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SOUTH AFRICAN RESERVE BANK
Prudential Authority

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

Guidance Note issued in terms of section 6(5) of the Banks Act 94 of 1990

Criteria for identifying outlier banks in relation to interest rate risk in the banking book

Executive summary

The amendments to regulation 30 of the Regulations relating to Banks (Regulations) were gazetted on 23 December 2022 and implemented with effect from 1 January 2023.

Regulation 30 of the Regulations specifies various requirements related to banks', controlling companies' and branches of foreign institutions' (hereinafter collectively referred to as 'banks') exposure to interest rate risk in the banking book.

This Guidance Note sets out criteria applied by the Prudential Authority (PA) to identify outlier banks in relation to interest rate risk in the banking book.

1. Introduction

1.1 The supervisory outlier test (SOT) in the context of interest rate risk in the banking book (IRRBB) refers to a supervisory assessment tool used by supervisors to evaluate a bank's exposure to changes in interest rates that could adversely affect its safety and soundness. This test is part of the broader framework for managing IRRBB, which aims to ensure that banks have adequate internal processes and adequate capital and reserve funds to withstand significant fluctuations in interest rates.

1.2 Banks identified as outliers are considered as potentially having undue exposure to IRRBB. When the PA's assessment of a bank's exposure to IRRBB reveals inadequate management thereof or a level of risk that is disproportionate to its capital, earnings or overall risk stance, the PA will respond accordingly.

1.3 The purpose of identifying outlier banks through the SOT is to act as an early warning indicator to both banks and the PA. The SOT indicates that further assessment and potential corrective actions may be required by banks to address and mitigate excessive exposure to IRRBB.

2. Background

2.1 A breakdown of the key points about the SOT and IRRBB:

2.1.1 Purpose: Identify banks with excessive interest rate risk relative to their capital or earnings.

2.1.2 Measurement: This compares a bank's potential decline in the economic value of equity (EVE) sensitivity under specific interest rate shock scenarios with a pre-defined threshold (15% of Tier 1 capital).

2.1.3 Threshold: Banks that exceed the threshold are identified as outliers and may be subject to further supervisory assessment by the PA.

3. Legislation in South Africa

3.1 Regulations 30(4) and 30(5) of the Regulations stipulate matters related to a bank's governance and risk management framework and matters related to the measurement and appropriate management of exposure to IRRBB respectively.

3.2 Regulation 39 of the Regulations, among other things, outlines the process of corporate governance that must be implemented, including the maintenance of effective risk management and capital management by a bank.

3.3 Under regulation 38(4) of the Regulations, the PA is required to take specific measures if it deems a bank's risk exposure calculations and internal control mechanisms to be insufficient.

4. Identification and assessment criteria

4.1 The PA will employ the sensitivity of a bank's EVE as a criterion to determine outlier banks. This will involve calculating the maximum loss from the six interest rate shock scenarios specified in regulation 30(5)(a)(iii)(H)(i) of the Regulations and dividing the maximum loss by the bank's Tier 1 capital. This ratio must not exceed 15% of the bank's Tier 1 capital.

4.2 The PA may require an outlier bank to take one or more of the following actions:

4.2.1 reduce its exposure to IRRBB by hedging the exposure or by other appropriate means.

4.2.2 impose additional capital requirements, as envisaged in regulation 38(4)(e) of the Regulations.

4.2.3 specify constraints on the internal risk parameters used by the bank.

4.2.4 improve the bank's risk management framework.

5. Acknowledgement of receipt

5.1 Kindly ensure that a copy of this guidance note 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.

Fundi Tshazibana

Fundi Tshazibana
Chief Executive Officer

Date: 08/07/24

The previous guidance note issued was Banks Act Guidance note 3/2024, dated 10 May 2024.