Basel Committee on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III risk-based capital regulations – South Africa

June 2015

BANK FOR INTERNATIONAL SETTLEMENTS

Note that this report refers to the RCAP grades prior to October 2025. The grade 'materially non-compliant (MNC)', ie one notch above the lowest grade, has since been renamed to 'partially non-compliant (PNC)' for greater clarity

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Glossary

AMA	Advanced Measurement Approaches (operational risk)
BCBS	Basel Committee on Banking Supervision
BIA	Basic Indicators Approach
BIS	Bank for International Settlements
BSD	(South African Reserve Bank's) Banking Supervision Department
C	Compliant (grade)
CEM	Current Exposure Method (counterparty credit risk)
CET1	Common Equity Tier 1
CVA	Credit Valuation Adjustment
D-SIB	Domestic systemically important bank
FAQ	Frequently asked question
G-SIB	Global systemically important bank
IMA	Internal Models Approach (market risk)
IMM	Internal Models Method (counterparty credit risk)
IRB	Internal Ratings-Based approach (credit risk)
LC	Largely compliant (grade)
LGD	Loss-given-default
MNC	Materially non-compliant (grade)
na	Not applicable
NC	Non-compliant (grade)
PON	Point of non-viability
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted assets
SARB	South African Reserve Bank
SIG	Supervision and Implementation Group
SME	Small and medium-sized entities
SREP	Supervisory review and evaluation process
ZAR	South African rand

Preface

The Basel Committee on Banking Supervision sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits of adopting the framework can only fully accrue if these standards are implemented consistently by all member jurisdictions. Through its Regulatory Consistency Assessment Programme (RCAP), the Basel Committee monitors, assesses and evaluates its members' implementation of the Basel framework, promoting full, timely and consistent implementation.

The assessments under the RCAP aim to ensure that each member jurisdiction adopts the Basel III framework in a manner consistent with the framework's letter and spirit. The framework's intent is to establish prudential requirements that are based on a sound, transparent and well defined set of regulations that will help strengthen the international banking system, improve market confidence in regulatory ratios and ensure an international level playing field.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Basel III risk-based capital regulations in South Africa.[1] The assessment focuses on the regulatory adoption applied to South African banks that are internationally or regionally active, and of significance to domestic financial stability.

The South African Reserve Bank, specifically its Bank Supervision Department, implement domestic requirements via the Banks Act (Act No. 94 of 1990), as amended in 2013, the "Regulations relating to Banks (the Regulations)", as amended, and other legally enforceable rule-making, including Directives and Circulars. The Regulations that contained the Basel III risk-based capital standards were implemented on 1 January 2013. As a result of the RCAP the full scope of regulatory instruments were utilised to strengthen local regulations. In particular, further amendments to the Regulations were issued by the South African authorities in March 2015.

The RCAP Assessment Team was led by Mr Frank Pierschel, Head of International Policy/Affairs – Banking Supervision, at Germany's Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). The Assessment Team comprised five technical experts from Brazil, Germany, Norway, Singapore, and the European Banking Authority (Annex 1). The overall report was supported by the Basel Committee Secretariat and BaFin staff. The main counterpart for the assessment was the South African Reserve Bank (SARB).

The assessment is based upon information provided up to 31 March 2015, and the work was completed in three phases: (i) completion of a RCAP questionnaire (a self-assessment) by the SARB; (ii) an off- and on-site assessment by the Assessment Team; and (iii) a post-assessment review phase. The off- and on-site phase included discussions with SARB counterparts and representatives from South African banks. The third phase consisted of a two-stage technical review of the assessment findings; first, by an independent RCAP Review Team and feedback from the Basel Committee's Supervision and Implementation Group (SIG), and second, by the RCAP Peer Review Board and the Basel Committee. This two-step process is a key instrument of the RCAP to provide quality control and ensure the integrity of the assessment findings.

The scope of the assessment was limited to the consistency and completeness of the domestic regulations with respect to the Basel framework. Where domestic regulations and provisions were

[1] This report complements the RCAP assessment report of South Africa's adoption of the Basel III Liquidity Coverage Ratio.

identified to be inconsistent with the Basel framework, those deviations were evaluated for their current and potential impact on reported capital ratios for a sample of internationally active banks in South Africa. The overall outcome was based on the materiality findings and the use of expert judgment. Issues relating to the adequacy of prudential outcomes, capital levels of individual banks or the SARB's supervisory effectiveness were not in the scope of this assessment.

This report is divided into three sections and a set of annexes: (i) an executive summary including a statement from the SARB; (ii) the assessment findings, including a description of the assessment, scope and methodology; and (iii) the details of the assessment findings along with other assessment observations.

The RCAP Assessment Team sincerely thanks Mr René van Wyk, Mr Rob Urry, Ms Mardolene van Hoven and the staff of the SARB for the professional and efficient cooperation with counterparts through the assessment process. The comprehensive discussions with the SARB helped the team arrive at their assessment. The Assessment Team hopes that the RCAP exercise contributes to further strengthening the domestic prudential framework.

Executive summary

The SARB has implemented the Basel III risk-based capital regulations consistently with the internationally agreed upon timeline, and has also applied the transitional arrangements in line with Basel III. The Banks Act and the Regulations apply uniformly to all 31 banks and banking groups in South Africa.

Overall, the Assessment Team finds the South African prudential regulations to be compliant with the standards prescribed under the Basel framework. South African regulations were found to be compliant with all 14 components of the capital framework.

South Africa's implementation of the Basel standards on scope of application relating to requirements for consolidated banking groups, and the sub-levels within a group, is compliant with the Basel framework. The Assessment Team had minor findings regarding the application of the global framework at the consolidated and sub-consolidated levels, but these will not affect the implementation of the framework.

Two non-material deviations have been identified by the Assessment Team. The first relates to the treatment of minority interest. The SARB regulations allow banks to calculate the eligible amount of minority interest, with reference to the countercyclical capital buffer, the D-SIB capital buffer and Pillar 2 capital requirements, ie as part of the minimum capital requirements. This results in a lower surplus to be deducted. In the course of the assessment, the SARB aligned domestic regulations where a clear deviation from the Basel standards was observed. The treatment of other elements within the minority interest calculation was assessed as non-material.

The South African regulations prescribe that loans that are fully secured by mortgages on residential property be given risk weights depending on the security of the parts of the loans. As a result, the loan is booked as a single loan, but portions of the loan are given different risk weights. The materiality assessment showed non-material deviations using the South African risk weight splitting method. However, given that the Basel framework does not directly address risk weight splitting, the Assessment Team suggests that the Committee take a fresh look at the treatment of residential real estate loans.

The Assessment Team recognises and appreciates the efforts made by the SARB to strengthen and align its capital regulations to the Basel III framework throughout the course of the assessment process. These amendments were published on 30 March 2015.

Response from the South African authorities

The South African Reserve Bank, and specifically the Bank Supervision Department, would like to thank the RCAP Team, under the leadership of Mr Frank Pierschel, for the detailed review conducted, interactive discussions held, and insights and knowledge shared during the assessment of South Africa's Basel III capital regulations. The team's input was a key driver for the improvements effected to the South African regulatory framework.

South Africa's drafting of the Basel III regulations was done with the intention of attaining full compliance with the Basel III framework and, in addition, capturing other eventualities that were either not envisaged during the drafting of the Basel III framework or which are unique to the South African economic environment.

Whilst South Africa is completely supportive of the complete, broad and consistent application of Basel standards, the SARB recommends that further work be done by the BCBS in two particular areas:

Surplus capital from minority interest

The Basel III rules text specifies that the percentage to be used when calculating surplus capital is the minimum total capital requirement of the subsidiary plus the capital conservation buffer. The SARB has interpreted the minimum total capital requirement to be the minimum required in the domestic framework (the "Regulations relating to Banks"), which, for conservatism, is higher than the Basel minimum of 8% due to the inclusion of a systemic risk buffer which has been imposed across the banking sector. In addition, the Basel III text and D-SIB framework state that the countercyclical and D-SIB buffers are an extension of the capital conservation buffer; therefore, these buffers have been included in our computation of the surplus capital calculation, with the consequence that they result in a lower surplus to be deducted. The SARB would welcome further guidance and clarity from the BCBS regarding the interpretation of both the minimum total capital and the capital conservation buffer to be used when calculating surplus capital.

Application of the 1,250% risk weight

Whereas under Basel II certain exposures were deducted 50% from Tier 1 and 50% from Tier 2, or had the option of being deducted or risk-weighted, Basel III requires these amounts to be risk-weighted at 1,250%. Whilst the Basel framework is calibrated on an 8% total capital requirement, an exposure that is risk-weighted at 1,250% will result in a capital requirement of 100% of the original exposure – effectively a deduction against capital. Any minimum capital requirement in excess of 8% results in a capital requirement for these exposures exceeding 100% of the original exposure amount, which is clearly not the intention of the Basel rules for ensuring adequacy of capital against risk of loss.

The SARB recommends that a more consistent application of the rules could be achieved by requiring banks to risk-weight these amounts at 1,250%, *or such imputed percentage that will effectively result in an amount equivalent to a deduction against capital*. This will make allowance for jurisdictions that apply higher minimum capital requirements and consistent use of 1,250% risk weighting when the minimum capital requirement exceeds 8% and results in a capital requirement that exceeds the value of the exposure in question.

1. Assessment context and main findings

1.1 Context

Status of implementation

South Africa implemented the Basel III capital framework from 1 January 2013, the internationally agreed date for implementation of this standard (Annex 2).

Status of approval of Basel advanced approaches — Table 1

	Number of banks using advanced approaches as at 30 June 2014
Credit risk (Internal Ratings-Based Approach (IRB) – other than securitisation)[2]	6
Credit risk (IRB – securitisation)	4
Counterparty credit risk (Internal Models Method (IMM))	0
Counterparty credit risk (Credit Valuation Adjustment (CVA) – advanced)	0
Market risk (Internal Models Approach (IMA))	6
Operational risk (Advanced Measurement Approaches (AMA))	4

Regulatory system and model of supervision

The SARB was established in 1921 and is responsible for ensuring the overall soundness of the South African monetary, banking and financial system. This includes specific responsibilities for monetary policy, banking supervision and the currency. The SARB is undergoing changes in the regulatory and supervisory framework for the overall financial system. The SARB is currently responsible for banking regulation and prudential supervision, and the Financial Services Board (FSB) regulates and supervises the non-banking financial services industry, including insurance companies. Oversight of fund managers and stock exchanges is shared by the FSB and the Johannesburg Stock Exchange. However, the authorities are planning to adopt a "Twin Peaks" model, expected to be finalised during 2016, that includes a Prudential Authority and a Financial Sector Conduct Authority.

[2] All banks in the RCAP sample but one have migrated to the IRB approach.

Financial system structure

As at 30 June 2014, the South African banking system comprised 11 domestic and 20 foreign banks (14 registered local branches of foreign institutions or international banks, and six foreign-controlled banks). The SARB does not distinguish between local or foreign banks from a supervisory point of view. All major domestic banks are organised under a non-operating holding company structure. Foreign branches operate under restricted banking licenses. Foreign-controlled banks operate under full banking licenses, similar to domestic banks, and therefore are required to have a controlling company. The operations of the 11 domestic banks were mainly concentrated in South Africa constituting 74% of the total banking assets in South Africa. The total capital adequacy ratio of the South African banking sector remained well above the regulatory requirement of 10%, although it decreased from 15.6% in December 2013 to 14.8% in June 2014. This was mainly the result of the gradual phasing-out of non-Basel III compliant capital instruments, and partly the result of the losses incurred by African Bank Limited, which was placed under curatorship on 10 August 2014.[3]

Under the South African capital regulations, the Basel capital adequacy standards are applied at the group level, ie at the holding level on a consolidated basis. The Regulations are also applied at the bank consolidated level on a sub-consolidated basis and at the individual banking entity level on a solo basis. The Banks Act and the Regulations apply uniformly to all 31 banks and banking groups in South Africa.

1.2 Structure and enforceability of prudential regulation

In South Africa, the Basel capital framework has been implemented through a three-tier regulatory structure (see Annex 4). The Tier 1 legislation consists of an amendment of a parliamentary Act called "Banks Act, 1990, as amended in 2013 (Act No. 94 of 1990 – the Banks Act)". While the Banks Act containing the key Basel provisions serves as the primary legislation implementing the Basel capital framework, the operational details that constitute the bulk of the Basel capital framework are contained in the Tier 2 legislation called "Regulations relating to Banks (the Regulations)" issued through Government Gazette No. 35950 dated 12 December 2012. The Banks Act and the Regulations framed thereunder are administered by the SARB.

The Banks Act provides enabling legislation that allows the SARB to prescribe the minimum requirements and selected supervisory review and evaluation process (SREP) in the Regulations and in Directives, Circulars and Guidance Notes issued in terms of the Banks Act. The Regulations specify the internationally agreed minimum prudential and other requirements necessary to implement and comply with internationally agreed frameworks, such as Basel II, 2.5 and III.

Other major regulatory instruments used to implement the Basel capital standards in South Africa include Directives, Circulars and Guidance notes issued by the SARB (generally referred to as Tier 3 legislation). The purpose of these instruments is to provide further direction, interpretation, guidance or clarification, and information on best practices. In terms of Section 6 of the Banks Act, the Directives and Circulars are binding in nature.

Being an act passed by the South African parliament, the Banks Act is the binding act, and so are the Regulations framed under this Act. The Directives are issued by the Registrar under the powers available under the Banks Act and are therefore binding in nature. Depending upon the nature of the matter, the Directives may be replaced by Regulations in due course. The objective of Circulars and

[3] South African Reserve Bank, *Financial Stability Review*, September 2014.

Guidance Notes is to provide elaborate guidance on more technical matters to facilitate and ensure accurate and uniform implementation of the Regulations across all banks in the country. Though the Guidance Notes are not binding, it was understood from the SARB authorities and banking associations that these are normally adhered to by the banks. All these instruments were relied upon for the assessment. Further details of the assessment of their binding nature are provided in Annex 7. Annex 4 lists the regulatory instruments implementing Basel III capital standards in South Africa. All these instruments are hitherto collectively referred to as "South African Regulations".

As a result of the RCAP, the full scope of regulatory instruments was utilised to strengthen local regulations. In particular, further amendments to the Regulations were issued by the South African authorities in March 2015 through Government Gazette No. R. 38616.

1.3 Scope of the assessment

Scope

The Assessment Team took into consideration the regulatory instruments and other documents mentioned in Annex 4 that implement and bring into force the Basel capital framework in South Africa. By the agreed cutoff date for the assessment of 31 March 2015, the assessment focused on two aspects:

- comparison of the South African Regulations with the capital requirements under the Basel framework to ascertain if all the required provisions have been adopted (*completeness* of the regulations); and
- differences in substance between the above South African Regulations relative to the Basel framework and their significance (*consistency* of the regulations).

The assessment did not evaluate the adequacy of capital or resilience of the banking system in South Africa, nor the supervisory effectiveness of the relevant supervising agencies. The assessment also did not involve verification of the actual implementation by banks.

Bank coverage

The identified findings were assessed for their materiality (current and potential) using both quantitative and qualitative information collected from the South African banks. Expert judgment was applied in drawing conclusions.

As per the RCAP methodology, the assessment of materiality was based on a sample of nine banks with the majority of them having cross-border activities outside South Africa. In order to apply a holistic approach and ensure that the materiality testing captured the interactions of the South African banking system with the rest of the world, the sample included four foreign bank subsidiaries.

The sample covered 94% of South African total banking system assets as at 30 June 2014. The data showed that banks at the solo entity level generally constituted more than 70% of the group in terms of risk-weighted assets, and in most cases, over 94% of the group. At the time of data collection, one of these groups had a significant number of entities outside South Africa, with 33% of its risk-weighted assets contributed by those banking entities.

Certain information required by the Assessment Team is not collected on a regular basis for the banking groups and was not readily available in the format requested. The Assessment Team therefore based their assessment on the data collected on a solo basis from the individual sample banks that constitute the largest portion of the banking group.

The Assessment Team worked with summarised statistics supplied by the SARB, without access to individual bank data in order to protect the anonymity of the sample banks. Further data were collected on a solo basis in order to assess materiality of deviations. Thus, while the Assessment Team was able to obtain some satisfaction as to the reasonableness of how the data were processed, it accepted the quality of the data in good faith.

Assessment grading and methodology

The outcome of the assessment was summarised using a four-grade scale, for each of the 14 key components of the Basel framework and for the overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant. The materiality of the deviations was assessed in terms of their current or, where applicable, potential future impact on capital ratios of the banks in the sample. The impact analysis did not extend to the wider South African economy or broader financial stability-related systemic risk.

The non-quantifiable assessment findings were discussed with the SARB, and outcomes were guided by expert judgment. The Basel Committee guidance on principles to guide non-quantifiable findings was also kept in view.

Ultimately, the Assessment Team relied on the general principle that the burden of proof rests with the assessed jurisdiction to show that a finding is not material or potentially material. Wherever stronger than the minimum Basel requirements, elements of the South African Regulations are fully in line with the nature of the international agreements, which are considered minima. However, per the RCAP methodology these "super-equivalent" measures were not considered as compensating for inconsistencies or gaps identified elsewhere, unless they fully and directly address the identified inconsistencies or gaps.

In cases where data limitations existed for quantifiable gaps, the team assessed materiality based on proxies such as the level of exposure to the affected asset class, the number of banks engaged in specific business activities, data from public sources, results of impact studies or other similar types of information made available by the assessed jurisdiction. In these cases, the Assessment Team used its collective expert judgment to form a best efforts estimate of the impact on banks' capital ratios and risk-weighted assets (RWA).

Summary information on the materiality aspects of the assessment is provided in Annex 9.

1.4 Main findings

A summary of the findings is given below. This should be read along with the list of detailed findings in Section 2, as well as other observations related to the South African system. The issues that were rectified during the assessment period are listed in Annex 6

To foster more consistent implementation, the Assessment Team has identified two issues that would benefit from further guidance and clarifications from the Basel Committee. These are listed in Annex 13.

Summary assessment grading — Table 2

Key components of the Basel capital framework	Grade
Overall grade:	C
Scope of application	C
Transitional arrangements	C
Pillar 1: Minimum capital requirements	
Definition of capital and calculation of minimum capital requirements	C
Capital buffers (conservation and countercyclical)	C

Credit risk: Standardised Approach	C
Credit risk: Internal Ratings-based Approach	C
Credit risk: securitisation framework	C
Counterparty credit risk framework	C
Market risk: standardised measurement method	C
Market risk: Internal Models Approach	C
Operational risk: Basic Indicator Approach and Standardised Approach	C
Operational risk: Advanced Measurement Approaches	C
Pillar 2: Supervisory review process	
Legal and regulatory framework for the supervisory review process and for taking supervisory actions	C
Pillar 3: Market discipline	
Disclosure requirements	C

Definition of the grades: **Compliant (C)**: all minimum Basel provisions have been satisfied and no material differences have been found that would give rise to prudential concerns or provide a competitive advantage to internationally active banks; **Largely compliant (LC)**: only minor provisions have not been satisfied and differences that have a limited impact on financial stability or the international level playing field have been identified; **Materially non-compliant (MNC)**: key provisions of the framework have not been satisfied or differences that could materially impact capital ratios have been identified: **Non-compliant (NC)**: the regulation has not been adopted or differences that could severely impact capital ratios and financial stability or international level playing field have been identified.

Colour code:

Compliant	C
Largely compliant	LC
Materially non-compliant	MNC
Non-compliant	NC

1.4.1 Scope of application

South Africa's implementation of Basel standards on scope of application relating to requirements for consolidated banking groups and the sub-levels within a group is compliant with the Basel framework. The Assessment Team had a minor finding regarding the application of Basel framework at the consolidated and sub-consolidated levels for the South African banks, but determined that this would not affect the implementation of the framework (see also Annex 12).

1.4.2 Transitional arrangements

The overall South African implementation of the transitional arrangements is compliant with the Basel framework. Moreover, the SARB decided to implement the stricter capital rules of Basel III as soon as possible: (i) the transitional phase for the phasing-out of existing hybrid regulatory capital instruments in Tier 1 issued prior to 12 September 2012 already ended by end-2014; (ii) no phasing-in of the deductions was granted; and (iii) the first step of the phasing-out of the former full minority interest recognition with 80% already started in 2013.

1.4.3 Definition of capital and calculation of minimum capital requirements

A key element of Basel III was the set of changes made to the standards that define the eligible components of regulatory capital. Overall, the South African Regulations relating to definition of capital and calculation of minimum capital requirements were found to be compliant with the Basel framework.

One non-material issue observed by the Assessment Team relates to the treatment of minority interest. The SARB Regulations allow banks to calculate the eligible amount of minority interest in addition to the capital conservation buffer requirements with references to the countercyclical capital buffer requirements, the D-SIB requirements and Pillar 2 capital requirements. The Pillar 2 requirement consists of two components, one of which is applied uniformly as a systemic buffer (Pillar 2A) to all banks at the same level and is publicly disclosed by them. The second, the idiosyncratic component called the Pillar 2B buffer, was excluded from the South African Regulations to align the Regulations with the Basel requirements. The Assessment Team evaluated the effect of including the D-SIB capital buffer (the only applicable buffer) for the purposes of calculating minority interest. The deviation was found to be non-material, resulting in an overall compliant grade for this section.

1.4.4 Capital buffers (conservation and countercyclical)

The implementation of the capital buffers framework in South Africa was found compliant with the Basel framework.

1.4.5 Credit risk: Standardised Approach

The Regulations implementing the Standardised Approach for credit risk in South Africa were assessed as compliant. However, the Assessment Team found one deviation to highlight to the Committee regarding the risk weights for residential mortgage loans (see also Section 1.4.15). According to the Basel framework, lending fully secured by mortgages on residential property will be risk-weighted at 35%. However, the South African Regulations prescribe that these loans be given risk weights depending on the security of the parts of the loans. Hence the loan is booked as a single loan, but the portions are given different risk weights.

The materiality assessment showed that the deviation was not material when using this South African risk weight splitting method. However, given that the Basel framework does not directly address risk weight splitting, the Assessment Team suggests that the Committee take a fresh look at the treatment of residential real estate loans.

1.4.6 Credit risk: Internal Ratings-Based (IRB) approach

Based on amendments completed during the assessment process, the Regulations implementing the credit risk IRB approach were assessed as compliant with the Basel framework.

1.4.7 Credit risk securitisation framework

Consistent with the amendments issued by the SARB, the securitisation framework was assessed as compliant with the Basel framework. One non-material deviation was noted. While the South African regulations set out the capital requirements for clean-up calls that are found to serve as credit enhancement, the disclosure requirements under the Basel framework applicable to such clean-up calls is missing in the domestic framework. The final regulation requiring this disclosure will be revised after the assessment cutoff date, so the Assessment Team recommends that this item be followed up in future assessments.

1.4.8 Counterparty credit risk framework

Overall, the counterparty credit risk framework of South Africa was judged as compliant with the Basel framework, given changes to Regulations issued during the assessment period. South African banks had been exempted from application of capital requirements for the CVA pertaining to over-the-counter derivative transactions denominated in the domestic currency and/or with local counterparts until December 2015. This exemption was removed effective 1 April 2015 (see Annex 6).

1.4.9 Operational risk: Basic Indicator Approach, Standardised Approach

The South African Regulations concerning implementation of the simpler approaches for operational risk are compliant with the Basel framework.

1.4.10 Operational risk: Advanced Measurement Approaches

South Africa's implementation of Basel standards on the operational risk AMA was found to be compliant with the Basel framework.

1.4.11 Market risk: Standardised Measurement Method

The Assessment Team assessed the South African Regulations implementing the Basel market risk: Standardised Measurement Method as compliant.

1.4.12 Market risk: Internal Models Approach (IMA)

The South African Regulations on the IMA for market risk were assessed as compliant with the relevant Basel standards.

1.4.13 Supervisory review process (Pillar 2)

Overall, the implementation of the Basel Pillar 2 requirements in South Africa was assessed as compliant.

1.4.14 Market discipline (Pillar 3)

The South African implementation of the Basel Pillar 3 requirements was assessed as compliant.

1.4.15 Observations and other findings

Interpretative issues

Treatment of residential real estate loans

According to the Basel framework, lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk-weighted at 35%. In applying the 35% weight, the supervisory authorities should be satisfied, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of a substantial margin of additional security over the amount of the loan based on strict valuation rules. The South African Regulations prescribe that these loans are given risk weights depending on the security of the parts of the loans. That is, the loan is booked as a single loan, but the portions of the loan are given different risk weights.

Broadly speaking, the Basel framework (paragraphs 72 and 73) does not address risk weight-splitting into fully secured and not fully secured parts. Considering the risk weights under the IRB approach for similar loans, and given that similar treatment of residential mortgage loans also exists in the capital adequacy framework of other jurisdictions, the Assessment Team recommends that the Basel Committee take a fresh look at risk weighting of the residential mortgage loans (see also Annex 13).

Minority interest

Under Basel III, the recognition of minority interest is calculated with reference to the minimum CET1 requirement of the subsidiary plus the capital conservation buffer, the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer, and the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer. The SARB minority interest calculations also include the

Pillar 2A capital requirement and other capital buffers (eg countercyclical buffer) in subsidiary capital calculations. The Assessment Team questioned whether the inclusion of the countercyclical buffer or other systemic buffers is a deviation, as these buffers are specified by the Basel Committee as an extension of the capital conservation buffer. This has been noted in previous jurisdictional assessments as well. Future guidance on this issue from the Basel Committee on its intent would be useful.

Issues for follow-up RCAP assessments

The Assessment Team had minor observations regarding the application of Basel framework at the consolidated and sub-consolidated levels for the South African banks, as the SARB excludes certain financial institutions where they are assessed as non-significant exposures. These will not affect the implementation of the framework.

2. Detailed findings

The component by component details of the assessment of compliance with the risk-based capital standards of the Basel framework are detailed here.

This section describes the findings that are considered as deviations. These deviations were assessed for their current and potential materiality on the RWA and CET1 ratios of banks in the sample based on data collected from banks and other information provided by the SARB. The final conclusions on materiality reflect the Assessment Team's judgment taking into account all this information.

2.1 Scope of application

Section grade	**Compliant**
Summary	The scope of application of the risk-based capital adequacy requirements is assessed as compliant. The Assessment Team had a minor finding regarding the application of Basel framework at the consolidated and sub-consolidated levels for the South Africa banks, but these will not affect the implementation of the framework. South Africa follows a bottom-up approach, as well as an "aggregation" method for supervisory purposes, to deepen the understanding of consolidation group information. The SARB amended regulation to clarify that this is complementary to, not a substitute for, a consolidation approach. The SARB also allows for the exclusion of certain non-banking entities to the extent that they are assessed as non-significant exposures. These exclusions, however, did not result in any material deviation. However, the Assessment Team does recommend that the matter be revisited in future RCAPs as the scope of consolidation is currently under review (see Annex 12). This follow-up is also considered in the RCAP assessment of LCR regulations for South Africa.

2.2 Transitional arrangements

Section grade	**Compliant**
Summary	Implementation of the transitional arrangement was found to be compliant with the Basel framework.

2.3 Pillar 1: Minimum capital requirements

2.3.1 Calculation of minimum capital requirements and definition of capital

Section grade	**Compliant**
Summary	Implementation of the minimum capital requirements and definition of capital were found to be compliant with the Basel framework. The SARB made several changes to its framework in order to align it with the Basel framework, notably the treatment of minority interest and the application of a 1,250% risk weight to exposures deducted from Tier 1 and Tier 2 capital under Basel II. The Assessment Team identified one non-material issue related to the treatment of minority interest. The Assessment Team is aware that the definition of minimum capital requirements, ie whether capital buffers are included, has been suggested for review by the Basel Committee. With respect to rules on minimum requirements to ensure loss absorbency at the point of non-viability (PON), no deviations were identified. Currently, the SARB follows a contractual approach but has already informed banks that they will move to a statutory approach in the near future. After accounting for the amendments made by the SARB, as well as the materiality assessment noted above, the Assessment Team did not identify any material deviations.
Basel paragraph number	Basel III 62–64 Minority interests
Reference in the domestic regulations	Reg 38(16)(a) and Circular 2/2013
Findings	As noted above, a non-material issue is related to the treatment of minority interest. In the context of determining the recognition in consolidated capital of minority interest and other capital issued out of consolidated banking subsidiaries held by third parties under Basel III, the amounts of allowable CET1, Additional Tier 1 and Total Capital of the subsidiary are calculated with reference to the minimum CET1 requirement of the subsidiary plus the capital conservation buffer (ie 7% of risk-weighted assets), the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 8.5% of risk-weighted assets) and the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (ie 10.5% of risk-weighted assets), respectively. The SARB Regulations require banks to calculate the eligible amount of minority interest in addition to the capital conservation buffer requirements with reference also to the countercyclical and D-SIB (where applicable) capital buffer requirements and to Pillar 2 capital requirements. The Pillar 2 requirement consists of a systemic component, called Pillar 2A, and an idiosyncratic component called Pillar 2B. The Pillar 2A buffer is applied uniformly as a systemic buffer to all banks at the same level and is publicly disclosed by them. The setting of the Pillar 2A requirement is assessed in terms of the potential macroeconomic impact on the banking system and is reviewed within the SARB's Financial Stability Committee. The setting of the requirement can be set (or amended) via a Directive from the Registrar, completed in consultation with the Governor of the SARB. SARB authorities considered the inclusion of higher minimum capital requirements as well as other capital requirements and buffer capital requirements to subsidiaries as consistent with the intent of the Basel III rules text that minority interest and other third-party investments reflect actual capital requirements in subsidiaries. In addition, the Assessment Team is aware that based on a recommendation in a past RCAP assessment the appropriateness of the inclusion of the countercyclical capital buffer requirements is already under Basel Committee consideration. Currently, no countercyclical buffer has been activated by the SARB and therefore no data are available to assess the materiality. Furthermore, the SARB does not envisage imposing the countercyclical capital buffer in the foreseeable future as the current credit-to-GDP gap is negative.
Materiality	With regard to the Pillar 2A buffer, such a buffer is seen by the Assessment Team to effectively operate as a Pillar 1 requirement. A uniform and publicly disclosed systemic buffer fulfils all requirements of the Basel framework. Therefore, the Assessment Team assessed the implementation of the Pillar 2A buffer as compliant. With regard to the Pillar 2B buffer, the Assessment Team initially identified a deviation from the Basel framework. The SARB has amended the rules by issuing Banks Act Circular 3/2015 to banks

	to exclude the Pillar 2B buffer requirements from the calculation. The Assessment Team acknowledges the amendment as a compliant implementation of the Basel framework. The Assessment Team evaluated the effect of including the D-SIB capital buffer, as it was deemed the only relevant buffer over the period of the materiality assessment, for the purposes of calculating minority interest. The deviation was found to be non-material, resulting in an overall compliant grade for this section.

2.3.2 Capital buffers (conservation and countercyclical)

Section grade	**Compliant**
Summary	The implementation of the capital buffers framework in South Africa was found to be compliant with the Basel framework.

2.3.3 Credit risk: Standardised Approach

Section grade	**Compliant**
Summary	Implementation of the Standardised Approach to credit risk was found to be compliant with the Basel framework. The SARB made several changes to its framework in order to align it with the Basel framework, notably the application of a 1,250% risk weight to exposures deducted from Tier 1 and Tier 2 capital. After accounting for the amendments made by the SARB, and quantitative evaluation of the finding noted above, the Assessment Team did not identify any material deviations. The Assessment Team did, however, identify one non-material deviation related to the treatment of risk weight splitting and recommends that the Basel Committee review this issue (see Annex 13).
Basel paragraph number	Basel II 72–73: Claims secured by residential property
Reference in the domestic regulations	Reg. 23(8)(c) on page 133
Findings	According to the Basel framework, lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk-weighted at 35%. In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. The South African Regulations describe a treatment that these loans are given risk weights depending on the security of the parts of the loans. Hence the loan is booked as a single loan, but the portions of it are given different risk weights. A loan of ZAR 105 granted on a house with a market value of ZAR 105 is given the following risk weights: ZAR 80 a 35% risk weight, ZAR 19.9 a 75% risk weight and ZAR 5.1 a 100% risk weight.
Materiality	On the risk weight splitting issue, only one of the banks in the sample applies the Standardised Approach for claims secured by residential property. The deviation of the risk weight splitting method over the total risk-weighted exposures of this bank is less material and, therefore, compliant. Using a conservative assumption of the proportion of the loan-to-value of issued loans over all standardised banks, the deviation still qualified as non-material.

2.3.4 Credit risk: Internal Ratings-Based approach

Section grade	**Compliant**
Summary	Implementation of the IRB approach to credit risk was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB, the Assessment Team did not identify any deviations.

2.3.5 Credit risk: securitisation framework

Section grade	Compliant
Summary	Implementation of the securitisation framework for credit risk was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB, the Assessment Team did not identify any material deviations. One non-material deviation relating to the disclosure requirement for clean-up calls remains. Basel II states that a clean-up call must be considered implicit support if it is found to serve as credit enhancement. It specifies the treatment for implicit support, which entails two components: (i) capital treatment and (ii) disclosure treatment. Domestic regulations set out the disclosure requirements where there is implicit support, consistent with the Basel framework. However, as there was no statement that a clean-up call found to serve as credit enhancement must be considered a form of implicit support, it is not apparent that the disclosure requirements are applicable. The SARB committed to clarifying this, but the amendment had not yet been issued at the cut-off date.
Basel paragraph number	Basel II 559 – Disclosure Treatment of Clean-up Calls found to serve as credit enhancement
Reference in the domestic regulations	Securitisation Notice: 4(3), 5(3), 11(1)(a)(iv), 11(1)(b)
Findings	According to the Basel framework, where a clean-up call is found to serve as credit enhancement, it must be subject to the disclosure requirements that apply to implicit support provided by a bank to a securitisation, ie the bank must disclose publicly (i) that it has provided non-contractual support and (ii) the capital impact of doing so. The South African Regulations do not require clean-up calls found to serve as credit enhancement to be subject to the disclosure requirements for implicit support as set out under the Basel framework.
Materiality	Non-material as there have been no cases of clean-up calls found to serve as credit enhancement. The SARB committed to amending its regulations to implement the disclosure requirement, but the amendment had was not yet been issued at the cutoff date. The Assessment Team recommends that future RCAPs review the amended regulations (see Annex 12).

2.3.6 Counterparty credit risk

Section grade	Compliant
Summary	Implementation of the treatment of counterparty credit risk was found to be compliant with the Basel framework. The South African Regulations initially exempted banks from application of capital requirements for the CVA for certain transactions due to no local central counterparty being available. However, this exemption was removed, and banks must apply the CVA charge in full, effective 1 April 2015. After accounting for the amendments made by the SARB, the Assessment Team did not identify any deviations.

2.3.7 Operational risk: Basic Indicator Approach and Standardised Approach

Section grade	Compliant
Summary	Implementation of the Basic Indicator Approach and the Standardised Approach for operational risk was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB, the Assessment Team did not identify any deviations.

2.3.8 Operational risk: Advanced Measurement Approaches

Section grade	Compliant
Summary	Implementation of the AMA for operational risk was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB, the Assessment Team did not identify any deviations.

2.3.9 Market risk: scope of application and Standardised Measurement Method

Section grade	Compliant
Summary	Implementation of the scope of application and the standardised measurement method for market risk was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB, the Assessment Team did not identify any deviations.

2.3.10 Market Risk: Internal Models Approach

Section grade	Compliant
Summary	Implementation of the IMA for market risk was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB, the Assessment Team did not identify any deviations.

2.4 Pillar 2: supervisory review process

Section grade	**Compliant**
Summary	Implementation of the principles of Pillar 2 was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB regarding the specific factors to be considered in stress tests for measuring market risk, the Assessment Team did not identify any deviations.

2.5 Pillar 3: market discipline

Section grade	**Compliant**
Summary	Implementation of Pillar 3 for market discipline was found to be compliant with the Basel framework. After accounting for the amendments made by the SARB, the Assessment Team did not identify any deviations.

2.6 Findings that are considered as "observations"

Basel II 319 – Discretion for exemption for small domestic corporate borrowers on calculating effective maturity
Regulation 23(11)(d)(ii)(A): M, read with Regulation 23(13)(d)(ii)(B)
Under the Basel framework, supervisory authorities have discretion to exempt the banks using the advanced IRB approach from calculation of effective maturity for small domestic corporate borrowers if their total sales and total assets are less than EUR 500 million and allow them to use the standard effective maturity of 2.5 years as under the Foundation IRB approach. If adopted, such exemption shall be applied to all IRB banks using the advanced IRB approach in that country. According to the South African Regulations, the SARB can grant exemption to any small corporate borrowers in exceptional cases subject to such conditions as may be specified in writing by the Registrar. The SARB informed the Assessment team that this exemption is to be granted only under exceptional circumstances, signalling the SARB's stance not to exercise discretion unless there are compelling reasons for doing so. The SARB confirmed that this discretion has not been used and that if there was a need it would issue a Directive applicable to all banks respecting the Basel scope of discretion.
Basel II 451 – Risk Quantification **Basel II 462 – Requirements specific to PD estimation** **Basel II 473 – LGD Estimates for Retail Exposures** **Basel II 527(b) – Quantitative standards under the internal models market-based approach for Equity Exposures**
Regulation 23(11)(b)(vi)(A) Regulation 23(13)(b)(v)(C) Regulation 23(13)(b)(v)(D) Regulation 23(11)(b)(vii)(A)
The Basel framework provides that a bank must add to its estimates a margin of conservatism that is related to the likely range of errors in estimation of PDs, LGDs and EADs. Where only limited data are available, or where underwriting standards or rating systems have changed, the bank must add a greater margin of conservatism in its estimate of PD. For LGD estimation in the case of retail exposures, the Basel framework requires banks to be more conservative in estimations when there are fewer data. Similarly, under the internal models market-based approach for equity exposures, banks must add appropriate margins of conservatism, where only limited data are available or where technical limitations exist. The above requirements to apply a margin of conservatism are not explicit in the South African Regulations. The SARB responded that any conservatism required to be designed in the model are addressed during the model review process. The SARB will generally not approve of any model that does not comply with the minimum requirements, without any conservative overlays. The SARB also provided evidence of cases where it had required banks to incorporate conservatism in estimations as part of its supervisory review process.
Basel II 674 – External data
Regulation 33(9)(d)(vi)(A)
The Basel framework requires that a bank's operational risk measurement system use relevant external data, either

public data and/or pooled industry data. However, the SARB Regulations provide that a bank shall have board-approved policies and procedures in order to determine the circumstances under which external data should be used in addition to internal data.

The SARB authorities clarified that banks are required to use relevant external data in the AMA as specified in Regulation 33(9)(D) and Regulation 33(9)(d)(vi), and that South African AMA banks can use external data directly in their models (provided an appropriate scaling factor is used) or indirectly in their models (to inform their scenarios). The SARB authorities are of the view that para 674 states that external data must be used, but only to the extent that the external data is relevant and that Regulation 33(9)(d)(vi)(A)(i) is worded with the same intention. Their understanding is that from the mentioned Regulation, a duty is imposed on the board to have board-approved policies and procedures related to external data, which are subject to review by the supervisors when analysing the bank's application to use AMA.

The Assessment Team originally believed that it is possible to interpret the wording of Regulation 33(9)(d)(vi)(A)(i) to mean that there are circumstances under which it would be acceptable if external data were not used, as it does not limit it to when the external data are found to be non-relevant.

However, one important point made by the SARB authorities is that, as the policies which include the circumstances under which external data should be used are subject to supervisory review, in practice, policies permitting the non-use of external data will not be accepted by supervisors. Therefore, any interpretation contrary to the Basel framework is potentially not accepted by the supervisors, who demand the use of external data, as the final part of Regulation 33(9)(d)(vi)(A) specifies.

In addition, the industry confirmed that the use of external data is required in all AMA models used by South African banks.

Therefore, while this point was originally raised due to interpretation issues generated by the phrasing of the Regulation, it is only an observation on interpretation of the Regulation, since SARB practices and application of the rules are compliant with the Basel framework in this regard.

Basel II 718(Lxxvi)(l), Table 2 of Annex 10a – Multiplication factor due to the back-testing of the internal model

Regulation 28(8)(e)(iv)

The Basel framework sets out specific scaling factors to each number of exceptions in the backtesting. In contrast, the SARB Regulations stipulate that it may be equal to zero or may increase by one, if the backtesting results fall from time to time into the red zone specified by the Registrar.

The SARB authorities clarified that the multiplication factors are not specified because the outcome of the multiplier assessment is determined not solely on backtesting results on which these factors are based, and said that qualitative aspects are also taken into consideration.

The Assessment Team sees Table 2 of Annex 10a of the Basel framework as a minimum requirement in terms of the value of the "plus-factor". Therefore, the South African Regulations should present the table as a minimum, even if qualitative aspects are also taken into consideration. The absence of the multiplication factors values in the Regulations could result in a factor lower than that specified by the Basel text being used by the SARB.

During the on-site visit, however, the SARB authorities mentioned that they do not normally make the conditions under which a specific supervisory decision will be made explicit in the Regulations. Therefore, they think it is better not to have the table in their Regulations, in order to prevent banks from arguing that the multiplication factor result would come just from backtesting. In addition, the SARB authorities provided the Assessment Team with their SREP procedures for the initial and renewal of the application to use IMA, in which it is explicit that the supervisors will consider the Basel requirements when analysing an application. Besides, data on the multiplication factors currently in use were provided, showing that the current numbers are above 3.

The Assessment Team, therefore, notes this only as an observation, mainly driven by the SARB's choice to not give details on supervisory decisions in the country's regulatory framework.

Annexes

Annex 1: RCAP Assessment Team and Review Team

Assessment Team Leader

Name	Affiliation
Mr Frank Pierschel	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)

Assessment Team Members

Name	Affiliation
Ms Ana Paula Castro Carvalho	Central Bank of Brazil
Mr Matthias Gutmann	Deutsche Bundesbank
Ms Sandy Ho	Monetary Authority of Singapore
Ms Meri Rimmanen	European Banking Authority
Ms Ingvild Eide Sanden	Finanstilsynet (Norway)

Supporting members

Name	Affiliation
Mr Rajinder Kumar	Basel Committee Secretariat
Ms Tamara Gomes	Basel Committee Secretariat
Ms Barbara Pohl	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)
Ms Tania Rollert	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)

Review Team

Name	Affiliation
Mr Jonas Bernes Fentanes	CNBV, Mexico
Mr Karl Cordewener	Basel Committee Secretariat
Mr Graydon Paulin	Bank of Canada
Mr Sudarshan Sen	Reserve Bank of India
Mr Sunny Yung	Hong Kong Monetary Authority

Annex 2: Implementation of the Basel framework as of the cutoff date

Overview of adoption of capital standards

Table A.1

Basel III regulation	Date of issuance by BCBS	Transposed in the domestic regulations	Date of implementation	Status[4]
Basel II				
Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework – Comprehensive Version	June 2006	2005, 2006, 2007	1 January 2008	
Basel 2.5				
Enhancements to the Basel framework Guidelines for computing capital for incremental risk in the trading book Revisions to the Basel II market risk framework	July 2009	2010, 2011	1 January 2012	
Basel III				
Basel III: A global regulatory framework for more resilient banks and banking systems – revised version	June 2011 (Consolidated version)	2012	1 January 2013	
Pillar 3 disclosure requirements for remuneration	July 2011	2012	1 January 2013	
Treatment of trade finance under the Basel capital framework	October 2011	2012	1 January 2013	
Composition of capital disclosure requirements	June 2012	2013	Directive 8/2013	
Capital requirements for bank exposures to central counterparties	July 2012	2012	1 January 2013 Directive 3/2012 Directive 14/2013 Directive 10/2014	

Number and colour code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. For rules which were due for implementation on 30 June 2012, the following colour code is used: green = implementation completed; yellow = implementation in process; red = not implemented.

[4] To be indicated through colour and numerical codes

Annex 3: List of capital standards under the Basel framework used for the assessment

(i) *International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (Basel II), June 2006

(ii) *Enhancements to the Basel II framework*, July 2009

(iii) *Guidelines for computing capital for incremental risk in the trading book*, July 2009

(iv) "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital", Basel Committee press release, 13 January 2011

(v) *Revisions to the Basel II market risk framework: updated as of 31 December 2010*, February 2011

(vi) *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011)

(vii) *Pillar 3 disclosure requirements for remuneration*, July 2011

(viii) *Treatment of trade finance under the Basel capital framework*, October 2011

(ix) *Interpretive issues with respect to the revisions to the market risk framework*, November 2011

(x) *Basel III definition of capital – Frequently asked questions*, December 2011

(xi) *Composition of capital disclosure requirements: rules text*, June 2012

(xii) *Capital requirements for bank exposures to central counterparties*, July 2012

(xiii) "Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee", Basel Committee press release, July 2012

(xiv) *Basel III counterparty credit risk – Frequently asked questions*, November 2011, July 2012, November 2012

Annex 4: Local regulations issued by the South African authorities for implementing Basel capital standards

A. Overview of issuance dates of important capital rules

Table A.2

Domestic regulations	Name of the document, version and date
Domestic Regulations implementing Basel II	Regulations relating to Banks, issued in terms of the Banks Act, 1990 as amended (the Banks Act). Implemented 1 January 2008 Government Gazette No. 30629
Domestic Regulations implementing Basel II.5	Regulations relating to Banks, issued in terms of the Banks Act Implemented 1 January 2012 Government Gazette No. 34838
Domestic Regulations implementing Basel III	Regulations relating to Banks, issued in terms of the Banks Act Implemented 1 January 2013 Government Gazette No. 35950 Amendment of Regulations relating to Banks, issued in terms of the Banks Act Implemented 1 April 2015 Government Gazette No. 38616

B. Hierarchy of South African laws and regulatory instruments

Table A.3

Level of rules (in legal terms)	Type/description
Laws – Banks Act (No. 94 of 1990)	Enacted by Parliament
Regulations, including reporting requirements	Approved and issued by the Minister of Finance
Directives, Circulars and Guidance Notes	Issued by the Office of the Registrar

Annex 5: Details of the RCAP assessment process

A. Off-site evaluation

- Agreement on principles and process for the assessment
- Completion of a self-assessment questionnaire by the SARB
- Evaluation of the self-assessment by the RCAP Assessment Team
- Independent comparison and evaluation of the domestic regulations issued by the SARB with corresponding Basel III standards issued by the BCBS
- Identification of observations for discussion with the SARB
- Refinement of the list of observations based on clarifications provided by the SARB and developing this into a structured list of preliminary findings
- Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgment
- Forwarding of the preliminary draft report to the SARB
- Receipt of comments on the detailed findings from the SARB

B. On-site discussions and assessment

1. Meetings with the SARB
2. Meetings with banks and other market participants

C. Review and finalisation of the RCAP report

- Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to the SARB authorities for comments
- Review of the SARB's comments by the RCAP Assessment Team
- Review of the draft report by the RCAP Review Team
- Review of the draft report by the Peer Review Board
- Reporting of findings to the SIG by the Assessment Team Leader
- Presentation of the report to the BCBS by the Assessment Team Leader and its approval

Annex 6: List of rectifications by the SARB

Table A.4

Basel paragraph	Domestic rule-making	Brief description of correction
Scope of application		
Basel II 21	Regulation 36(7)	The Regulation was amended to ensure that the "aggregation" method of consolidation is in addition, and complementary, to the top-down consolidation approach provided for under Basel II.
Definition of capital and minimum capital requirements		
Basel II 33	Regulation 36 (10)(d)	The SARB amended the Regulations and the Form BA 600 (Consolidated Supervision) to ensure that surplus capital from insurance entities are not included in qualifying capital at the group level.
Basel III 49, 52, 54, and 57	The Banks Act 2013, Section 1, Definitions Regulation 38	The SARB amended the Regulations removing the word "instrument" from CET1 criteria to ensure that common shares are the sole qualifying capital and intends to amend the Banks Act accordingly. References to CET1 and reserve funds will be corrected where necessary.
Basel III 55	Regulation 38 (13)(b)	The Banks Act was amended to include requirements for subordination of AT1 instruments.
Basel III 90		The SARB amended the Regulations to remove the option to apply deductions, and all relevant exposures will be risk-weighted at 1,250%. The SARB amended the Regulations to remove the reference to "imputed calculation" from all Regulations.
Minority interest	Circular 2/2013	The SARB issued a Circular excluding Pillar 2B capital buffers while determining the eligible amount of minority interest to be included in the regulatory capital.
Credit risk: Standardised Approach		
Basel II 64	Regulation 23(6)(j)	The Regulation was amended to ensure that claims on banks should be denominated and funded in domestic currency if given a 20% risk weight.
Basel II 65	Regulation 23(8)(a) Regulation 23(6)(j)	The Regulation was amended to ensure that claims on securities firms should be denominated and funded in domestic currency if given a 20% risk weight.
Basel II 90, 91	Regulation 51	The SARB published a finalised public document called "Information requirements for external credit assessment institutions for recognition purposes" on its website.
Basel II 197	Regulation 23(9)(d)(vi)(B), read with 23(6)(j) and footnote 1	The Regulation was amended such that the footnote allowing for the application of an imputed risk weight was deleted.
Credit risk: IRB approach		
Basel II 231	Regulation 23(11)(c)(iv)(A)(i)-(iii), read with Regulation 23(6)(c), 23(11)(b)(iv)	The SARB amended the Regulations to require that exposures to a small business borrower are to be calculated on a consolidated basis.
Basel II 234	Regulation 23(11)(c)(iv)(B)(ii)	The SARB amended the Regulations to align the definition of qualifying revolving retail exposures to the Basel II text, specifically clarifying that the use of the QRRE risk weight function is constrained to portfolios that have exhibited low volatility of loss rates, relative to their average level of loss rates.

Table A.4

Basel paragraph	Domestic rule-making	Brief description of correction
Basel II 274	Regulation 23(11)(d)(ii)(C)	The SARB amended the Regulations to limit the SARB's discretion to substituting sales for assets only as the base for computing the firm-size adjustment for SMEs.
Basel II 386 (read with Basel III 90)	Regulation 23(11)(q) Regulation 23(11)(a)(vii) Regulation 23(13)(a)(vi)	For certain equity exposures under the PD/LGD approach, the SARB amended the Regulations to remove the option to apply deductions or to apply an imputed risk weight that effectively results in an amount equivalent to a capital deduction, and to require all such exposures to be risk-weighted at 1,250%.
Basel II 402	Regulation 23(11)(b)(v)(D)(i)(bb)	The SARB amended the Regulations to require banks to address cross-collateral provisions in their rating systems for retail exposures.
Basel II 406	Regulation 23(11)(b)(v)(B)(i)(aa), (bb)	The SARB amended the Regulations to clarify the requirements for loan portfolios with significant concentrations within borrower grades.
Basel II 444	Regulation 23(11)(b)(v)(I)(iii)	The SARB amended the Regulations to require banks to demonstrate the reasonableness of differences where banks do not use the same estimates for both capital and internal purposes.
Basel II 264, 445	Regulation 23(11)(b)(ii) Regulation 23(13)(b)(ii)(G)	The SARB amended the Regulations to remove the discretion to lower the minimum period of three years of use of the rating system, and to require that a bank estimate LGDs and EADs in a manner that is broadly consistent with the minimum requirements for at least three years, prior to qualification for adopting the IRB approach.
Basel II 462	Regulation 23(11)(b)(vi)(A)(i)(cc)	SARB regulations implementing the Basel requirement for default probability models to meet standards on use of models referred to the wrong paragraph for the location of the standards on use of models. The SARB amended the Regulations to correct the paragraph reference.
Credit risk: securitisation		
Basel II 559	Securitisation Notice: 4(3), 5(3), 11(1)(a)(iv), 11(1)(b)	The SARB intends to amend paragraph 11 of the Securitisation Exemption Notice to require clean-up calls found to serve as credit enhancement to be subject to the same disclosure requirements as implicit support. This notice will only be issued in May, so the Assessment Team recommends that future assessments follow up on this item (see Annex 12).
Basel II 567, 573, 609, 615 (read with Basel III 90)	Regulation 23(6)(h)(i) Table 3 footnote 3 Regulation 23(6)(h)(iii)(B)(ii) Regulation 23(6)(j), Table 7, footnote 1 Regulation 23(11)(b)(xii)(D)(iii)(ee) Regulation 23(11)(b)(xii)(D)(v) Regulation 23(11)(e)(i) to (iv)(A) and (B), Table 12 and 13	The SARB amended the Regulations to remove the option to apply an imputed risk weight that effectively results in an amount equivalent to a capital deduction for certain securitisation exposures, and to require all such exposures to be risk-weighted at 1,250%.
Basel II 576	Regulation 23(6)(h)(vii)(A)(ii) 1	The SARB amended the Regulations to require that eligible liquidity facilities be risk-weighted based on the highest risk weight assigned to any of the underlying individual exposures covered by the facility.
Basel II 618(d)	Regulation 23(11)(f)(v)	SARB Regulations implementing the Basel requirement that use of external ratings for reference securitisation exposures must satisfy general requirements for recognition of external ratings referred to the wrong paragraph for the location of the requirements for recognition of external ratings. The SARB amended the Regulations to correct the paragraph reference.

Basel paragraph	Domestic rule-making	Brief description of correction	Table A.4
Basel II 632	Regulation 23(11)(m)(ii)(A)	The SARB amended the Regulations to clarify that CEM should be used to determine potential future exposure of exposures arising from interest rate or currency swaps under the Supervisory Formula Approach.	
Basel II 639 (as revised by Basel 2.5)	Regulation 23(11)(b)(xii)(D)(iii)(dd)	The SARB amended the Regulations to stipulate that banks using the Supervisory Formula Approach can only temporarily apply the highest risk weight of underlying exposures.	
Counterparty credit risk			
Basel II, Annex 4 92(i)	Regulation 23(17)(a)(i) Regulation 23(17)(a)(ii)	The SARB amended the Regulations to also include the notes of the Basel text for calculating add-on amounts of specific types of derivatives.	
Basel III, Revised Annex 4	Regulation 23(15) (iii to iv) Directive 5/2015	The exemption of the CVA capital charge for over-the-counter derivative transactions denominated in the local currency or entered into between local counterparties was removed effective 1 April 2015.	
Operational risk: general aspects and Standardised Approach			
Basel II 663	Regulation 33(8)(b)(ii)(F)	The SARB published an amendment to the Regulations specifying the scope of independent reviews.	
Operational risk: Advanced Measurement Approaches			
Basel II 656, 658	Regulation 33(9)(c) Guidance note 2/2013	The SARB published an amendment to the Regulations including Basel requirements for the use of allocation mechanism.	
Basel II 669(f)	Regulation 33(9)(i)(G) Regulation 33(9)(e) Guidance Note 2/2013 Guidance Note 7/2014	The SARB published an amendment to the Regulations including Basel requirements on weighting the four fundamental elements.	
Basel II 673	Regulation 33(9)(d)(v)(B)(v) Regulation 33(9)(d)(v)(B)(vi) Regulation 33(9)(d)(v)(B)(vii) Guidance Note 7/2014	The SARB published an amendment to the Regulations clarifying the treatment of boundary events.	
Market risk: Standardised Measurement Method			
Basel II 712(iv)	Regulation 28(7)(b)(ii)(C)	The Regulation was amended to include the option to apply deductions, and the reference to “such imputed percentage” was deleted. All exposures will be risk-weighted at 1,250%.	
Basel II 718(xxv), (xxvi)	Regulation 28 (7)(c)(v)(B)(ii) Regulation 28(7)(c)(v)(C)	The Regulation was amended to clarify that the capital requirement to an index contract is the sum of a general market risk requirement of 8%, a specific risk charge of 8% and a further capital requirement of 2%.	
Market risk: Internal Models Approach			
Basel II 718(Lxxxv)	Regulation 28(8)(g) Regulation 39(14)(b)(i) and (b)(ix)	The SARB published an amendment to the Regulations clarifying the issue on external validation.	
Basel II 718(cii)	Regulation 39(13)(a)	The SARB published an amendment to the Regulations clarifying that the valuation estimates must be prudent and reliable and must include, among other thing, procedures for adjusting valuations end of month and ad-hoc verification procedures.	
Basel II 718(cix)	Regulation 39(13)(a)(x)(C)	The SARB published an amendment to the Regulations aligning language with Basel II text	
Basel II 718(cxii)	Regulation 39(13)(c)(i)(C)	The SARB published an amendment to the Regulations specifying that the valuation adjustment must impact Tier 1 capital.	

Table A.4

Basel paragraph	Domestic rule-making	Brief description of correction
Pillar 2		
Basel 738(ii)	Regulations 28(8), 28(8)(f)(i)(A)(iii)(aa) 28(8)(f)(i)(A)(iii)(bb) 28(8)(f)(i)(A)(iv)(aa) 28(8)(h)(i)(D) 38(4), 39(5) 39(14)(b)(viii)(E) and (F)	The SARB published an amendment to the Regulations aligning VaR in stress testing requirements to the Basel framework.
Pillar 3		
Basel III disclosure requirements for capital	Directive 8/2013	The SARB published a Directive to require disclosure and reconciliation templates to be disclosed semiannually, or as often as financial statements are published.

Annex 7: Assessment of the binding nature of regulatory documents

Table A.5

Criterion	Assessment
(1) The instruments used are part of a well defined, clear and transparent hierarchy of legal and regulatory framework.	The SARB is responsible for bank regulation and supervision in South Africa. The purpose is to achieve a sound, efficient banking system in the interest of the depositors of banks and the economy as a whole. This function is performed by issuing banking licenses to banking institutions, and monitoring their activities in terms of the Banks Act, as amended (Act No. 94 of 1990 – Banks Act) and the Regulations relating thereto. "Bank" refers to a public company registered as a bank in terms of the Banks Act or registered branches of foreign institutions. The Banks Act is enacted by Parliament and provides enabling legislation that allows the Minister of Finance to prescribe minimum requirements and selected supervisory activities in the Regulations relating to Banks, as amended ("the Regulations"). The Regulations enable the Bank Supervision Department (BSD) to put in place a supervisory review and evaluation process. Sections 70 and 70A of the Banks Act provides such enabling legislation for the enforcement of the prudential requirements in respect of capital that are stipulated in Regulation 38 of the Regulations. Registered banks must have qualifying capital and reserves as defined in the Banks Act to meet the minimum capital requirements calculated for credit risk, market risk and operational risk, including any additional capital requirements identified as part of Pillar 2, as determined by the Registrar of Banks, as specified in Regulation 38. Amended Regulations were implemented in 2008, 2012 and 2013 to adopt and implement Basel 2, 2.5 and III standards, respectively. The Regulations are supplemented by additional Circulars, Directives and Guidance Notes. Circulars, Directives and Guidance Notes are issued by the Registrar of Banks in terms of Section 6 of the Banks Act. Banks Act Circulars and Banks Act Directives are legally binding. In addition, securitisation schemes are approved and supervised by the SARB via an Exemption Notice relating to securitisation schemes. As a result of the RCAP, the full scope of regulatory instruments were utilised to strengthen local Regulations. In particular, further amendments to the Regulations were issued in March 2015.
(2) They are public and easily accessible.	The Banks Act, Regulations, Banks Act Circulars, Banks Act Directives, Banks Act Guidance Notes and Exemption Notices are published in final form on the SARB's website at www.resbank.co.za.

Table A.5

Criterion		Assessment
(3)	They are properly communicated and viewed as binding by banks as well as by the supervisors.	In 2006, an Accord Implementation Forum (AIF) was constituted to assist with the implementation of Basel II standards. The AIF consisted primarily of the SARB's BSD and representatives of the banking industry who were organised in task groups to discuss amendments needed to implement Basel II fully. Task groups continued to discuss Basel 2.5 and III challenges. The amendments to the Banks Act and Regulations that gave effect to Basel 2, 2.5 and III standards were subject to public consultation, scrutiny by the National Treasury and the Standing Committee for the Revision of the Banks Act. Once the Banks Act and Regulations thereto are published as Government Notices in the Government Gazette, they become binding from the effective date of implementation stipulated in the Government Gazette. Guidance on market practices or matters of interpretation and application are addressed through the issuance of Banks Act Circulars and Guidance Notes. Directions to perform acts necessary to effect a required change are addressed through Banks Act Directives, but only after public consultation. The above are specifically issued to banks, bank controlling companies, branches of foreign institutions and external auditors. Banks Act Circulars and Banks Act Directives are binding from date of publication, unless otherwise stated.
(4)	They would generally be expected to be legally upheld if challenged and are supported by precedent.	Since the legal framework as described above is legally enforceable, subject to strict scrutiny and gives effect to internationally agreed standards/best practice, the SARB expects it will be upheld if challenged. There has been no legal challenge historically, and none is expected.
(5)	Consequences of failure to comply are properly understood and carry the same practical effect as for the primary law or regulation.	The Banks Act, Regulations thereto, Banks Act Directives, Banks Act Circulars and Exemption Notices are legally enforceable. Contravention of any of these is an offence, punishable by penalty, fines and legal sanctions. In addition to the criminal offence, there are also administrative sanctions under section 91A (1) which vest the Registrar with the power to impose a penalty not exceeding ZAR 10,000,000 for every day during which contravention or non-compliance with the Act continues if he believes that a bank or controlling company has contravened or failed to comply with the Act.
(6)	The regulatory provisions are expressed in clear language.	In order to ensure that the legal framework is clear and concise, South Africa adopted Basel standards as a minimum. Minimum requirements were appropriately incorporated considering the South African domestic jurisdictional perspective and implications arising from local legislation, together with internationally agreed standards and best practice in other disciplines, such as International Financial Reporting Standards, corporate governance etc. Interactions with banks have indicated that the regulatory provisions are clearly understood. Should areas of uncertainty be identified as part of ongoing interactions with banks, the BSD may issue Guidance on market practises or matters of interpretation and application are addressed through the issuance of Banks Act Circulars and Guidance Notes.

Table A.5

Criterion		Assessment
(7)	The substance of the instrument is expected to remain in force for the foreseeable future.	The Banks Act and Regulations thereto remain in force until amended by the necessary legal structures. Banks Act Directives remain in force until cancelled by the Registrar in writing. Circular 1 of each year reconfirms applicability of Banks Act Circulars and Directives issued previously. Guidance Note 1 of each year reconfirms applicability of Banks Act Guidance Notes.

Annex 8: Key financial indicators of the South African banking system

Overview of banking system as of 30 June 2014

Table A.6

Size of banking sector (ZAR millions)	
Total assets of all banks operating in the jurisdiction	ZAR 4,178,699
Total assets of all major locally incorporated banks	ZAR 4,178,699
Total assets of all locally incorporated banks to which capital standards under the Basel framework are applied	ZAR 4,178,699
Number of banks	
Number of banks operating in South Africa[5]	31
Number of internationally active banks	31
Number of banks required to implement Basel standards (according to domestic rules)	31
Number of global systemically important banks (G-SIBs)	0 (1 subsidiary of a G-SIB, 6 branches of foreign institutions regarded as GSIBs)
Number of domestic systemically important banks (D-SIBs)	na[6]
Capital standards under the Basel framework	
Number of banks on IRB approach for credit risk	6
Number of banks on IMA for market risk	6
Number of banks on AMA for operational risk	4
Number of banks on IMM for counterparty credit risk	0
Capital adequacy (internationally active banks) (ZAR millions; per cent)	
Total capital	ZAR 319,885
Total Tier 1 capital	ZAR 257,749
Total CET1 capital	ZAR 245,829
Total risk-weighted assets	ZAR 2,023,011
RWA for credit risk (percentage of total RWAs)	82.3%
RWA for counterparty credit risk (percentage of total RWAs)	2.9%
RWA for market risk (percentage of total RWAs)	3.4%
RWA for operational risk (percentage of total RWAs)	11.4%
Total off-balance sheet bank assets[7]	ZAR 1,113,969
Capital adequacy ratio (weighted average)	14.8%
Tier 1 ratio (weighted average)	11.9%
CET1 ratio (weighted average)	11.4%

5 Excluding two cooperative banks and three mutual banks. The combined assets of cooperative and mutual banks amounted to less than 1% of total banking assets in South Africa as at 30 June 2014.

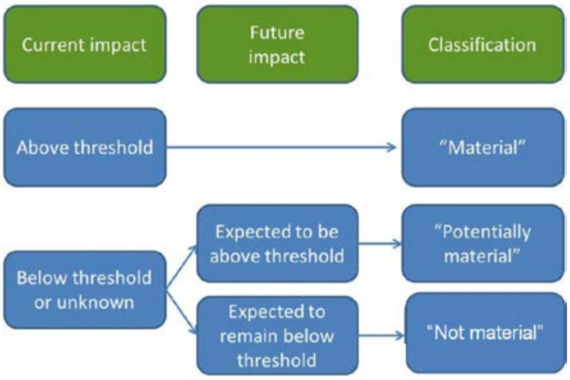
6 The D-SIBs framework has been implemented but corresponding data are not publicly available.

7 Includes derivatives at fair value and the credit equivalent amount of non-market related off-balance sheet exposures prior to credit conversion.

Annex 9: Materiality assessment

The assessment of materiality distinguished between quantifiable and non-quantifiable gaps. For the South African RCAP, an attempt was made to quantify the impact of all quantifiable gaps for each bank in the sample affected by the gap. In total, two gaps/differences were assessed based on bank data and data available to the SARB authorities. In those cases where the computation of the impact was not straightforward, the computation erred on the conservative side. Where no data were available to quantify gaps, the review team relied on expert judgment. Following this approach, an attempt was made to determine whether gaps were "non-material," "material" or "potentially material".

Classification of quantifiable gaps — Figure A.7



Number of gaps / differences by component — Table A. 7

Component	Non-material	Material	Potentially material
Scope of application	0	0	0
Transitional arrangements	0	0	0
Definition of capital	1	0	0
Capital buffers	0	0	0
Pillar 1			
Minimum capital requirements (general)	0	0	0
CR: Standardised Approach	1	0	0
CR: IRB	0	0	0
CR: Securitisation	0	0	0
Counterparty credit risk	0	0	0
MR: Standardised Approach	0	0	0
MR: Internal Models	0	0	0
OR: Standardised Approach/BIA	0	0	0
OR: AMA	0	0	0
Pillar 2	0	0	0
Pillar 3	0	0	0

Materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgment (for the non-quantifiable gaps). See Section 2 with the detailed assessment findings for further information.

Annex 10: Areas where the SARB requirements are stricter than the Basel minimum standards

In several places, the SARB authorities believe that they have adopted a stricter approach than the minimum standards prescribed by the Basel Committee. Alternatively, they consider that they have simplified or generalised an approach in ways that do not necessarily result in stricter requirements under all circumstances, but never result in less rigorous requirements than the Basel standards. The following list provides an overview of these areas. The information in this annex has been provided by the SARB and has not been cross-checked or assessed by the RCAP Assessment Team. It should be noted that these areas have not been taken into account as mitigating factors in the overall assessment of compliance.

Table A.8

Basel paragraphs	SARB regulatory reference	Additional requirements
Capital		
Basel II, paragraph 20	Banks Act	Paragraph 20 of Basel II requires that the Basel II framework be applied on a consolidated basis to internationally active banks. In South Africa, the framework is applied to all banks (solo basis), bank controlling companies and branches of foreign institutions registered in terms of the Banks Act.
Basel III, paragraph 50	Directive 5/2013	SARB minimum required ratios are higher at all levels compared to Basel III, throughout the phase-in period. At the end of 2019 the minimum capital requirements would be CET 1 at 5%, AT1 at 6.75% and Total Capital at 9%, excluding the capital conservation, countercyclical and D-SIB buffers.
Basel III, paragraph 52	Directive 5/2013 and Regulation 38(10)	No dividends may be declared out of CET1, meaning the local banking sector has a large pool of retained earnings not included in CET1.
	Guidance note 7/2013	The SARB PON trigger is set at 5.875%, versus the BCBS trigger of 5.125%.
Basel III, paragraph 94 (d)		No phase-in of the other deductions, apart from surplus capital relating to minority interest, which was phased in from 2013.
Basel III, paragraph 132(c)	Regulation 38(8)(e)(iv)(D)	Restrictions on distributions would be applied on a bank solo and group level with effect from 2016.
Basel III, paragraph 153	Regulation 38(17)	The minimum leverage requirement was already implemented in 2013, ahead of 2018 when it would migrate to Pillar 1. The minimum leverage ratio was set at 4%, compared to Basel III at 3%.
Credit risk: Standardised Approach		
Basel II, paragraph, 70	Regulation 23(8)(b), read with Regulation 23(6)(b), Circular 3/2014	EUR 1 million absolute threshold converted to ZAR 7.5 million. The current exchange rate is ZAR 12.80/EUR 1 and the threshold of ZAR 7.5million is therefore very conservative. At the current exchange rate, the threshold would be around ZAR 12,800,000, which would result in more exposures falling into the retail category and thereby receiving the preferential risk weight of 75%.
Basel II, paragraph 84(ii)	Regulation 23(8)(g), read with Regulation 23(6)(g) Table 2	The Basel framework states that certain transaction-related contingent items (eg performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) will receive a CCF of 50%. The South African Regulations only refer to performance guarantees. The other types of transactions covered by this paragraph would default to a CCF of 100%.
Basel II, paragraph 173	Regulation	In cases of legal uncertainty, the Regulations require banks to obtain

	23(9)(b)(xvi)(A)	a legal opinion to the effect that their right to apply netting is legally founded and legally enforceable in the event of a default.
Securitisation		
–	Regulation 23(6)(h)(vii)	The BSD took a policy decision not to allow banks to provide liquidity facilities to securitisation structures if they have originated the underlying assets. This is not a requirement under the Basel framework.
Credit risk: IRB approach		
Basel II, paragraphs 231 (retail threshold) and 273 (firm size adjustment)	Regulation 23(11)(c)(iv) read with Regulation 26(c) and Regulation 23(11)(d)(ii)(C)	The conversion of the EUR amounts to ZAR at the 1:7.5 conversion rate.
Basel III, paragraph 102	Regulation 23(11)(d)(ii)(A)	The Basel framework requires that the asset value correlation multiplier be applied for regulated financial institutions whose total assets are greater that USD 100 billion. At the current exchange rate, the threshold would be around ZAR 1.211 billion. This absolute threshold was converted to ZAR 700 billion, which would result in the multiplier being applied to more exposures.
Operational risk		
Basel II, paragraphs 649-651	Regulation 33(7)(a)(ii)	"Amounts included in the calculation of average gross income shall be **the relevant audited amounts** in respect of the relevant year. When audited amounts are not available, the bank may with the prior written approval of and subject to such conditions as may be specified in writing by the Registrar use the latest amounts reported by the bank to its board of directors or senior management in respect of the relevant period;"
Basel II, paragraphs 652-654	Regulation 33(8)(c)(i):	"Subject to the provisions of subparagraph (ii) below, a bank shall separately calculate a capital requirement in respect of each **relevant business line specified in table 1 below by multiplying the three-year average amount of gross income relating to each relevant business line with the beta factor specified in table 1 below, and in accordance with the formula specified below, provided that the requirements and conditions specified in sub-regulation (7) relating to gross income,** and in particular any relevant negative amount of gross income, to the extent that the said requirements and conditions are relevant, shall mutatis mutandis apply to each relevant business line specified in table 1 below." P654 states: "In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit." This paragraph is not included in the South African Regulations, as this not allowed.
Market risk		
Basel II, paragraph 718(xLvii)	Regulation 28(7)(e)(ii)(B) & (C) and Regulation 28(7)(e)(iv)(B)	BSD exercised national discretion and the netting of subcategories is not allowed.
Basel II, paragraph 718(L)	Regulation 28(7)(e)(iii)(F)(i) - (iv)	BSD decided not to implement the footnote.

Annex 11: List of approaches not allowed by the SARB's framework

None

Annex 12: List of issues for follow–up by future RCAP Assessments

Scope of application

As noted above, the Assessment Team had minor findings regarding the application of Basel framework at the consolidated and sub-consolidated levels for the South African banks, as the Registrar of Banks can exercise discretion to exempt a financial entity, financial activity or non-financial entity from being included in consolidated returns/reporting, subject to specified conditions.

Although the discretion is not clearly circumscribed, the Assessment Team believes that the SARB authorities explained to the satisfaction of the Assessment Team that such exemptions are only granted in rare cases and where the size and the significance of the relevant entity is non-material. These features will not affect the implementation of the framework.

Securitisation

Basel II requires that clean-up calls found to serve as credit enhancement are subject to the same disclosure requirements as implicit support. As noted in Annex 6, the SARB committed to revise a notice to clarify this requirement, but it was not revised by the assessment cutoff date.

Annex 13: Areas for further guidance from the Basel Committee

Treatment of residential real estate loans

According to the Basel framework (Basel II, paragraphs 72 and 73), lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk-weighted at 35%. In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules.

However, it is not clear whether this concessionary risk weight is only applicable if the entire loan is fully secured, or if the loan can be split into tranches for the purpose of risk weighting, depending on the availability of the security cover for parts of the loan. In certain cases, the margin of security is contributed by the lending bank itself (not the borrower) and it is not clear that in such cases assigning a risk weight of 35% to a substantial part of the loan is appropriate. The loan portioning approach could lead to lower capital charges over the lifetime of the loan. However, the Assessment Team also recognises that, as informed by the SARB, similar loans under the IRB approach attract a much lower risk weight.

The SARB believes that the treatment using two or three risk weight categories on a single loan is consistent with the Basel framework because the amount of lending up to 80% of the value of the collateral is protected by a substantial margin of security from the collateral value. The fact that there is a second part, and potentially a third part, does not, in their view, impair the credit quality of the first part of the loan.

On balance, since the Basel framework does not address risk weight splitting into fully secured and not fully secured parts, and given that similar treatment of residential mortgage loans also exists in the capital adequacy framework of other jurisdictions, the Assessment Team recommends that the Basel Committee review the treatment of loan portioning.

Minority interest

In the context of determining the recognition in consolidated capital of minority interest and other capital issued out of consolidated banking subsidiaries held by third parties under Basel III, the amounts of allowable CET1, Additional Tier 1 and Total Capital of the subsidiary are calculated with reference to the minimum CET1 requirement of the subsidiary plus the capital conservation buffer (ie 7.0% of risk-weighted assets), the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 8.5% of risk-weighted assets) and the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (ie 10.5% of risk-weighted assets), respectively.

The SARB minority interest calculations also include a so-called Pillar 2A capital requirement and other capital buffers (eg countercyclical buffer) in subsidiary capital calculations. The Assessment Team questioned, as in previous jurisdictional assessments, whether the inclusion of the countercyclical buffer or other systemic buffers is a deviation as these buffers are specified by the Basel Committee as an extension of the capital conservation buffer. Materiality assessments were based on current levels of the countercyclical buffer, but it is difficult to assess materiality for future levels. Different RCAPs have shown certain room for interpretation of the Basel rules. Therefore, future guidance on this issue from the Basel Committee on its intent is needed.

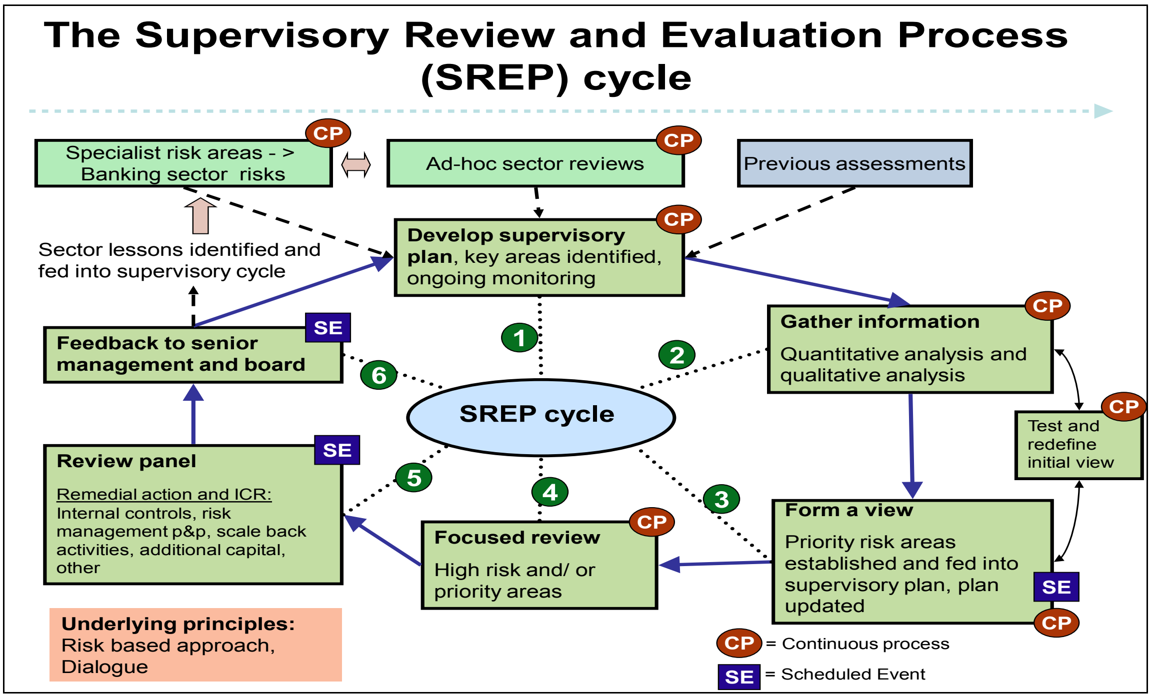
Application of 1,250% risk weights

Under Basel III, a 1,250% risk weight is required to be applied to certain exposures. The SARB amended its regulations to remove the option to apply deductions or to apply an imputed risk weight that effectively results in an amount equivalent to a capital deduction, and to require all such exposures to be risk-weighted at 1,250%. However, the SARB, as well as the South African banking industry, has highlighted that this treatment results in a capital requirement exceeding the outstanding exposure amounts. In view of the capital effect of a 1,250% risk weight on exposures where domestic jurisdictions have set higher minimum capital requirements, the Assessment Team proposes that the Committee reviews the applicability and appropriateness of the 1,250% treatment in such cases and consider if modifications may be needed.

Annex 14: SARB's summary of its Pillar 2 supervisory review process

The Bank Supervision Department's (BSD) methodology is captured in the Supervisory Review and Evaluation Process (SREP) manual. The SREP manual is consists of six main stages that take place as a continuous and ongoing process, as well as scheduled events. The SREP manual is an overarching manual for both on- and off-site analysis.

High-level overview of the SREP cycle:



Stage one

A sound, robust and well considered supervisory plan is a necessary prerequisite to an effective SREP and entails continuous analysis and planning.

Stage two

The SREP includes a review of data submitted by banks by utilising time series analysis, automated key stats, trigger reports and automated graphical analysis. The frequency and intensity of the supervision of banks are determined by the relevant entity's risk assessment, referred to as the Management Information Report (MIR), and the Risk Review document, and would also feed into stage 1 of the SREP, that is, "supervisory planning".

Off-site supervision includes conducting meetings (as part of the supervisory programme) with the banks' board of directors, management, business unit heads, internal audit, compliance officer and external auditors to gather information about a bank's risk profile, business/strategic plan, budgets, strategic objectives, corporate governance and compliance risks, amongst other items. Throughout the cycle a risk-based supervisory approached is followed which is a structured forward-looking approach process designed to identify key risk factors to which individual banks or the entire banking sector are exposed. The "forward-looking" approach includes presentations by the board on a bank's short- and long-term strategy, the bank's projections for the next 12 months and the BSD's views on the aforementioned information.

Stage three

Information gathered from banks would be assembled, and then analysed and synthesised in order to form a view of the bank. The focus is on materiality and risk. The rating assigned to a particular bank takes into account the entity's sector relevance, an assessment of key risk areas, information obtained from interactions with the bank, key focus areas, corporate governance, detailed analysis of capital adequacy and liquidity as well as issues of concerns. Key supervisory focus areas are identified throughout the SREP cycle.

Stage four

A forward-looking view of the risk profile of the banks is also obtained through, among others, the Internal Capital Adequacy Assessment Process (ICAAP). In terms of regulation, banks are required to have in place a robust ICAAP, as part of the bank's overall risk management framework and processes. The ICAAP contains, amongst other information, financial and capital projections as well as the results of various stress scenarios and simulations. The BSD conducts ICAAP on-site reviews using a risk-based approach. A variety of resources is currently involved in an ICAAP review, for example frontline analysis, capital management teams, representative from every risk area and quants. The methodology for the calculation of internal capital with regards to the use of models is also reviewed by the BSD's quant division. Board-approved capital buffers are reviewed in conjunction with stress testing and macroeconomic conditions. Pillar 2 risks are identified and analysed in conjunction with a bank's internal risk assessment, risk appetite and subsequent economic capital.

The BSD ensures that the Pillar 2B add-on is commensurate with the risk profile of the bank.

Stage five

A panel review process is followed whereby a panel, consisting of executives from the BSD, risk specialists and analysts review the procedural and substantive correctness of the SREP, as well as of the conclusions reached and recommendations made. The conclusions reached and recommendations generated during the "forming-of-a-view" stage (stage 3) and the focused review stage (stage 4) by the analyst (in conjunction with the relevant risk specialists, if applicable) form the basis for the panel review.

The review panel's recommendations may include remedial actions to be taken and adjustments to the individual capital requirement (ICR). (It is important to note that the ICR should not be seen as the only tool in a supervisor's armoury, but that other recommendations, such as strengthening of internal controls or risk management policies and procedures, may in certain circumstances be more appropriate.) A review panel is a prerequisite to any capital add-on.

Stage six

Conclusions and recommendations reached in stage 5 are fed back to the bank's board of directors, risk committee, audit committee and senior management. Industry lessons identified are fed back into the macro-surveillance cycle and report, and may warrant the conducting of ad hoc sector reviews.

Notwithstanding the above process, it should be noted that it is prescribed in the Regulations that whenever the Registrar is of the opinion that a bank's:

1. calculated aggregate risk exposure does not sufficiently reflect:
  - the bank's actual risk profile;
  - the factors external to the bank, such as the effect of business cycles;
  - the risk relating to a particular type of exposure, such as credit risk, market risk or operational risk;
  - the risk relating to a group of exposures, such as corporate exposure or retail exposure;
2. qualifying capital and reserve funds are likely to be overstated;
3. policies, processes and procedures relating to its risk assessment are inadequate;
4. policies, processes and procedures relating to compensation or remuneration are inadequate; and
5. internal control systems are inadequate,

the Registrar, among other things, may require a bank to maintain additional capital, to make prescribed deductions against qualifying capital and reserve funds, to strengthen the bank's risk management policies and processes or to duly align the bank's compensation or remuneration policies, processes or procedures with the bank's relevant exposure to risk.