

D3/2022

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

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

Matters related to the requirements for measuring and controlling large exposures

Executive summary

The Basel Committee on Banking Supervision's (the Committee) standard issued in April 2014 titled "Supervisory framework for measuring and controlling large exposures"¹ (revised LEX framework) complements the Committee's risk-based capital standard as the revised LEX framework is designed to specifically protect banks from material losses resulting from the non-performance of a single counterparty or group of connected counterparties which could ultimately threaten the solvency and liquidity of the bank or the banking group.

Amendments to the Regulations relating to Banks were published on 31 March 2022 and implemented with effect from 1 April 2022, which amongst other things, incorporated the revised LEX framework into the Regulations relating to Banks (the Regulations). The amended Regulations provide the Prudential Authority (the Authority) with enabling provisions to specify conditions or limits in writing for measuring and controlling specific types of large exposures.

This Directive serves to direct banks, branches of foreign institutions and controlling companies (hereinafter collectively referred to as 'banks') to apply the conditions and/ or limits specified herein from 1 April 2022 onwards.

1. Introduction

- 1.1 The revised LEX framework issued by the Committee in April 2014 complements the Committee's risk-based capital standard as the revised LEX framework is designed to specifically protect banks from material losses resulting from the non-performance of a single counterparty or a group of connected counterparties which could ultimately threaten the solvency and liquidity of the bank or the banking group.

¹ Available online at: https://www.bis.org/basel_framework/standard/LEX.htm

1.2 The amended Regulations published on 31 March 2022, provide the Authority with enabling provisions to specify conditions and/ or limits in writing for measuring and controlling specific types of large exposures.

1.3 This Directive serves to direct banks to apply the conditions and/ or limits specified herein from 1 April 2022 onwards.

2. Treatment and limits imposed on interbank exposures

2.1 Paragraphs 16 and 17 of the revised LEX framework specify that the sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than 25 per cent of the bank's qualifying tier 1 capital. The limit is set at 15 per cent for a global systemically important bank's (G-SIB) exposures to another G-SIB.

2.2 Paragraph 91 of the revised LEX framework specifies that member countries are at liberty to set more stringent standards, as with any other standards approved by the Committee. In particular, the concern related to contagion has led the Committee to propose a relatively tighter limit on exposures between G-SIBs, in principle, at the jurisdictional level to domestic systemically important banks (D-SIBs). The Committee therefore encourages jurisdictions to consider applying stricter limits to exposures between D-SIBs and to exposures of smaller banks to G-SIBs.

2.3 Paragraphs 65 and 66 of the revised LEX framework specify that only intraday interbank exposures are not subject to the revised LEX requirements but that in stressed circumstances, supervisors may have to accept a breach of an interbank limit ex post, in order to ensure stability in the interbank market.

2.4 Currently, credit concentration risk is not subject to pillar 1 capital requirements in terms of the capital framework and due to the banks' large exposures to other individual banking counterparties, it is important to limit banking institutions' exposures to each other where possible. One of the reasons why the interbank market in South Africa poses a significant credit concentration risk is due to the larger banking groups in South Africa creating a natural concentration in the interbank market. Therefore, in order to promote the safety and soundness of individual banks and to assist in limiting the systemic impact the failure of one large banking institution could have on the South African banking sector, it is equally important to limit the exposures between these larger banking institutions and banking groups.

2.5 Previously, no limit was imposed on interbank exposures and in order to provide banks with sufficient time to implement the respective specified large exposure limits on a continuous daily basis, banks would be allowed, for a specified time period, to meet the respective specified limits for exposures, on an average daily balance for the month, where the average daily balance shall be calculated in accordance with the requirements specified in regulation 8 of the Regulations.

2.6 Furthermore, in order to provide an institution identified by the Authority or the Reserve Bank from time to time as a D-SIB with sufficient time to reduce their

exposures to systemically important financial institutions (SIFIs), D-SIBs would be required to, through a transitional approach, reduce their maximum exposures to other identified SIFIs, where, based on an average daily balance for the month, a threshold of 15 per cent of the bank's qualifying common equity tier 1 capital and reserve funds and additional tier 1 capital and reserve funds (qualifying tier 1 capital) would need to be met from 1 January 2025 onwards.

3. Application of the LEX requirements on other banking entities within a banking group, where a bank within the group has been designated as a D-SIB/D-SIFI or a G-SIB

- 3.1 As specified in regulation 24(6)(c)(iv) of the Regulations, D-SIBs and other domestic systemically important financial institutions (D-SIFIs) are designated by the Authority or the Reserve Bank, while a list of G-SIBs is published by the Financial Stability Board (FSB).
- 3.2 Furthermore, in terms of the provisions of regulation 24(6)(b) of the Regulations, banks are required to determine whether a control relationship or situation of economic interdependence or connectedness, respectively envisaged in regulations 24(6)(b)(i)(A) and 24(6)(b)(i)(B), exists, which group of connected counterparties must for purposes of regulation 24(6) be regarded as a single counterparty.
- 3.3 As such where a bank within a banking group is designated as a D-SIB or a G-SIB, for large exposure purposes and when determining the limit applicable to other banking entities within the banking group, the D-SIB/G-SIB designation would be applied to the controlling company of the D-SIB/G-SIB as well as all other subsidiaries of the bank and controlling company.
- 3.4 Therefore, the D-SIB/G-SIB limit would apply to all subsidiaries of the bank holding company and not only to the designated D-SIB/G-SIB. For each entity within the banking group, the limit would be based on the qualifying tier 1 capital as specified in regulation 24(7)(c) of the Regulations.

4. Application of the LEX requirements on intragroup exposures

- 4.1 Core Principle (CP) 20 of the Core Principles for Effective Banking Supervision issued by the Committee (Core Principles), deals with transactions with related parties. CP 20 of the Core Principles requires that in order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.
- 4.2 Essential criteria 5 of CP 20 of the Core Principles, requires that laws or regulations are set, or the supervisor shall have the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralisation of such exposures. When limits are set on aggregate

exposures to related parties, those are at least as strict as those for single counterparties or groups of connected counterparties.

- 4.3 Paragraphs 8 and 9 of the revised LEX framework specify the application of the large exposure framework to types of concentration risk other than a single counterparty or a group of connected counterparties and indicate that intragroup exposures have not been included in the scope of the revised LEX framework, although it could be considered as another source of concentration risk that might potentially endanger banks' survival.
- 4.4 Consequently, regulation 24(6)(c)(vii) of the Regulations specifies that a bank shall manage its intragroup exposures in such a manner that the aggregate amount of its exposure to entities within the group complies with such conditions or limits as may be specified in writing by the Authority from time to time, in addition to any conditions or limits that may be specified in these Regulations or by the board of directors of the relevant bank or controlling company.
- 4.5 The Authority acknowledges the interconnectedness between entities within the group, but also acknowledges that for the large exposure requirements, intragroup exposures cannot necessarily and in all cases be regarded as a group of connected counterparties and be regarded as a single counterparty. Therefore, the Regulations have an enabling provision to specify conditions where intragroup exposures would not be subject to all of the large exposure requirements.
- 4.6 Through ongoing supervision, compliance with CP 20 of the Core Principles will continue to be monitored, to ensure no abuse arises from transactions with related parties, the risk of conflict of interest is addressed and ultimately that there is no threat to the safety and soundness of the bank or the banking group due to exposure to other entities within the group. Where required, the Authority will take the needed supervisory action.

5. Application of the LEX requirements on a foreign subsidiary of a controlling company required to report on a solo basis

- 5.1 CP 12 of the Core Principles, which deals with consolidated supervision, states that an essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.
- 5.2 Essential criteria 5 of CP 12 of the Core Principles requires the supervisor to review the main activities of parent companies, and of companies affiliated with the parent companies, that have a material impact on the safety and soundness of the bank and the banking group, and to take appropriate supervisory action.
- 5.3 As such, regulation 24(6)(a) of the Regulations requires a bank or controlling company to calculate and report its credit concentration risk at every relevant tier within the banking group, that is, as a minimum, at every relevant branch,

bank solo and consolidated level, in accordance with the relevant requirements.

- 5.4 The Authority acknowledges that foreign subsidiaries would be subject to the regulatory requirements and concentration risk requirements as imposed by the prudential supervisors in the countries where they conduct business (host supervisor) and that the controlling company would be subject to regulatory requirements and concentration risk requirements as imposed by the Authority as the home supervisor. Therefore, the large exposure limit imposed on a foreign subsidiary, will be based, unless otherwise instructed by the Authority, on the controlling company's qualifying tier 1 capital.
- 5.5 Foreign subsidiaries are however exposed to concentration risk similar to any other separately capitalised institution or bank, which might potentially endanger their survival and ultimately the survival of their bank controlling companies or potentially even the wider banking group. Therefore, in order for the Authority to monitor and supervise concentration risk within a foreign subsidiary in accordance with the requirements specified in the revised LEX framework read with the Core Principles, the said subsidiary will be required to report credit concentration risk exposures on the form BA610 - Foreign operations of South African banks based on the foreign subsidiary's own qualifying tier 1 capital calculated in accordance with the relevant requirements specified in the Regulations.

6. Treatment of breaches of the LEX limit

- 6.1 Paragraph 18 of the revised LEX framework specifies that any breaches of the limit, which must remain the exception, must be communicated immediately to the supervisor and must be rapidly rectified.
- 6.2 Regulation 24(6)(g) of the Regulations specifies that when a bank entered into any transaction in the form of an investment with or a loan, advance or other direct or indirect credit facility granted to any person where the transaction results in the bank being exposed to that person to an amount in excess of the prescribed LEX limit, the bank shall (i) immediately report its failure or inability to comply with the specified limit in writing to the Authority, stating the reasons for such failure or inability to comply; (ii) submit in writing to the Authority such further information in such a format as may be directed in writing by the Authority.
- 6.3 The Authority acknowledges that specific circumstances can exist where the prescribed LEX limit would not be able to be met. In these instances, a bank can engage the Authority bilaterally to consider these specific circumstances. The Authority will assess whether the limit breach should be allowed and where allowed, the bank will be subject to the conditions prescribed by the Authority.

7. Directive

Based on the aforesaid and in accordance with the provisions of section 6(6) of the Banks Act 94 of 1990, from 1 April 2022 onwards, banks are hereby directed to ensure that:

- 7.1 For the purpose of regulation 24(6)(c)(iv)(A)(i) of the Regulations, a bank other than a D-SIB or D-SIFI shall manage its business in such a manner that the aggregate amount of its concentrated credit exposure, calculated in accordance with the relevant requirements specified in subregulation (6) to an institution identified by the Authority or the Reserve Bank from time to time as a D-SIB or D-SIFI, complies with the requirements specified below:
- 7.1.1 For the period from 1 April 2022 to 31 December 2024, the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with the requirements specified in regulation 8 of the Regulations) exceed 25 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA700 - Capital adequacy and leverage, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 (Credit risk quarterly return) relates.
- 7.1.2 From 1 January 2025 onwards, the aggregate exposure does not at any time exceed 25 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates.
- 7.2 For the purpose of regulation 24(6)(c)(iv)(A)(ii) of the Regulations, following the 12th month after the date that the bank or controlling company itself has been identified as a D-SIB or D-SIFI, the aggregate amount of its concentrated credit exposure calculated in accordance with the relevant requirements specified in subregulation (6) to an institution identified by the Authority or the Reserve Bank from time to time as a D-SIB or D-SIFI, complies with the requirements specified below:
- 7.2.1 For the period from 1 April 2022 to 31 December 2022, the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with the requirements specified in regulation 8 of the Regulations) exceed 20 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates, provided that the maximum daily exposure shall at no stage exceed 25 per cent of the aforementioned sum of the bank or controlling company's qualifying tier 1 capital.
- 7.2.2 For the period from 1 January 2023 to 31 December 2024, the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with the requirements specified in regulation 8 of the Regulations) exceed 18 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates, provided that the maximum daily exposure shall at no stage exceed 20 per cent of the aforementioned sum of the bank or controlling company's qualifying tier 1 capital.
- 7.2.3 From 1 January 2025 onwards, the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with

the requirements specified in regulation 8 of the Regulations) exceed 15 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates, provided that the maximum daily exposure shall at no stage exceed 18 per cent of the aforementioned sum of the bank or controlling company's qualifying tier 1 capital.

7.3 For the purpose of regulation 24(6)(c)(iv)(B)(i) of the Regulations, a bank other than a D-SIB or a G-SIB shall manage its business in such a manner that the aggregate amount of its concentrated credit exposure, calculated in accordance with the relevant requirements specified in subregulation (6) to an institution identified as and included in the list of G-SIBs (which includes any branch of a G-SIB), published by the FSB from time to time, complies with the requirements specified below:

7.3.1 For the period from 1 April 2022 to 31 December 2024 the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with the requirements specified in regulation 8 of the Regulations) exceed 25 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates.

7.3.2 From 1 January 2025 onwards, the aggregate exposure does not at any time exceed 25 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates.

7.4 For the purpose of regulation 24(6)(c)(iv)(B)(ii) of the Regulations, a bank identified as a D-SIB shall manage its business in such a manner that the aggregate amount of its concentrated credit exposure, calculated in accordance with the relevant requirements specified in subregulation (6) to an institution identified as and included in the list of G-SIBs (which includes any branch of a G-SIB), published by the FSB from time to time, complies with the requirements specified below:

7.4.1 For the period from 1 April 2022 to 31 December 2022, the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with the requirements specified in regulation 8 of the Regulations) exceed 20 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates, provided that the maximum daily exposure shall at no stage exceed 25 per cent of the aforementioned sum of the bank or controlling company's qualifying tier 1 capital.

7.4.2 For the period from 1 January 2023 to 31 December 2024, the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with the requirements specified in regulation 8 of the Regulations) exceed 18 per cent of the sum of the bank or controlling

company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates, provided that the maximum daily exposure shall at no stage exceed 20 per cent of the aforementioned sum of the bank or controlling company's qualifying tier 1 capital.

- 7.4.3 From 1 January 2025 onwards, the aggregate exposure does not at any time on an average daily balance basis for the month (calculated in accordance with the requirements specified in regulation 8 of the Regulations) exceed 15 per cent of the sum of the bank or controlling company's qualifying tier 1 capital, as reported in item 77 of the form BA 700, as at the end of the reporting date immediately preceding the reporting date to which the current form BA 210 relates, provided that the maximum daily exposure shall at no stage exceed 18 per cent of the aforementioned sum of the bank or controlling company's qualifying tier 1 capital.
- 7.5 For the purpose of regulation 24(6)(c)(vii) of the Regulations, a bank or a controlling company shall manage its intragroup exposures in such a manner that the aggregate amount of its exposure to entities within the group complies with the requirements specified below:
- 7.5.1 Unless otherwise specified in writing by the Authority, intragroup exposures risk weighted at 0 per cent in terms of regulation 23(6)(j) of the Regulations, will be exempted from the large exposure limit.
- 7.5.2 For intragroup exposures other than intragroup exposures risk weighted at 0 per cent in terms of regulation 23(6)(j) of the Regulations, unless otherwise specified in writing by the Authority, the bank or controlling company would not be required to determine the connectedness of the intragroup entities, however the aggregate exposure to each intragroup entity must comply with the large exposure limit as specified in regulation 24(6) and 24(7) of the Regulations.
- 7.5.3 Where the bank or controlling company is of the opinion that the large exposure limit specified or imposed would not be appropriate for a certain intragroup entity, the bank or controlling company shall demonstrate to the satisfaction of the Authority that due to the existence of specific circumstances, a different large exposure limit or treatment should be considered.
- 7.6 For the purposes of regulation 24(7)(a)(iii) of the Regulations, in the case of a foreign subsidiary of a controlling company required to report on a solo basis, where the Authority is also responsible for the supervision of the controlling company, the specified amount as contemplated in section 73(1)(a) of the Banks Act, 1990 shall for reporting purposes be 10 per cent of the sum of the qualifying tier 1 capital of the relevant foreign subsidiary, calculated in accordance with the relevant requirements specified in the Regulations.
- 7.7 For the purposes of regulation 24(7)(c)(iii) of the Regulations, in the case of a foreign subsidiary of a controlling company required to report on a solo basis, the specified percentage and the specified amount shall, unless specifically otherwise directed in writing in specific cases, be the relevant percentage of the sum of the qualifying tier 1 capital of the controlling company of the foreign subsidiary.

8. Acknowledgement of receipt

- 8.1 Kindly ensure that a copy of this Directive is made available to your institution's external auditors. The attached acknowledgement of receipt duly completed and signed by both the chief executive officer of the institution and the said auditors should be returned to the Authority at the earliest convenience of the aforementioned signatories.

Fundi Tshazibana

Fundi Tshazibana
Deputy Governor and CEO: Prudential Authority

Date: 1-Apr-2022

Encl. 1

The previous Directive issued was Directive 02/2022, dated 25 February 2022.