23(6) of the Regulations instead of regulation 38(6) of the Regulations.

This Office proposes to amend the provisions of regulation 23(11)(f)(v) of the Regulations to correct this oversight.

- 6.5 Paragraph 632 of the Basel II framework requires that in the case of securitisation exposures arising from interest rate or currency swaps, a bank must incorporate potential future exposure in determining the thickness of exposure (T). The Basel II framework specifies that the potential future exposure add-on must be calculated using the current exposure method.

Regulation 23(11)(m) of the Regulations does not state clearly that the potential future exposure is to be calculated using the current exposure method.

In order to remove any uncertainty in this regard, this Office proposes to amend the provisions of regulation 23(11)(m) of the Regulations to state clearly that the potential future exposure shall be calculated using the current exposure method.

- 6.6 Paragraph 639 of the Basel II framework allows banks using the standard formula approach for liquidity facilities, when it is not practical to use either the bottom-up approach or the top-down approach for calculating  $K_{IRB}$ , to temporarily apply the highest standardised approach risk weight of the underlying exposures, subject to supervisory approval.

Regulation 23(11)(b)(xii)(D)(iii)(dd) of the Regulations includes the Basel II requirement but it does not specify that this treatment would be allowed only temporarily.

In order to remove any uncertainty in this regard, this Office proposes to amend the provisions of regulation 23(11)(b)(xii)(D)(iii)(dd) of the Regulations to state clearly that the aforesaid treatment would be allowed only temporarily.

## 7. Counterparty credit risk

- 7.1 Paragraph 92(i) of Annex 4 of the Basel II framework sets out the requirements for calculating replacement cost and an add-on under the current exposure method, and includes, among other things, notes on specific types of over-the-counter (OTC) derivatives. In particular, paragraph 92(i) of Annex 4 of the Basel II framework states that:

- For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
- For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on factor is subject to a floor of 0,5 per cent.

- Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns of this matrix are to be treated as “other commodities”.
- No potential future credit exposure would be calculated for single currency floating for floating interest rate swaps; thus the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

Currently regulation 23(17) of the Regulations does not include the aforesaid notes on specific types of OTC derivatives.

In order to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to incorporate the aforesaid notes into the provisions of regulation 23(17)(a) of the Regulations.

## **8. Operational risk - general aspects and standardised approaches**

- 8.1 Paragraph 663(e) of the Basel II framework states that in the case of a bank following the standardised approach (TSA) for operational risk, the bank's operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and of the operational risk management function.

Currently regulation 33(8)(b)(ii)(F) of the Regulations requires that the bank's operational risk management process has to be subject to regular independent review, but the regulation does not specifically require that the scope of the independent reviews includes both the activities of the business units and of the operational risk management function.

In order to remove any potential uncertainty, and to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 33(8)(b)(ii)(F) of the Regulations to state clearly that the scope of the independent reviews shall include both the activities of the business units and of the operational risk management function.

## **9. Operational risk - advanced measurement approaches**

- 9.1 Paragraph 656 of the Basel II framework states that a bank adopting the advanced measurement approach (AMA) may, with the approval of its host supervisors and the support of its home supervisor, use an allocation mechanism for the purpose of determining the regulatory capital requirement for internationally active banking subsidiaries that are not deemed to be significant relative to the overall banking group, but are themselves subject to the Basel II framework in accordance with Part 1 of the said framework. Supervisory approval would be conditional on the bank demonstrating to the satisfaction of the relevant supervisors that the allocation mechanism for these subsidiaries is appropriate and can be supported empirically. The board of directors and senior management of each subsidiary are responsible for conducting their own assessment of the subsidiary's operational risks and controls, and ensuring the subsidiary is adequately capitalised in respect of those risks.

Furthermore, paragraph 658 of the Basel II framework states that the appropriateness of the allocation methodology will be reviewed with consideration given to the stage of development of risk-sensitive allocation techniques and the extent to which it reflects the level of operational risk in the legal entities and across the banking group. Supervisors expect that AMA banking groups will continue efforts to develop increasingly risk-sensitive operational risk allocation techniques, notwithstanding initial approval of techniques based on gross income or other proxies for operational risk.

Currently the provisions of regulation 33(9)(c) of the Regulations state that when a bank wishes to apply an allocation mechanism in order to determine the capital requirements relating to operational risk for the bank's internationally active subsidiaries, the bank shall include in its application to the Registrar sufficient details, including details relating to the empirical process to calculate the capital requirements of the said subsidiaries, in order for the Registrar to determine the significance and risk profile of the said subsidiaries. However, the Regulations do not list the items to be reviewed by this Office when assessing the appropriateness of the allocation mechanism.

In order to remove any potential uncertainty, and to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 33(9)(c) of the Regulations to state clearly that the appropriateness of the allocation methodology will be reviewed with consideration at least being given to matters such as the stage of development of risk-sensitive allocation techniques and the extent to which it reflects the level of operational risk in the legal entities and across the banking group.

- 9.2 Paragraph 669(f) of the Basel II framework states that a bank needs to have a credible, transparent, well-documented and verifiable approach for weighting the fundamental elements in its overall operational risk measurement system. In all cases, the bank's approach for weighting the four fundamental elements should be internally consistent and avoid double counting of qualitative assessments or risk mitigants already recognised in other elements of the framework.

Currently these quantitative standards are not contained in regulation 33(9)(d) of the Regulations, but form part of this Office's SREP.

Nevertheless, in order to remove any potential uncertainty, and to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 33(9)(d) of the Regulations to state clearly that a bank shall have in place a credible, transparent, well-documented and verifiable approach for weighting the specified fundamental elements in its overall operational risk measurement system. In all cases, the bank's approach for weighting the four fundamental elements shall be internally consistent and avoid double counting of qualitative assessments or risk mitigants already recognised in other elements of the Regulations.

9.3 Paragraph 673 (bullet point 5) of the Basel II framework states that operational risk losses that are related to credit risk and have historically been included in banks' credit risk databases (e.g. collateral management failures) will continue to be treated as credit risk for the purposes of calculating minimum required capital under the Basel II framework. Therefore, such losses will not be subject to the operational risk capital requirement. Nevertheless, for the purposes of internal operational risk management, banks must identify all material operational risk losses consistent with the scope of the definition of operational risk (as set out in paragraph 644 and the loss event types outlined in Annex 9 of the Basel II framework), including those related to credit risk. Such material operational risk-related credit risk losses should be flagged separately within a bank's internal operational risk database. The materiality of these losses may vary between banks, and within a bank across business lines and event types. Materiality thresholds should be broadly consistent with those used by peer banks.

Furthermore, paragraph 673 (bullet point 6) of the Basel II framework states that operational risk losses that are related to market risk are treated as operational risk for the purposes of calculating minimum required capital under the Basel II framework and will therefore be subject to the operational risk capital requirement.

Currently regulation 33(9)(d)(v)(B) of the Regulations refers to the collection of loss data but does not include the above requirements, which form part of this Office's SREP.

Nevertheless, in order to remove any potential uncertainty, and to fully align the provisions of the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 33(9)(d)(v)(B) of the Regulations to state clearly that:

- operational risk losses that are related to credit risk and have historically been included in banks' credit risk databases (e.g. collateral management failures) will continue to be treated as credit risk for the purposes of calculating minimum required capital and reserve funds in terms of the Regulations. Therefore, such losses shall not be subject to the operational risk capital requirement;
- material operational risk-related credit risk losses shall be flagged separately within the bank's internal operational risk database; and
- operational risk losses that are related to market risk shall be treated as operational risk for the purposes of calculating minimum required capital and reserve funds in terms of the Regulations, and shall therefore be subject to the operational risk capital requirement.

## 10. Market risk - standardised measurement method

10.1 Paragraph 712(iv) of the revisions to the Basel II market risk framework states that the specific risk capital requirements for positions covered under the standardised approach for securitisation exposures are defined in the table below. These charges must be applied by banks using the standardised approach for credit risk. For positions with long-term ratings of B+ and below and short-term ratings other than A-1/P-1, A-2/P-2, A-3/P-3, deduction from capital as defined in paragraph 561 of the Basel II framework is required. Deduction is also required for unrated positions with the exception of the circumstances described in paragraphs 571 to 575 of the Basel II framework.

Paragraph 561 of the Basel II framework states that when a bank is required to deduct a securitisation exposure from regulatory capital, the deduction must be taken 50 per cent from tier 1 and 50 per cent from tier 2, with the one exception noted in paragraph 562 of the Basel II framework.

Subsequently paragraph 90 of the Basel III framework amended the requirements related to deduction, and now requires that specific securitisation exposures, which were deducted 50 per cent from tier 1 and 50 per cent from tier 2 (or had the option of being deducted or risk weighted) under the Basel II framework, will now be assigned a risk weight of 1 250 per cent. The Basel III framework makes no provision for deviating from the 1 250 per cent risk weight.

Table 2 of regulation 28(7)(b)(ii)(C) of the Regulations prescribes that a bank shall in respect of securitisation or resecuritisation exposures with a long-term rating below BB-, or that are unrated, and securitisation or resecuritisation exposures with a short-term rating below A-3/P-3, or that are unrated, maintain a specific risk capital requirement of 100 per cent, that is, 1 250 per cent risk weight multiplied with 8 per cent capital adequacy ratio, or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds.

In order to remove any potential uncertainty, and to fully align the provisions of the Regulations with the requirements specified in the Basel III framework, this Office proposes to amend the provisions of table 2 of regulation 28(7)(b)(ii)(C) of the Regulations by deleting footnote 2, which states “or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds”, thereby ensuring that banks maintain a specific risk capital requirement of 100 per cent, that is, 1 250 per cent risk weight multiplied with 8 per cent capital adequacy ratio, in respect of securitisation or resecuritisation exposures with a long-term rating below BB-, or that are unrated, and securitisation or resecuritisation exposures with a short-term rating below A-3/P-3, or that are unrated.

- 10.2 Paragraph 718(xxi) of the Basel II framework states, among other things, that the capital requirement for specific risk will be 8 per cent, unless the portfolio is both liquid and well-diversified, in which case the requirement will be 4 per cent. The general market risk requirement is 8 per cent.

Subsequently, the requirements of paragraph 718(xxi) of the Basel II framework were revised by deleting the phrase “unless the portfolio is both liquid and well-diversified, in which case the requirement will be 4 per cent”, and the revised paragraph 718(xxi) of the Basel II framework now states that the capital requirement for specific risk and for general market risk will each be 8 per cent.

Furthermore, paragraph 718(xxv) of the Basel II framework states, among other things, that besides general market risk, a further capital requirement of 2 per cent will apply to the net long or short position in an index contract. This capital requirement is intended to cover factors such as execution risk.

Regulation 28(7)(c)(ii) of the Regulations correctly imposes a minimum specific risk capital requirement of 8 per cent. However, in respect of the net long or short position relating to an index contract, the provisions of regulations 28(7)(c)(v)(B)(ii) and 28(7)(c)(v)(C) of the Regulations incorrectly still refer to the application of a 4 per cent capital requirement.

In order to fully align the Regulations with the requirements specified in the revised Basel II framework, this Office proposes to amend the provisions of regulations 28(7)(c)(v)(B)(ii) and 28(7)(c)(v)(C) of the Regulations to require that, in respect of the net long or short position relating to an index contract, banks maintain a specific risk capital requirement of 8 per cent in addition to the general market risk requirement of 8 per cent and the further capital requirement of 2 per cent to cover factors such as execution risk.

## **11. Market risk - internal models approach**

- 11.1 Paragraph 718(Lxxxv) of the Basel II framework requires, among other things, that the accuracy of a bank’s internal model has to be subject to external validation. The validation of models’ accuracy by external auditors or supervisory authorities should at a minimum include specific steps.

While the provisions of regulation 28(8)(g) of the Regulations incorporate the requirements of paragraph 718(Lxxxv) of the Basel II framework substantively, regulation 28(8)(g) of the Regulations states that from time to time the Registrar may require that a process of external validation be conducted in respect of the accuracy of the models of a bank that obtained the approval of the Registrar to adopt the internal models approach for the measurement of the bank’s exposure to market risk, which may create an impression that the accuracy of a bank’s internal model will only be subject to external validation when requested by the Registrar.

In order to remove any potential uncertainty, and to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 28(8)(g) of the Regulations to state clearly that the authority granted to the Registrar to require that a process of external validation be conducted in respect of the accuracy of the bank's models does not in any way derogate from the general requirement imposed on banks that wish to obtain the approval of the Registrar to adopt the internal models approach to measure their exposure to market risk to ensure that the accuracy of their internal models is subject to external validation.

- 11.2 Paragraph 718(cii) of the revisions to the Basel II market risk framework requires that banks must establish and maintain adequate systems and controls sufficient to give management and supervisors the confidence that their valuation estimates are prudent and reliable. Such systems must include specific items, including procedures for adjusting valuations, end-of-the-month and ad hoc verification procedures, which may be of particular relevance in the case of illiquid positions.

While the provisions of regulation 39(13)(a) of the Regulations incorporate the requirements of paragraph 718(cii) of the revisions to the Basel II market risk framework and the enhancements to the Basel II framework substantively, regulation 39(13)(a) of the Regulations does not include the specific requirements relating to procedures for adjusting valuations, end-of-the-month and ad hoc verification procedures as envisaged in paragraph 718(cii) of the revisions to the Basel II market risk framework.

In order to remove any potential uncertainty, and to fully align the Regulations with the requirements specified in the revisions to the Basel II market risk framework, this Office proposes to amend the provisions of regulation 39(13)(a) of the Regulations to state clearly that:

- a bank shall establish and maintain adequate systems and controls sufficient to give the bank's board of directors, senior management and the Registrar the confidence that the bank's valuation estimates are prudent and reliable; and
- the aforesaid systems shall include documented policies and procedures for the process of valuation, including procedures for adjusting valuations, end-of-the-month and ad hoc verification procedures.

- 11.3 Paragraph 718(cix) of the revisions to the Basel II market risk framework states that supervisory authorities expect the following valuation adjustments or reserves to be formally considered at a minimum: unearned credit spreads, closeout costs, operational risks, early termination, investing and funding costs, and future administrative costs and, where appropriate, model risk.

While the provisions of regulation 39(13) of the Regulations incorporate the requirements of paragraph 718(cix) of the revisions to the Basel II market risk framework substantively, regulation 39(13) of the Regulations does not include the specific requirement that, as a minimum, the following valuation adjustments or reserves have to be formally considered: unearned credit spreads, closeout costs, operational risks, early termination, investing and funding costs, and future administrative costs and, where appropriate, model risk as envisaged in paragraph 718(cix) of the revisions to the Basel II market risk framework.

In order to remove any potential uncertainty, and to fully align the Regulations with the requirements specified in the revisions to the Basel II market risk framework, this Office proposes to amend the provisions of regulation 39(13)(c) of the Regulations to state clearly that, as a minimum, a bank shall formally consider the following valuation adjustments or reserves: unearned credit spreads, closeout costs, operational risks, early termination, investing and funding costs, and future administrative costs and, where appropriate, model risk.

- 11.4 Paragraph 718(cxii) of the revisions to the Basel II market risk framework states that the adjustment to the current valuation of less liquid positions made under paragraph 718 (cxi) must impact tier 1 regulatory capital and may exceed those valuation adjustments made under financial reporting accounting standards and paragraphs 718 (cviii) and 718 (cix) of the revised framework.

The requirement specified in paragraph 718(cxii) of the revisions to the Basel II market risk framework was not incorporated into the Regulations.

In order to fully align the Regulations with the requirements specified in the revisions to the Basel II market risk framework, this Office proposes to amend the provisions of regulation 39(13)(c) of the Regulations to state clearly that a bank shall ensure that any relevant adjustment to the current valuation of less liquid positions is duly reflected in the bank's common equity tier 1 capital and unimpaired reserve funds, which adjustment may exceed the valuation adjustments made under any relevant financial reporting standard, provided that in the case of complex products, including but not limited to securitisation exposures and n-th-to-default credit derivatives, the bank shall explicitly assess the need for valuation adjustments to reflect the model risk associated with using a possibly incorrect valuation methodology, and the risk associated with using unobservable (and possibly incorrect) calibration parameters in the valuation model.

## 12. Pillar 2 of the Basel II framework

12.1 Paragraph 738(ii) of the Basel II framework requires that banks must supplement their value-at-risk (VaR) model with stress tests (factor shocks or integrated scenarios whether historic or hypothetical) and other appropriate risk management techniques. In the bank's internal capital assessment it must demonstrate that it has enough capital to not only meet the minimum capital requirements, but also to withstand a range of severe but plausible market shocks. In particular, it must factor in, where appropriate:

- illiquidity/gapping of prices;
- concentrated positions (in relation to market turnover);
- one-way markets;
- non-linear products and deep out-of-the money positions;
- events and jumps-to-defaults;
- significant shifts in correlations; and
- other risks that may not be captured appropriately in VaR (e.g. recovery rate uncertainty, implied correlations, or skew risk).

Currently neither regulation 28(8) nor regulation 39(14) of the Regulations specifies an exact list of requirements concerning stress tests for VaR-based internal models for measuring the bank's required capital and reserve funds for market risk, since the BSD assesses the robustness and adequacy of the bank's stress tests as part of its SREP.

Nevertheless, in order to remove any potential uncertainty, and to fully align the Regulations with the requirements specified in the Basel II framework, this Office proposes to amend the provisions of regulation 39(14) of the Regulations to state clearly that in the bank's internal capital assessment it shall demonstrate to the satisfaction of the Registrar that it has enough capital to not only meet the minimum capital requirements, but also to withstand a range of severe but plausible market shocks. In particular, and as a minimum, the bank shall demonstrate to the satisfaction of the Registrar that it factors in, where appropriate:

- illiquidity/gapping of prices;
- concentrated positions (in relation to market turnover);
- one-way markets;
- non-linear products and deep out-of-the money positions;
- events and jumps-to-defaults;
- significant shifts in correlations;
- other risks that may not be captured appropriately in VaR (e.g. recovery rate uncertainty, implied correlations, or skew risk).

**13. Directives, circulars and guidance notes to be updated**

13.1 In order to ensure that all directives, circulars and guidance notes remain relevant and current, the BSD will make the relevant amendments to and replace the directives, circulars and guidance notes specified below:

- Directive 8/2013, dated 7 June 2013;
- Directive 12/2013, dated 2 August 2013;
- Directive 10/2014, dated 10 December 2014;
- Banks Act Circular 2/2013, dated 28 January 2013;
- Banks Act Circular 4/2013, dated 20 May 2013; and
- Guidance Note 7/2014, dated 23 July 2014.

**14. Directive**

14.1 Based on the aforesaid, and in accordance with the provisions of section 6(6) of the Banks Act 94 of 1990, banks are hereby directed as follows:

14.1.1 in all relevant cases to continue to complete the form BA 600 on an aggregated basis as envisaged in and based on the relevant directives specified in regulation 36 of the Regulations and, in addition, to continue to complete the form BA 700 on a consolidated basis as envisaged in and based on the relevant directives specified in regulation 38 of the Regulations;

14.1.2 to note that an amendment to regulation 36(10)(d) of the Regulations will be effected soon to delete the current enabling provision related to surplus capital from insurance entities, and the related wording from all other relevant or related regulations, subregulations or prescribed returns in the Regulations, including line item 11, columns 1 to 4 of the form BA 600, and any relevant disclosure requirements;

14.1.3 to note that an amendment to regulation 38(13)(a) of the Regulations will be effected soon to delete the word “instrument” from the provisions of regulation 38(13)(a) of the Regulations, and as such banks shall ensure that only common shares or ordinary shares that comply with the relevant requirements specified in the Banks Act and the Regulations are included in common equity tier 1 capital;

14.1.4 to note that an amendment to the definition of common equity tier 1 unimpaired reserve funds in section 1(1) of the Banks Act will be effected to delete the word “instrument” from the said definition in section 1(1) of the Banks Act;

14.1.5 in all relevant cases, unless the context clearly states otherwise, to interpret the phrase “common equity tier 1” or any relevant derivative thereof, as the sum of common equity tier 1 capital and common equity tier 1 unimpaired reserve funds.

In this regard, for example, the reference to common equity tier 1 capital in the regulations, subregulations or items specified below, means the sum of common equity tier 1 capital and common equity tier 1 unimpaired reserve funds:

- BA 700 line items 95 and 188;
- Regulation 38(5)(a)(i)(D);
- Regulation 38(5)(a)(i)(F);
- Regulation 38(5)(a)(i)(H)(iii);
- Regulation 38(5)(a)(i)(L)(iv);
- Regulation 38(5)(a)(i)(L)(v);
- Regulation 38(5)(a)(ii)(C);
- Regulation 38(5)(b)(iii)(A);
- Regulation 38(5)(b)(iii)(C);
- Regulation 38(5)(b)(iii)(D);
- Regulation 38(11);
- Regulation 38(11)(a);
- Regulation 38(16)(a);
- Regulation 38(16)(a)(ii);
- Regulation 38(16)(a)(ii)(A);
- Regulation 38(16)(a)(ii)(A)(i);
- Regulation 38(16)(a)(ii)(A)(ii);
- Regulation 38(16)(a)(ii)(B);
- Regulation 38(16)(c);
- Regulation 38(19), line item 40;
- Regulation 43(2)(c)(ii)(B)(i)(ff); and
- Regulation 43(2)(c)(ii)(B)(i)(gg);

14.1.6 to note that in the definition of additional tier 1 capital, in section 1(1) of the Banks Act, the word “shares” will be substituted with the words “shares or debt instruments”;

14.1.7 to note that in respect of Table 7 in regulation 23(6)(j) of the Regulations, on page 117 of the Regulations, an amendment will be effected soon to delete footnote 1, that is, banks shall be required to risk weight the relevant exposures at 1 250 per cent.

The amendment shall also apply to all other related or consequential references in regulations or subregulations that refer to Table 7 in regulation 23(6)(j) of the Regulations, in terms of which the relevant exposure shall be risk weighted at 1 250 per cent;

14.1.8 to note that in respect of regulation 23(11)(b)(xii)(D)(v) of the Regulations, on page 201 of the Regulations, an amendment will be effected soon to delete the phrase “or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds”;

14.1.9 to note that in respect of regulation 23(11)(q) of the Regulations, an amendment will be effected soon to delete the phrase “or such imputed percentage that effectively results in a risk weighted exposure amount equivalent to a deduction against capital and reserve funds”, and as such banks shall be required to assign to the relevant exposure a risk weight of 1 250 per cent;

14.1.10 to note that in respect of Table 14 in regulation 23(11)(q) of the Regulations, on page 266 of the Regulations, an amendment will be effected soon to delete footnote 1, and as such banks shall be required to assign to the relevant exposure a risk weight of 1 250 per cent.

The amendment shall also apply to all other related or consequential references in regulations or subregulations that refer to table 14 in regulation 23(11)(q) of the Regulations, in terms of which the relevant exposure shall be risk weighted at 1 250 per cent;

14.1.11 to note that in respect of regulation 31(6)(c)(viii) of the Regulations an amendment will be effected soon to delete the phrase “...or the relevant imputed percentage equivalent to a deduction from the bank’s capital and reserve funds, provided that instead of adding to the bank’s risk weighted exposure amount the said equity exposure amount, the reporting bank may deduct from its common equity tier 1 capital and reserve funds the relevant equity exposure amount, which amount shall in the case of the said deduction approach be deemed to represent the expected loss amount relating to the said equity exposure ...”;

14.1.12 to note that in respect of proviso (ii) of regulation 23(20)(b)(ii) of the Regulations, an amendment will be effected soon to delete the phrase “...deduct from its common equity tier 1 capital and reserve funds the full amount of value transferred plus any relevant replacement cost until the said second payment or delivery leg is effectively made...”, and as such banks shall be required to assign to the full amount of value transferred plus any relevant replacement cost a risk weight of 1 250 per cent;

14.1.13 to note that in respect of Table 2 of regulation 28(7)(b)(ii)(C) of the Regulations, an amendment will be effected soon to delete footnote 2, which states “or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds”, that is, the bank shall be required to maintain a specific risk capital requirement of 100 per cent (1 250 per cent risk weight multiplied with 8 per cent capital adequacy ratio), in respect of any securitisation or resecuritisation exposures with a long-term rating below BB-, or that are unrated, and any securitisation or resecuritisation exposures with a short-term rating below A-3/P-3, or that are unrated;

14.1.14 to note that in relation to any other relevant exposure envisaged in the Regulations, not included in paragraphs 14.1.7 to 14.1.13 above, in respect of which the bank is required to risk weight the relevant exposures at 1 250 per cent or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds, amendments will be effected to the relevant regulations soon to delete the phrase “or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital and reserve funds”, and as such banks shall be required to risk weight the relevant exposures at 1 250 per cent.

In this regard, for example, the provisions of this paragraph 14.1.14 shall apply to the relevant exposures envisaged in the regulations specified below, in respect of which the bank shall be required to apply a risk weight of 1 250 per cent:

- regulation 23(6)(h) Table 3;
- regulation 23(6)(h)(iii)(B)(ii);
- regulation 23(6)(j) Table 7;
- regulation 23(9)(d)(ii)(C)(i) Table 11;
- regulation 23(9)(d)(ii)(C)(ii);
- regulation 23(11)(b)(xii)(D)(iii)(ee);
- regulation 23(11)(b)(xii)(D)(v);
- regulation 23(11)(e) Tables 12 and 13;
- regulation 23(11)(q);
- regulation 23(15)(d)(viii);
- regulation 23(15)(e)(ii);
- regulation 28(7)(b)(ii)(C)(iii)(cc)(ii);
- regulation 28(7)(b)(ii)(C)(v); and
- regulation 31(6)(c)(viii);

14.1.15 to note that in respect of Table 7 in regulation 23(6)(j) and Table 8 in regulation 23(8)(a) of the Regulations, an amendment will be effected soon to specify that a bank shall apply the preferential risk weight of 20 per cent only when the relevant claim on a bank is denominated and funded in Rand;

14.1.16 to note that in respect of Table 7 in regulation 23(6)(j) and Table 8 in regulation 23(8)(a) of the Regulations, an amendment will be effected soon to specify that a bank shall apply the preferential risk weight of 20 per cent only when the relevant claim on a securities firm is denominated and funded in Rand;

14.1.17 in all relevant cases in regulation 23(11)(c)(iv)(A)(iii) of the Regulations, the bank shall ensure that the total exposure of the banking group to the relevant small business borrower is determined or calculated on a consolidated basis for that small business borrower;

- 14.1.18 in all relevant cases in regulation 23(11)(c)(iv)(B)(ii)(ee) of the Regulations, the bank shall ensure that the use of the QRRE risk weight function is limited to portfolios that have exhibited low volatility of loss rates, relative to their average level of loss rates;
- 14.1.19 to note that in respect of regulation 23(11)(d)(ii)(C) of the Regulations, an amendment will be effected soon to substitute the phrase “the Registrar may specify in writing a different threshold amount or base, such as assets instead of sales”, with the phrase “the Registrar may specify in writing a different threshold amount and/or specify in writing to substitute sales for assets as the base”;
- 14.1.20 in respect of regulation 23(11)(b)(v)(D)(i) of the Regulations, the bank shall ensure that it also explicitly addresses any relevant cross-collateral provision where present;
- 14.1.21 in respect of regulation 23(11)(b)(v)(B)(i)(aa) of the Regulations, the bank shall ensure that significant concentrations within a single grade or grades are supported by convincing empirical evidence that the grade or grades cover reasonably narrow PD bands and that the default risk posed by all borrowers in a grade fall within that band;
- 14.1.22 in respect of regulation 23(11)(b)(v)(I) of the Regulations, when the bank does not use the same estimates for both IRB and internal purposes, the bank shall document such differences and demonstrate their reasonableness to the BSD;
- 14.1.23 to note that in respect of regulations 23(11)(b)(ii) and 23(13)(b)(ii) of the Regulations an amendment will be effected soon to delete the phrase “or such lesser minimum period as may be specified in writing by the Registrar”;
- 14.1.24 in respect of regulation 23(13)(b)(ii) of the Regulations, in addition to compliance with the relevant minimum requirements relating to PD specified in regulation 23(11) of the Regulations, advanced IRB banks shall be broadly in compliance with the relevant minimum requirements relating to own estimates of LGDs and EADs specified in regulation 23(13) of the Regulations, for at least the three years prior to qualification;
- 14.1.25 to note that in respect of regulation 23(11)(b)(vi)(A)(i)(cc) of the Regulations, an amendment will be effected soon to substitute the reference to regulation 23(11)(b)(v)(G) of the Regulations with the reference to regulation 23(11)(b)(v)(H) of the Regulations;
- 14.1.26 in respect of paragraph 11 of the Securitisation Exemption Notice, when the exercise of any clean-up call is found by the Registrar to serve as credit enhancement, and the exercise of the clean-up call therefore constitutes a form of implicit support, the bank shall be subject to the capital and disclosure requirements relating to implicit support set out in paragraphs 4(3) and 5(3) of the Securitisation Exemption Notice;

- 14.1.27 to note that in respect of regulation 23(6)(h)(vii)(A)(ii) of the Regulations, in the case of eligible liquidity facilities where the conditions for use of external credit assessments are not met, an amendment will be effected soon to delete the reference to “senior commercial paper” and require from banks to apply to the relevant exposure’s credit equivalent amount the highest risk weight assigned to any of the underlying individual exposures covered by the facility;
- 14.1.28 to note that in respect of regulation 23(11)(f)(v) of the Regulations, an amendment will be effected soon to substitute the reference to regulation 23(6) of the Regulations with a reference to regulation 38(6) of the Regulations;
- 14.1.29 in respect of regulation 23(11)(m) of the Regulations, a bank shall calculate the potential future exposure in accordance with the relevant provisions of the current exposure method, specified in regulation 23(17) of the Regulations;
- 14.1.30 in respect of regulation 23(11)(b)(xii)(D)(iii)(dd) of the Regulations, when it is not practical to use either the bottom-up approach or the top-down approach for calculating  $K_{IRB}$ , the bank may, subject to the prior written approval of and such conditions as may be specified in writing by the Registrar, which approval shall be granted only on a temporary basis, apply the highest standardised approach risk weight of the underlying exposures;
- 14.1.31 in relation to the application of the current exposure method as envisaged in regulation 23(17)(a) of the Regulations:
- for contracts with multiple exchanges of principal, the bank shall multiply the factors by the number of remaining payments in the contract;
  - for contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity shall be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the specified criteria, the add-on factor shall be subject to a floor of 0,5 per cent;
  - forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns of the relevant specified matrix shall be treated as “other commodities”; and
  - the bank shall not calculate a potential future credit exposure for single currency floating for floating interest rate swaps, but shall evaluate the credit exposure on these contracts solely on the basis of the relevant mark-to-market value;
- 14.1.32 in respect of regulation 33(8)(b)(ii)(F) of the Regulations, a bank shall ensure that the scope of the independent reviews shall include both the activities of the business units and of the relevant operational risk management function;

- 14.1.33 in respect of regulation 33(9)(c) of the Regulations, the appropriateness of the allocation methodology shall be assessed by this Office with consideration at least being given to matters such as the stage of development of risk-sensitive allocation techniques and the extent to which it reflects the level of operational risk in the legal entities and across the relevant banking group;
- 14.1.34 in respect of regulation 33(9)(d) of the Regulations, a bank shall have in place a credible, transparent, well-documented and verifiable approach for weighting the specified fundamental elements in its overall operational risk measurement system. In all cases, the bank's approach for weighting the four fundamental elements shall be internally consistent and avoid double counting of qualitative assessments or risk mitigants already recognised in other elements of the Regulations;
- 14.1.35 in respect of regulation 33(9)(d)(v)(B) of the Regulations, the bank shall ensure that:
- operational risk losses that are related to credit risk and have historically been included in banks' credit risk databases (e.g. collateral management failures) continue to be treated as credit risk for the purposes of calculating minimum required capital and reserve funds in terms of the Regulations, that is, such losses shall not be subject to the operational risk capital requirement;
  - material operational risk-related credit risk losses are flagged separately within the bank's internal operational risk database; and
  - operational risk losses that are related to market risk are treated as operational risk for the purposes of calculating minimum required capital and reserve funds in terms of the Regulations, and shall therefore be subject to the operational risk capital requirement;
- 14.1.36 to note that in relation to regulations 28(7)(c)(v)(B)(ii) and 28(7)(c)(v)(C) of the Regulations, an amendment will be effected soon to require banks to maintain a specific risk capital requirement of 8 per cent in addition to the general market risk requirement of 8 per cent and the further capital requirement of 2 per cent to cover factors such as execution risk, in respect of the relevant net long or short position relating to the relevant index contract;
- 14.1.37 in relation to regulation 28(8)(g) of the Regulations, the authority granted to the Registrar to require that a process of external validation be conducted in respect of the accuracy of the bank's models does not in any way derogate from the general requirement imposed on banks that wish to obtain the approval of the Registrar to adopt the internal models approach to measure their exposure to market risk to ensure that the accuracy of their internal models is subject to a process of robust external validation;

14.1.38 in relation to regulation 39(13) of the Regulations:

- a bank shall establish and maintain robust systems and controls sufficient to give the bank's board of directors, senior management and the Registrar the confidence that the bank's valuation estimates are prudent and reliable, provided that the aforesaid systems shall include documented policies and procedures for the process of valuation, including procedures for adjusting valuations, end-of-the-month and ad hoc verification procedures; and
- as a minimum, a bank shall formally consider the following valuation adjustments or reserves: unearned credit spreads, closeout costs, operational risks, early termination, investing and funding costs, and future administrative costs and, where appropriate, model risk;

14.1.39 in relation to regulation 39(13)(c) of the Regulations, the bank shall ensure that any relevant adjustment to the current valuation of less liquid positions is duly reflected in the bank's common equity tier 1 capital and unimpaired reserve funds, which adjustment may exceed the valuation adjustments made under any relevant financial reporting standard, provided that in the case of complex products, including but not limited to securitisation exposures and n-th-to-default credit derivatives, the bank shall explicitly assess the need for valuation adjustments to reflect the model risk associated with using a possibly incorrect valuation methodology, and the risk associated with using unobservable (and possibly incorrect) calibration parameters in the valuation model;

14.1.40 in relation to regulation 39(14) of the Regulations, the bank shall demonstrate to the satisfaction of the Registrar that it has enough capital to not only meet the relevant specified minimum capital requirements, but also to withstand a range of severe but plausible market shocks. In particular, and as a minimum, the bank shall demonstrate to the satisfaction of the Registrar that it factored in, where appropriate:

- illiquidity/gapping of prices;
- concentrated positions (in relation to market turnover);
- one-way markets;
- non-linear products and deep out-of-the money positions;
- events and jumps-to-defaults;
- significant shifts in correlations; and
- other risks that may not be captured appropriately in VaR (e.g. recovery rate uncertainty, implied correlations, or skew risk);

14.2 This Office will continue to engage banks during 2015 to ensure full compliance with the relevant directives specified in this Directive.

14.3 Should a bank be unable to comply with any of the relevant directives specified in this Directive, the bank shall, in accordance with the provisions of regulation 5 of the Regulations, report its inability to comply in writing to the Registrar, stating the reasons for such failure or inability to comply.

**15. Acknowledgement of receipt**

- 15.1 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.



René van Wyk  
**Registrar of Banks**

The previous directive issued was Directive 3/2015, dated 24 March 2015.