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SOUTH AFRICAN RESERVE BANK
Prudential Authority

Ref.: 15/8/1/3

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

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

Proposed amendments to the Regulations relating to Banks

Executive summary

The Prudential Authority (PA) continues to strive towards ensuring that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant.

As part of the internationally agreed regulatory reforms to promote the safety and soundness of the international financial system, the Basel Committee on Banking Supervision (BCBS) has issued various new or revised frameworks or requirements during recent years for implementation by member jurisdictions.

In this regard, on 7 December 2017, the BCBS issued the remaining components of the Basel III post-crisis regulatory reforms.

Accordingly, on 12 September 2022, the PA issued proposed amendments to the Regulations relating to Banks (Regulations), incorporating the remaining components of the Basel III post-crisis regulatory reforms into the Regulations. All banks, controlling companies, branches of foreign institutions, eligible institutions and auditors of banks or controlling companies (hereinafter collectively referred to as 'interested persons') were invited to submit their comments to the PA.

The PA decided to issue the updated proposed amendments to the Regulations for a final round of consultation. The PA invites all interested persons to submit their comments in respect of the proposed updated amendments to the Regulations, by no later than 25 October 2023.

1. Introduction

1.1 In response to the global financial crisis that commenced in 2007, the Group of Twenty (G-20) initiated a reform programme in 2009 to strengthen the International Financial Regulatory System.[1]

[1] G-20, Pittsburgh summit declaration: Pittsburgh declaration

1.2 In this regard, on 7 December 2017, as part of the internationally agreed regulatory reforms, the BCBS issued for implementation by member jurisdictions the remaining components of the Basel III post-crisis regulatory reforms.[2]

1.3 To ensure that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant, the PA issued proposed amendments to the Regulations on 12 September 2022, incorporating the relevant remaining components of the Basel III post-crisis regulatory reforms into the Regulations.

1.4 All interested persons were invited to submit their comments to the PA. The PA wishes to express its sincere appreciation for the comments subsequently received. The PA has worked through all the comments received, had further engagements with interested persons, and appropriately updated the proposed amendments to the Regulations. The respective comment matrices with responses are attached to this proposed Directive as Annexures 4 to 6.

1.5 The PA decided to issue the updated proposed amendments to the Regulations for a final round of consultation.

1.6 Some of the key components of and matters related to the Basel III post-crisis reforms communicated by the BCBS on 7 December 2017 are set out in further detail in paragraphs 2 to 6 below.

2. Standardised approach for credit risk

2.1 The revisions to the standardised approach for credit risk aim to enhance the regulatory framework:

2.1.1 By improving its granularity and risk sensitivity. For example, in the case of-

2.1.1.1 exposures to banks, some of the risk weights for rated exposures have been recalibrated. In addition, the risk-weighted treatment for unrated exposures is more granular than the existing flat risk weight.

2.1.1.2 exposures to corporates, a more granular look-up table has been developed. A specific risk weight applies to exposures to small and medium-sized enterprises (SMEs). In addition, the revised standardised approach includes a standalone treatment for exposures to project finance, object finance and commodities finance.

2.1.1.3 residential real estate exposures, more risk-sensitive approaches have been developed, whereby risk weights vary based on the loan-to-value (LTV) ratio of the mortgage, and in ways that better reflect differences in market structures.

2.1.1.4 retail exposures, a more granular treatment applies, which distinguishes between different types of retail exposures. For example, the regulatory retail portfolio distinguishes between revolving facilities (where credit is typically drawn upon) and transactors (where the facility is used to facilitate transactions rather than a source of credit).

2.1.1.5 commercial real estate exposures, approaches have been developed that are more risk-sensitive than the flat risk weight which generally applies.

2.1.1.6 subordinated debt and equity exposures, a more granular risk weight treatment applies (relative to the current flat risk weight).

2.1.1.7 off-balance sheet items, the credit conversion factors (CCFs), which are used to determine the amount of an exposure to be risk-weighted, have been made more

[2] Available online at: Basel III post-crisis reforms

risk-sensitive, including the introduction of positive CCFs for unconditionally cancellable commitments.

2.1.2 By reducing mechanistic reliance on credit ratings, by requiring banks to conduct sufficient due diligence, and by developing a sufficiently granular non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings.

2.1.3 By providing the foundation for a revised output floor to internally modelled capital requirements (to replace the existing Basel I floor).

2.1.4 By introducing revised disclosure requirements to enhance comparability across banks and restore a level playing field.

3. Internal ratings-based (IRB) approaches for credit risk

3.1 The financial crisis highlighted several shortcomings related to the use of internally modelled approaches for regulatory capital, including the IRB approaches to credit risk. The shortcomings include-

3.1.1 the excessive complexity of the IRB approaches.

3.1.2 the lack of comparability in banks' internally modelled IRB capital requirements.

3.1.3 the lack of robustness in modelling certain asset classes.

3.2 To address these shortcomings, the BCBS has revised the IRB approaches, including:

3.2.1 removing the option to use the advanced IRB (A-IRB) approach for certain asset classes.

3.2.2 adopting "input" floors (for metrics such as probabilities of default (PD) and loss-given-default (LGD)) to ensure a minimum level of conservativism in model parameters for asset classes where the IRB approaches remain available.

3.2.3 providing greater specification of parameter estimation practices to reduce variability in risk weighted exposure (RWE).

3.3 Given the enhancements to the IRB framework and the introduction of an aggregate output floor, the BCBS has agreed to remove the 1.06 scaling factor that is currently applied to RWE determined by the IRB approach to credit risk.

4. Operational risk

4.1 The financial crisis highlighted two main shortcomings with the existing operational risk framework:

4.1.1 capital requirements for operational risk proved insufficient to cover operational risk losses incurred by some banks.

4.1.2 the nature of the losses – covering events such as misconduct, and inadequate systems and controls – highlighted the difficulty associated with using internal models to estimate capital requirements for operational risk.

4.2 As such, the BCBS has streamlined the operational risk framework. The advanced measurement approaches (AMA) for calculating operational risk capital requirements (which are based on banks' internal models) and the existing three standardised approaches are replaced with a single risk-sensitive standardised approach to be used by all banks.

4.3 The new standardised approach for operational risk determines a bank's operational risk capital requirements based on two components:

4.3.1 a measure of a bank's income.

4.3.2 a measure of a bank's historical losses.

4.4 Conceptually, the revised operational risk framework assumes:

4.4.1 that operational risk increases at an increasing rate with a bank's income.

4.4.2 banks which have experienced greater operational risk losses historically are assumed to be more likely to experience operational risk losses in the future.

5. Leverage ratio framework

5.1 The leverage ratio framework complements the risk-weighted capital requirements-

5.1.1 by providing a safeguard against unsustainable levels of leverage.

5.1.2 by mitigating gaming and model risk across both internal models and standardised risk measurement approaches.

5.2 The BCBS has made various refinements to the definition of the leverage ratio exposure measure. These refinements include modifying the way in which derivatives are reflected in the exposure measure and updating the treatment of off-balance sheet exposures to ensure consistency with their measurement in the standardised approach to credit risk.

6. Output floor

6.1 The Basel II framework introduced an output floor based on the Basel I capital requirements. That floor was calibrated at 80% of the relevant Basel I capital requirements. Implementation of the Basel II floor has been inconsistent across countries, partly because of differing interpretations of the requirement and because it is based on the Basel I standards, which many banks and jurisdictions no longer apply.

6.2 The Basel III reforms replace the existing Basel II floor with a floor based on the revised Basel III standardised approaches. Consistent with the original floor, the revised floor places a limit on the regulatory capital benefits that a bank using internal models can derive relative to the standardised approaches. This helps to maintain a level playing field between banks using internal models and those on the standardised approaches. It also supports the credibility of banks' risk-weighted calculations and improves comparability via the related disclosures.

6.3 In terms of the BCBS's Basel III post-crisis regulatory reforms and the related required output floor calculation, banks must calculate their risk-weighted assets as the higher of:

6.3.1 total risk-weighted assets calculated using the approaches that the bank has supervisory approval to use in accordance with the Basel capital framework (including both standardised and internal model-based approaches); and

6.3.2 a specified percentage of the total risk-weighted assets calculated using only the standardised approaches phased in over a specified period, as follows:

- from 1 January 2023: 50%
- from 1 January 2024: 55%
- from 1 January 2025: 60%
- from 1 January 2026: 65%
- from 1 January 2027: 70%
- from 1 January 2028: 72.5%.

6.4 Since it has been decided to only implement the proposed amendments to the Regulations in South Africa with effect from 1 July 2025, instead of the internationally agreed implementation date of 1 January 2023, as set out in Guidance Note 3 of 2023,[3] and not to deviate from the respective internationally agreed phase-in percentages related to the output floor calculation during the period 2025 to 2028, South Africa will commence with a phase-in output floor percentage of 60% on 1 July 2025.

6.5 In addition, at national discretion, supervisors may cap the increase in a bank's total RWE that results from the application of the output floor during its phase-in period. The transitional cap on the increase in RWE is set at 25% of a bank's RWE before the application of the floor. If a supervisor uses this discretion, the bank's RWE will effectively be capped at 1.25 times the internally calculated RWE during that time.

7. Statement of expected impact and matters related thereto

7.1 To ensure adequate engagement and that the potential impact, costs and benefits of proposed amendments to the Regulations are duly considered and measured, the preparation of a statement of expected impact forms an integral part of the process of proposing amendments to the Regulations.

7.2 As such, the PA engaged all relevant interested persons on the respective proposed amendments to the Regulations, to gather the necessary qualitative and quantitative information that the PA required to determine or assess the potential impact of the proposed amendments to the Regulations, as well as to prepare the relevant required statement of expected impact.

8. Directive

8.1 Based on the aforesaid and in accordance with the provisions of section 6(6) of the Banks Act 94 of 1990, all interested persons are hereby directed to take note of the proposed updated amendments to the Regulations, attached to this proposed directive as Annexure 1, with a proposed implementation date of 1 July 2025.

[3] Available online at: Guidance Note 3 of 2023

9. Invitation for comment

9.1 All interested persons are hereby invited to submit their comments on the proposed updated amendments to the Regulations, attached to this proposed directive as Annexure 1, the statement of need for, expected impact and intended operation of the proposed updated amendments to the Regulations, attached to this proposed directive as Annexure 3, and the proposed implementation date of 1 July 2025, to: SARB-PA@resbank.co.za, for the attention of Mr A J Smal, by no later than 25 October 2023.

9.2 All comments received may be published on the website of the PA, unless a respondent specifically requests confidential treatment.

Fundi Tshazibana

Fundi Tshazibana
Chief Executive Officer

Date: 19-Sep-2023

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