South African Reserve Bank

Prudential Authority

Ref: 15/8/3

D2/2018

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

Directive issued in terms of section 6(6) of the Banks Act 94 of 1990

Materiality threshold in respect of exposure to a foreign jurisdiction in applying jurisdictional reciprocity in the countercyclical capital buffer calculation

Executive summary

With effect from 1 January 2016, all countercyclical capital buffers (CCyBs) implemented by members of the Basel Committee on Banking Supervision (BCBS), and by non-member countries, should be incorporated into a weighted average CCyB calculation based on jurisdictional reciprocity[1]. Reciprocity ensures that the application of the CCyB in each jurisdiction does not distort the level playing field between domestic banks and foreign banks with exposures to counterparties in the same jurisdiction.

Through this process, credit exposures to a private sector entity located in any given jurisdiction will attract the same capital buffer requirement, irrespective of the location of the bank providing the credit. The Prudential Authority (PA) is committed to the implementation of the Basel III requirements relating to reciprocity. However, the PA acknowledges the potential regulatory and public reporting burden of transactions regarded as immaterial and the related accounting and auditing thereof.

The purpose of this directive is to direct banks, branches of foreign institutions and controlling companies (hereinafter collectively referred to as 'banks') to apply a materiality threshold in the calculation of a bank's exposures to foreign jurisdictions in respect of which reciprocity must be applied.

1. Introduction

1.1 Reciprocity is important to limit cross-border leakages and to ensure a level playing field between internationally active banks. Reciprocity is a minimum requirement for BCBS members and the PA is committed to upholding the related requirements.

[1] Available online at: https://www.bis.org/bcbs/ccyb/index.htm

1.2 The CCyB calculation and implementation methodology is set out in regulation 38(8)(g)(v) of the Regulations relating to Banks and further expanded upon in Circular 8/2015 issued in terms of section 6(4) of the Banks Act 94 of 1990. However, subsequently, it was found that reciprocity adds a degree of administration and complexity, especially if non-zero CCyB rates become more commonly used and change across jurisdictions over time.

1.3 As such, a materiality threshold is specified.

2. Directive

2.1 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 to calculate at least on a quarterly basis, the required CCyB by allocating exposures to the relevant jurisdictions based on the following specified thresholds:

2.1.1 When risk-weighted assets (RWA) relating to private sector credit exposures[2] to a foreign jurisdiction amount to 2% or more of the total RWA relating to private sector credit exposures of the bank, then those exposures are treated as foreign exposures and are allocated to that specific foreign jurisdiction when the bank calculates its CCyB requirements.

2.1.2 When RWA on private sector credit exposures to a foreign jurisdiction amount to less than 2% of total RWA relating to private sector credit exposures, those exposures shall be treated as local (home jurisdiction) exposures for the purposes of calculating CCyB requirements. This implies that the calculation will use individual foreign jurisdiction-specific RWA relating to private sector credit exposures as a percentage of total RWA relating to private sector credit exposures.

2.1.3 However, when the aggregate amount of all RWA on private sector credit exposures to foreign jurisdictions individually amounting to less than 2% of total RWA relating to private sector credit exposures, amount to 10% or more of the total RWA relating to private sector credit exposures of the bank, the bank must include in its calculation the countercyclical buffer add-on in respect of the three most significant foreign jurisdiction exposures where the foreign jurisdictions have a CCyB requirement in place. The remaining foreign jurisdiction exposures which are considered insignificant are allocated to the home jurisdiction exposures.

2.2 The aforementioned thresholds shall apply to bank-wide total RWA relating to private sector credit exposures as used in the calculation of all risk-based capital ratios. The materiality thresholds in this directive shall be applied at a bank solo, consolidated bank, consolidated controlling company and foreign entity level. Please refer to Annexure A of this directive for examples on the implementation of the aforementioned requirements.

2.3 In line with the BCBS document titled *"Pillar 3 disclosure requirements – consolidated and enhanced framework"* dated March 2017, the methodology for geographical allocation used as well as the use of materiality thresholds must be disclosed by banks in Template CCyB1 as contained in the aforementioned BCBS document.

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[2] As defined: https://www.bis.org/bcbs/publ/d339.htm

3. Acknowledgement of receipt

3.1 Kindly ensure that a copy of this directive is made available to 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 the PA at the earliest convenience of the aforementioned signatories.

Kuben Naidoo
Deputy Governor and CEO: Prudential Authority

Date: 13 August 2018

Encl. 1

The previous directive issued was Directive 1/2018 dated 18 April 2018.

Annexure A

Simplified examples on the application of the materiality thresholds

When RWA on all foreign jurisdiction exposures amount to less than 10% of total bank-wide RWA

Example 1: Applying the 2% threshold – Foreign jurisdiction RWA (credit private sector, including trading book specific risk) is less than 2% of total RWA (relating to credit private sector and trading book specific risk)

Bank A, a local bank, has total risk weighted assets (RWA) of R1 000 000, consisting of:

- R890 000 – private sector credit RWAs
- R10 000 market risk – specific risk RWAs
- R100 000 operational risk RWA

The countercyclical buffer (CCyB) threshold is based on the total RWA relating to private sector credit and trading book specific risk ("Total RWA"). In the current example, this totals R900 000.

Bank A has exposures to the following jurisdictions that have implemented CCyB:

- Sweden (CCyB add-on 2%): Total RWA of R 15 000 or **1.7%** of the total RWA.
- UK (CCyB add-on 0.5%): Total RWA of R 10 000 or **1.1%** of the total RWA.

In this case, total RWA relating to private sector credit exposures in foreign jurisdictions amount to R 25 000 or 2.81%, which is less than 10% of total RWA.

Furthermore, the RWA relating to private sector credit exposures in each foreign jurisdiction are measured individually against the total RWA and are not to be aggregated to determine if the foreign exposures are less than the 2% threshold.

The RWA relating to private sector credit exposures in Sweden are 1.7% (that is, less than 2%) of total RWA of Bank A. Therefore, the RWA relating to private sector credit exposures in Sweden must be allocated to the home jurisdiction. This means that the CCyB requirement as announced in Sweden would not form part of the weighted average CCyB rate, as the Swedish private sector credit exposures will attract the home jurisdiction CCyB requirement (where/when applicable). The private sector credit exposures in the United Kingdom will be treated similarly.

As a result, all the Swedish and United Kingdom private sector non-bank exposures[1] must be allocated to South Africa and South Africa's CCyB requirement, which may be more than zero at that time, must be imputed in the calculation of the weighted average CCyB rate.

[1] The term "private sector credit exposures" is defined in Banks Act Circular 8 of 2015.

Example 2: Applying the 2% threshold – Foreign jurisdiction RWA is more than 2%

Bank A, a local bank, has total risk weighted assets (RWA) of R1 000 000, consisting of:

- R890 000 – private sector credit RWAs
- R10 000 market risk – specific risk RWAs
- R100 000 operational risk RWA

The CCyB threshold is based on the Total RWA. In the current example, this totals R900 000.

Bank A has private sector credit exposures to the following jurisdiction that has implemented a CCyB requirement:

- Sweden (CCyB add-on 2%): Total RWA of R 22 000 or 2.4% of the total RWA.

The ratio of RWAs relating to private sector credit exposures in Sweden to total RWAs is more than 2%. Sweden would be viewed as a material jurisdiction, above the threshold. The CCyB add-on must then be applied as announced in Sweden and not the home jurisdiction.

The CCyB add-on is calculated as:

CCyB add-on rate of foreign jurisdiction x (private sector credit exposures in foreign jurisdiction)

(Total private sector credit exposures of Bank A)

= 2% x R22 000/R900 000
= 2% x 2.4%
= 0.049%

Weighted CCyB is added to the minimum capital requirement (%)[2], and applied to the Total RWA (including all risk types).

When the total RWA on all foreign jurisdiction exposures amount to 10% or more of the total bank-wide RWA

Example 3: Applying the 10% threshold

Bank A, a local bank, has total RWA of R 10 000 000 consisting of:

- R 8 900 000 – private sector credit RWAs
- R 100 000 – market risk-specific RWAs
- R 1 000 000 – operational RWAs

Bank A has private sector credit exposures to foreign jurisdictions as follows:

[2] Minimum capital requirement as per capital framework. Total RWA includes all Pillar 1 risk types as per the submitted BA700.

- All foreign jurisdictions (individually less than 2%): Total RWA of R 1 023 500 or 11.5% of total RWA relating to private sector credit exposures, which includes exposures in the following jurisdictions:

    - Sweden (CCyB add-on 2%): Total RWA of R 150 000 or 1.7% of the total RWA relating to private sector credit exposures.
    - Germany (CCyB add-on 0%): Total RWA of R 160 200 or 1.8% of total RWA relating to private sector credit exposures.
    - Hong-Kong (CCyB add-on 1,875%): Total RWA of R 169 100 or 1.9% of total RWA relating to private sector credit exposures.

The three most significant exposures relate to Sweden, Hong-Kong and Germany. As a result, the CCyB requirements of Sweden, Hong-Kong and Germany must be used in the calculation of the CCyB add-on for Bank A as those exposures are the three most significant foreign jurisdictions' exposures. Private sector credit exposures that are considered to be insignificant are allocated to the home jurisdiction.

To calculate the CCyB for the exposures in these three jurisdictions, Bank A shall follow the same approach applied in Example 2 above.