The capital buffer regime for SIFI-banks (D-SIBs) in South Africa

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SUMMARY

This contribution examines the potential harmful effects of adopting the international rules known as the Basel Accords on small local banks in developing countries. It argues that while these uniform global financial stability rules may be tenable for larger, often foreign-owned banks, they often place a heavy burden on small financial institutions with limited capital and weak financial resources. This is important because small banks play a vital role in economic growth and financial inclusion in developing nations, particularly in underserved communities in Zambia and other developing countries. The strict capital requirements and increasing regulatory complexity mandated by the Basel Accords risk forcing small banks to either consolidate their market position by merging with larger banks to survive or risk falling into insolvency, thus reducing the number and the role of small banks in an economy. To address this issue, the contribution suggests pragmatic, alternative regulatory frameworks. Key recommendations include, amongst other things, implementation of tiered capital requirements that reflect a bank's size and risk profile, offering targeted government support like "infant industry" support, and fostering a regulatory environment suited to the specific challenges faced by smaller institutions. By adopting customised policies, regulators can safeguard the sustainability of small banks and ensure they remain a crucial driver of economic development.

1 Introduction

The 2008 Global Financial Crisis (GFC or Crisis) that had its epicentre in the United States (US), was a financial crisis of seismic proportions that subsequently caused financial regulation to be improved considerably in various areas with the aim to promote and maintain financial stability on a domestic and global level. As evidenced at the inception of the GFC, the disorderly collapse of the global financial firm, Lehman Brothers, highlighted the adverse impact of the failure of a Too-big-Too-Fail (TBTF)

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financial institution on the financial system.[1] TBTF financial institutions are giant financial conglomerates that have over the years come to be regarded as being "too big to be allowed to fail" because it was feared that their exit from the financial system would cause significant disruption, or could even trigger a system-wide financial collapse, due to their unique characteristics: very large size, high interconnectedness and complexity.[2] The notion of a financial institution being TBTF further became problematic as it attracted its own set of regulatory paradigms, most notably, that of the application of "bail-outs", which simply entails the use of taxpayers' money to prevent the demise of TBTF financial institutions in an attempt to avert systemic crisis.[3] The bail-out conundrum in turn encouraged a "moral hazard" problem that is defined as a tendency for excessive risk-taking and a lack of market discipline by financial institutions that anticipate implied government guarantees to prevent their failure.[4] Because of this bail-out aspect, the TBTF concept is said to refer to government intervention to forestall the failure of these systemically important financial institutions (SIFIs).[5] These TBTF financial institutions thus became major recipients of unprecedented bail-outs required to mitigate the impact that their financial distress or failure would have on financial systems during the GFC.[6]

In the aftermath of the GFC, the Financial Stability Board (FSB), as global standard setter on financial stability matters, subsequently issued the *SIFI Framework* in 2010. This framework seeks to resolve the TBTF-conundrum associated with the potential elevated risk of SIFIs relative to

1 At the time of its failure and subsequent bankruptcy, Lehman Brothers was the fourth largest investment bank in the US and was alleged to have triggered the collapse of the subprime mortgage industry in September 2008 because of its substantial engagement in toxic financial assets. Notably, the US Federal Reserve decided not to extend a bail-out to Lehman Brothers, thus leaving it to fail, as a result of which the GFC ensued given Lehman's interconnectedness in the global financial system. For this, see The Financial Crisis Inquiry Report "Final Report of the National Commission on the causes of the financial and economic crisis in the United States" 2011 https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (last accessed 2023-03-22); Johnson and Mamun "The failure of Lehman Brothers and its impact on other financial institutions" 2022 *Applied Financial Economics* 375 377; Lumsdaine, Rockmore, Foti, Leibon, Farmer "The intrafirm complexity of systemically important financial institutions" 2021 *Journal of Financial Stability* 1 2.

2 Morrison "Systemic risks and the 'too-big-to-fail' problem'" 2011 *Oxford Review of Economic Policy* 498 499.

3 Allen, Carletti, Goldstein, Leonello A "Moral hazard and government guarantees in the banking industry" 2015 *Journal of Financial Regulation* 30.

4 Mishkin "How big a problem is Too Big to Fail? A review of Gary Stern and Rob Feldman's Too Big to Fail: the hazards of bank bailouts" 2006 *Journal of Economic Literature* 988 989.

5 Athavale "Uninsured deposits and the too-big-to-fail policy in 1984 and 1991" 2000 *American Business Review* 123-128.

6 Schwarcz "Too big to fool: moral hazard, bailouts, and corporate responsibility" 2017 *Minnesota Law Review* 761.

financial institutions that are not systemically important.[7] Its purpose is to safeguard financial stability in line with the G-20 international financial reforms post GFC. The elevated risk posed by SIFIs is ascribed to their unique characteristics, as alluded to above: a huge size, high interconnectedness and complexity, which accounts for the systemic risk and the associated moral hazard it engenders.[8]

The *FSB SIFI Framework* recommends the setting out of a Higher Loss Absorbency (HLA) requirement as a regulatory measure designed to increase the resilience of SIFIs to prevent their probability of default when they experience financial distress.[9] It recommends that these institutions should hold an extra capital buffer and be subject to more stringent prudential measures and enhanced supervision to them to keep them safe and sound. This framework further recommends the establishment of an orderly resolution regime that will be applied in the event that a SIFI nevertheless fails. Such resolution regime focuses on mitigating the impact of the failure of SIFIs on the financial system to avoid financial system collapse and thereby eliminating the possibility of their bail-out with the taxpayers' money or at least keeping it as a last resort measure and not the first "go to"-option.[10]

As the international standard-setting body for banks, the Basel Committee on Banking Supervision (Basel Committee) which was established in 1974, introduced numerous reforms fundamental to international banking regulation that are in alignment with the financial stability objective incorporated in the *FSB SIFI Framework*. Post the Crisis, the *Basel III Capital Framework* was initially issued in 2010 to spearhead the international banking regulatory reforms that are aimed at increasing the resilience of banks and the banking system.[11] As part of these regulatory measures, the *Basel III Capital Framework,* issued post-GFC, incorporates a capital buffer regime that adopts a macro-prudential approach focusing on strengthening the resilience of a country's banking system and entire financial system.[12] The *Basel III Capital Framework* macro-prudential approach sought to augment the *Basel II Framework,* issued in June 2004,[13] which established a micro-prudential regulatory

7 Reducing the moral hazard posed by systemically important financial institutions 2010 https://www.fsb.org/wp-content/uploads/r_101111a.pdf (last accessed 2023-03-22).

8 Part I The FSB SIFI framework.

9 Part II The FSB SIFI framework.

10 Part III The FSB SIFI framework; The resolution regime was later introduced by the FSB Key Attributes for Effective Resolution Regimes for Financial Institutions 2011 https://www.fsb.org/wp-content/uploads/r_111104cc.pdf (last accessed 2023-03-22); See also an updated version of the FSB Key Attributes for Effective Resolution Regimes for Financial Institutions 2014 https://www.fsb.org/wp-content/uploads/r_141015.pdf (last accessed 2023-03-22).

11 Basel III: A global regulatory framework for more resilient banks and banking systems 2010 https://www.bis.org/publ/bcbs189.pdf (last accessed 2023-03-22).

12 Para 6 The Basel III capital framework.

13 Para 6 The Basel III capital framework.

framework addressing the safety and soundness of individual banks.[14] The objective of the *Basel II Framework* was to strengthen the soundness and stability of the international banking system by promoting consistent capital adequacy for competitive equality among internationally active banks and to improve risk-sensitive capital requirements and risk-management standards. Further, the *Basel III Capital Framework* recommended a "Higher Loss Absorbency" (HLA) requirement to be applied to systemically important banks (SIBs) to address their heightened systemic risk relative to banks that are not systemically important.[15] Thus the rationale was that systemic banks had to be subjected to more stringent prudential regulation due to the systemic risk they pose.

Accordingly, the Basel Committee released the *Basel G-SIB Framework* in 2011 and subsequently updated it in 2013 and 2018.[16] The G-SIB Framework seeks to regulate the systemic risk arising from global systemically important banks (G-SIBs), being banks whose safety and soundness are regarded as critical for the proper functioning of the global financial system. Banks that are identified as G-SIBs are consequently subjected to the HLA requirement in the form of a "global systemically important surcharge" (G-SIB surcharge). The G-SIB surcharge is thus a stringent prudential instrument that is deployed to raise the loss-absorbency capacity of G-SIBs by means of an extra capital surcharge in order to minimise the likelihood of their demise when encountering financial distress. Subsequently it was decided to publish a similar type of framework for domestic systemically important bank (D-SIBs) and the *Basel D-SIB Framework* was published in 2012. It was designed to complement the *Basel G-SIB Framework* by targeting the systemic risk posed by D-SIBs to their domestic financial system in order to primarily

14 International Convergence of Capital Measurement and Capital Standards 2004 https://www.bis.org/publ/bcbs107.pdf (last accessed 2023-03-22). The Basel II framework revised the Basel Accord, fully known as the International Convergence of Capital Measurement and Capital Standards 1988, being a framework that sets forth the capital standard for banks, https://www.bis.org/publ/bcbs04a.pdf (last accessed 2023-03-22).

15 Para 32 The Basel III capital framework.

16 Global systemically important banks: assessment methodology and the additional loss absorbency requirements 2011 https://www.bis.org/publ/bcbs207.pdf (last accessed 2023-03-22); Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement 2013 https://www.bis.org/publ/bcbs255.pdf (last accessed 2023-03-22); Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement 2018 https://www.bis.org/bcbs/publ/d445.pdf (last accessed 2023-03-22). This assessment methodology was later updated to give effect to changes of the Basel G-SIB framework published in 2018 and these changes were effective as of November 2021. For this, see Scope and definitions – Global systemically important banks 2021 https://www.bis.org/basel_framework/chapter/SCO/40.htm?inforce = 20211109&published = 20211109 (last accessed 2023-03-22).

facilitate the application of the HLA requirement, referred to as "the domestic systemically important banks buffer" (D-SIB buffer).[17]

Notably, South Africa did not experience any bank failures during the GFC.[18] The South African financial system emerged relatively unscathed from the GFC, mainly because it had limited exposure to toxic financial activities in the global financial markets during the Crisis.[19] It was however evident that TBTF-banks existed in the South African financial system that could potentially pose systemic risk and that the fragmented financial regulatory approach that was in existence at the time could not afford holistic regulatory coverage of the financial system hence the need to transition to a more optimal model of financial regulation.[20]

South Africa subsequently transitioned to a Twin Peaks model of financial regulation (Twin Peaks model) through the enactment of *the Financial Sector Regulation Act of 2017*.[21] The Twin Peaks model takes a more comprehensive approach to financial regulation as, in addition to its focus on micro-prudential aspects of financial regulation, it has a very distinct macro-prudential focus that is aligned with the G20 global financial reforms implemented after the 2008 GFC, which pursue financial stability as a core regulatory objective.[22] Within the South African Twin Peaks model regulatory architecture, the Prudential Authority (PA) is responsible for prudential regulation of financial institutions, including banks[23] and the Financial Sector Conduct Authority (FSCA) oversees the market conduct of financial institutions,

17 A framework for dealing with domestic systemically important banks 2012 https://www.bis.org/publ/bcbs233.pdf (last accessed 2023-03-22).

18 South Africa: Financial System Stability Assessment, Including Report on the Observance of Standards and Codes on the following topic: Securities Regulation 2008, https://www.imf.org/external/pubs/ft/scr/2008/cr08349.pdf (accessed 2023-03-22).

19 As above.

20 As above.

21 The Financial Sector Regulation Act No.9 of 2017, http://www.treasury.gov.za/legislation/acts/2017/Act%209%20of%202017%20FinanSectorRegulation.pdf (last accessed 2023-03-22).

22 According to the South African National Treasury Department, Twin Peaks model is ideal for the South African jurisdiction because the South African financial system is highly interconnected and dominated by financial conglomerates and financial institutions providing complex financial products. See Twin Peaks in South Africa: response and explanatory document – accompanying the second draft of the Financial Sector Regulation Bill 2014, https://juta.co.za/media/filestore/2015/03/2014_12_12_Response_document.pdf (last accessed 2023-03-22).

23 S32(1) of the FSR Act establishes the PA. In terms of S33 of the FSR Act, the objectives of the PA are: to promote and enhance the safety and soundness of financial institutions and financial market infrastructures; to protect financial customers against the risk that financial institutions will default on their obligations; and to assist the SARB in its financial stability mandate.

including banks, to protect financial customers.[24] Notably, the South African Twin Peaks model is, in fact, a three-peak model[25] as the South African Reserve Bank (SARB), as central bank, forms yet another (arguably apex) peak, being mandated with an express macro-prudential oversight mandate to ensure the promotion and maintenance of the stability of the South African financial system.[26]

Part of the SARB's financial stability mandate entails the "designation"[27] of financial institutions as SIFIs by the Governor of the SARB pursuant to section 29 of the FSR Act.[28] The SIFI-designation serves to operationalise the stringent prudential regulation of SIFI-banks

24 S56 (1) of the FSR Act creates the FSCA. S57 of the FRS Act stipulates that the objectives of the FSCA are: to enhance and support the efficiency and integrity of financial markets; to protect financial customers by promoting fair treatment of financial customers by financial institutions, providing customers and potential customers with financial education programs and promoting financial literacy to enhance the ability of financial customers to make sound financial decisions; and to assist the SARB in maintaining financial stability.

25 Some authors like Schmulow opine that it is actually a four peak model given that the National Credit Regulator, established in terms of the National Credit Act No.34 of 2005, that is responsible for the regulation and supervision of the South African credit market has not been assimilated into the FSCA as the general market conduct regulator. See Schmulow "Retail market conduct reforms in South Africa under Twin Peaks" 2017 *Law and Financial Markets Review* 163 166-168; Schmulow "Curbing reckless and predatory lending: A statutory analysis of South Africa's National Credit Act" 2016 *Competition and Consumer Law Journal* 24. Further, the Financial Stability Board observed that the role of the National Credit Regulator will be expected to overlap with the market conduct regulation of the FSCA within the South African Twin Peaks model. See FSB Peer Review of South Africa – Review Report 2013 https://www.fsb.org/wp-content/uploads/r_130205.pdf (2023-03-22).

26 S11(1) FSR Act.

27 It should be noted that the Basel G-SIB and D-SIB frameworks use the word "identification", in reference to the assessment of systemic importance of G-SIBs and D-SIBs, and not "designation".

28 S29(1) and (2) of the FSR Act authorises the Governor of the SARB to designate, on non-delegable basis, a financial institution as a SIFI after notifying the Financial Stability Oversight Committee and seeking its advice, and the financial institution concerned must be provided an opportunity to make submissions regarding its designation. S29(3) thereof provides that such designation will be based on factors such as size, interconnectedness, substitutability, complexity, the recommendations of the FSOC and the submissions of the financial institution concerned and any other matter that has been prescribed by the Regulations. S29(4) thereof authorises the Governor of the SARB to further designate a SIFI upon the happening of a systemic event in terms of S14 of the FSR Act. This emergency designation is made without compliance with the notice afforded to, and advice sought from, the Financial Stability Oversight Committee, and the financial institution concerned is allowed to make submissions post-designation. For more discussions on the SIFI-designation in South Africa, see Van Heerden and Lichaba "The designation and stringent prudential regulation of systemically important banks (SIFI-banks) in South Africa" 2022 *Journal of International Banking Law and Regulation* 462 467-468.

by the PA in line with section 30 of the Act. Consistent with section 29 of the FSR Act, the Governor of the SARB has, in 2019, designated six banks as SIFIs in South Africa[29] in line with the *SARB D-SIB Framework.*[30] This current framework modified the SARB's original framework[31] that was issued in line with *The Regulations Relating to Banks* which came into force from January 2013.[32] These SIFI-banks (D-SIBs) are thus subject to the PA's stringent prudential requirements set out in section 30 of the FSR Act, part of which consist of the capital framework.[33] It should however be noted that, prior to the coming into force of the FSR Act and the provisions relating to designation of SIFIs, the SARB had already introduced a capital buffer regime in 2013 as part of the stringent prudential requirements for D-SIBs in South Africa in accordance with *The Regulations Relating to Banks.*[34]

Against this backdrop, this article will consider the capital buffers set out in the *Basel III Capital Framework* as well as the D-SIB buffer which is established in the *Basel D-SIB Framework*. The extent to which *The Regulations Relating to Banks* have consistently required D-SIBs to implement these capital buffers and the D-SIB buffer regime in South Africa as part of the stringent prudential regulation of South African SIFI-

29 The Financial Stability Review 2019 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2019/9606 (last accessed 2023-03-22). These SIFI-banks that accepted their proposed designation without making any submissions are: Absa Bank Limited; The Standard Bank of South Africa Limited; FirstRand Bank Limited; Nedbank Limited, Investec Bank Limited; and Capitec Bank Limited.

30 A methodology to determine which banks are systemically important within the South African context 2019 https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-stability/resolution-planning/A-methodology-to-determine-which-banks-are-systemically-important-within-the-South-African-context%20(2).pdf (last accessed 2023-03-22).

31 The Financial Stability Review 2013 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2013/5961 (last accessed 2023-03-22).

32 The Regulations Relating to Banks 2012 http://www.treasury.gov.za/legislation/35950_12-12_ReserveBankCV01.pdf (last accessed 2023-03-22).

33 It should be noted that Reg 38(8)(e)(vi)(A) of The Regulations Relating to Banks, as amended by The Amendment of Regulations 2016 https://www.gov.za/sites/default/files/gcis_document/201605/40002gen297.pdf (last accessed2023-03-22) initially, in 2013 mandated the Registrar of banks that was the SARB official that was the head of the Office of Banks in the (then) Bank Supervision Department (BSD) to identify D-SIBs and to impose the D-SIB buffer on the identified D-SIBs to implement the Basel D-SIB regime in South Africa. This task of identifying D-SIBs is now performed by the PA, having assumed the role of the (then) BSD subsequent to coming into operation of the FSR Act within the Twin Peaks model of financial regulation. According to South Africa: Financial Sector Assessment Program – Technical Note on systemic risk oversight and macroprudential policy 2022 https://www.imf.org/en/Publications/CR/Issues/2022/06/16/South-Africa-Financial-Sector-Assessment-Program-Technical-Note-on-Systemic-Risk-Oversight-519731 (last accessed 2023-03-22), all banks that have been identified as SIFIs by the Governor of the SARB are automatically categorised as D-SIBs by the PA. Thus, the terms "SIFI-banks" and "D-SIBs" are used interchangeably in the discussions in this article.

34 Reg 38(8)(e) The Regulations Relating to Banks.

banks/D-SIBs in line with section 30 of the FSR Act, will thereafter be critically considered. As South Africa is a developing country that does not currently have banks that are systemically important at the global level, the scope of this article is limited to the stringent prudential regulation of South African D-SIBs.

2 Overview of the Basel minimum capital requirements and buffer regime

The *Basel III Capital Framework* stated that the banking sector's high leverage was one of the key drivers of the severity of the GFC and that banks' insufficient capital and liquidity buffers further amplified this high leverage.[35] As a result, banks were unable to fulfil their credit intermediation role; failed to perform their critical services and also defaulted on their financial obligations to customers.[36] Banks became highly leveraged because they increasingly engaged in an array of complex financial activities such as securitisation and over-the-counter (OTC) derivatives.[37] However, the *Basel II Framework* proved to have insufficient risk-sensitivity to address risks associated with securitisation and OTC derivatives and further accounted for the procyclicality[38] of the financial markets.[39] Therefore, public sector interventions in the form of large bail-out packages consisting of capital injections and liquidity facilities were provided to distressed banks in order to address their solvency and liquidity concerns, as well as to address risks to the financial system in pursuit of the financial stability objective.[40]

2 1 Minimum regulatory capital

Consequently, the *Basel III Capital Framework* was developed to address the regulatory flaws of the banking sector which surfaced during the Crisis.[41] Accordingly, the *Basel III Capital Framework* seeks to strengthen the resilience of banking systems by raising the quality and quantity of capital for banks as well as making its definition consistent across

35 Para 4 The Basel III capital framework.
36 Acharya, Mora "A crisis of banks as liquidity providers" 2015 *The Journal of Finance* 1.
37 Para 20 The Basel III capital framework.
38 A financial system tends to be pro-cyclical in nature when financial institutions abundantly provide credit in times of benign economic conditions and tighten it during market downturn. See para 18 of the Basel III capital framework.
39 Paras 20 The Basel III capital framework. See further, Jones, Zeitz "The limits of globalising Basel banking standards" 2017 *Journal of Financial Regulation* 89 96-124.
40 Para 4 The Basel III capital framework; See further, Flemming "Federal Reserve liquidity provision during the financial crisis of 2007-2009" 2012 *Annual Review of Financial Economics* 161 162.
41 Para 6 The Basel III capital framework.

jurisdictions.[42] A key element of the new definition of the capital focuses on Common Equity Tier 1 (CET1) capital which comprises of common shares and retained earnings.[43] The Basel Committee regards such CET1 capital as the most effective loss-absorbing, and higher form of, regulatory capital for purposes of ensuring that a bank can continue operating as a going concern, and having adequate CET1 capital is thus vital for a bank's continued operation.[44] The *Basel III Capital Framework* thus recommends that banks should maintain a certain minimum level of regulatory capital consisting of the sum of the following: Tier 1 capital (consisting of CET1 capital and Additional Tier 1 (AT1) and Tier 2 capital. Tier 1 capital constitutes part of regulatory capital covering the going concern of banks while Tier 2 capital covers its gone concern.[45] The *Basel III Capital Framework* set forth the following minimum regulatory capital for banks: CET1 capital of at least 4.5 per cent of risk weighted assets (RWAs), Tier 1 capital of minimum of 6 per cent of RWAs and total capital of minimum of 8 per cent of RWAs.[46]

To fortify minimum regulatory capital, the *Basel III Capital Framework* incorporates the capital buffer regime comprising of the capital conservation buffer (CCvB) and the countercyclical capital buffer (CCyB), as discussed hereinafter, being macroprudential instruments that are applied generally to all banks, including D-SIBs. The *Basel III Capital Framework* stresses the significance of these macroprudential buffers as instruments designed to prevent or mitigate systemic risk that banks pose to a financial system in order to safeguard financial stability. As such, they are buffers designed to augment the regulatory capital incorporated in the *Basel II Framework* that adopts a micro-prudential approach addressing the safety and soundness risks of individual banks.

2 2 The capital conservation buffer (CCvB) requirement

The Basel Committee noted that, at the onset of the GFC, banks continued making large capital distributions in the form of dividends and general compensation despite their deteriorating financial condition and thus rendering the financial system less resilient.[47] To address these challenges, the Basel Committee introduced the CCvB regime, requiring banks to conserve capital to build up buffers that increase their resilience during an economic downturn.[48] The Basel Committee deemed that the implementation of the CCvB framework would serve the purpose of

42 Para 8 The Basel III capital framework.
43 Paras 9, 52 The Basel III capital framework.
44 See Paras 48, 49 The Basel III capital framework. See further, Hanson, Kashyap, Stein "A macroprudential approach to financial regulation" 2011 *Journal of Economic Perspectives* 3 9 noting that since a bank's total Tier 1 capital includes CET1 capital and preferred shares, among other items, in a scenario where a bank is troubled, CET1 capital enables recapitalisation as it ranks more junior than preferred shares.
45 Paras 49 The Basel III capital framework.
46 Paras 49, 50 The Basel III capital framework.
47 Para 27 The Basel III capital framework.
48 Para 28 The Basel III capital framework.

conserving capital that can be used to support the ongoing business operations of banks during times of market stress.[49]

The CCvB is a macro-prudential buffer made up of a certain amount of capital above the minimum regulatory capital.[50] Banks must build up such CCvB in good times and can then draw upon it to act as a cushion in times of stress.[51] Banks that are systemically important as well as banks that are not systemically important are required to maintain, at all times, a CCvB of 2.5 per cent to RWAs comprising of CET1 capital.[52]

As indicated in the *Basel Capital III Framework*, a bank that contravenes the CCvB requirement becomes subject to constraints on capital distributions.[53] That means a bank will be restricted from making capital distributions when its capital levels fall within the CCvB range – however, such bank will be allowed to continue its normal operations. These capital distributions constraints imposed on a bank when its capital levels fall into the CCvB range are set to be more stringent as the bank's capital levels drop closer to the minimum capital requirements.[54] Therefore, capital distributions constraints imposed on a bank with capital levels at the top of the range would be less stringent. Consequently, a bank that meets the CCvB with a full requirement of CET1 capital will however, not be subject to restrictions relating to capital distributions.

2 3 The countercyclical capital buffer (CCyB) requirement

As observed by the Basel Committee, the height of the GFC demonstrated that undue credit expansion during market upswings preceded significant losses during a downturn that greatly destabilised the banking sector.[55] Thus, the CCyB was introduced as a macro-prudential instrument designed to regulate cyclical systemic risk by restricting excessive credit growth associated with the build-up of risk over a certain time-dimension.[56]

The *Basel III Capital Framework* requires jurisdictions to designate national authorities responsible for implementing the CCyB regime.[57] The CCyB is set at zero per cent of a bank's RWAs under benign market conditions.[58] When credit provision unabatedly escalates to such extent

49 Para 27 The Basel III capital framework.
50 See para 2.1 above.
51 Paras 27, 28,122 The Basel III capital framework; See further, Ramirez *Handbook of Basel III capital: enhancing bank capital in practice* (2017) 13 notes that the CCvB regime is designed to absorb losses during the periods of stress.
52 Para 129 The Basel III capital framework.
53 Para 129 The Basel III capital framework.
54 Para 130 The Basel capital framework.
55 Para 29 The Basel III capital framework.
56 Paras 30, 31, 136 The Basel III capital framework.
57 Para 139 The Basel III capital framework.
58 Para 31 The Basel III capital framework.

that it is associated with a build-up of systemic risk, a CCyB of up to 2.5 per cent of RWAs composed of CET1 capital, is activated by the designated national authorities.[59] When credit supply is judged not to be raising cyclical systemic risk concerns, the CCyB is released to enable the flow of credit and allow economic activity to be carried out in a financial system.[60] For such period when a bank would not be required to hold the CCyB, it is permitted to use it to carry out any of its other operations. When it is activated, the CCyB constitutes an extension of the CCvB.[61] Breach of the CCyB also subjects a bank to capital distributions constraints.[62] The capital that is used to comply with the CCyB requirement cannot however, be simultaneously used to fulfil other minimum capital requirements, such as the Pillar 2 requirements of the *Basel II Framework*.[63]

In its document titled, *Guidance for national authorities operating the countercyclical capital buffer*, the Basel Committee states that national authorities' decisions regarding the level of the CCyB should be guided by the objective of the CCyB, namely to protect the financial system against potential future losses when excessive credit expansion is leading to a build-up of systemic risk.[64] In particular, national authorities have to take into consideration the Credit-to-GDP gap and other variables in their country that indicate the existence of abundant credit supply, when exercising judgment on whether a particular instance of undue credit growth is associated with a build-up of systemic risk.[65] Further, the national authorities may apply their own judgment in setting the CCyB based on the best information available to evaluate the build-up of risk and such judgment should be underpinned by a clear set of principles to back up supervisory decisions.[66] Regular supervisory updates regarding the anticipated imposition of the CCyB is recommended, and effective communication strategies are required to be put in place for such purpose.[67]

The Basel Committee further indicated that host authorities are responsible for setting the CCyB to credit exposures of banks located in

59 Paras 137, 139 The Basel III capital framework.
60 Para 30 The Basel capital framework.
61 Para 146 The Basel III capital framework.
62 Paras 138 The Basel III capital framework.
63 The Basel Committee states that the exception to this general rule is made when the CCyB is adapted to capture some of the Pillar 2 capital requirements when it is set above zero per cent to avoid the duplication of capital requirements.
64 Guidance for national authorities operating the countercyclical capital buffer 2010 https://www.bis.org/publ/bcbs187.pdf (last accessed 2023-03-23).
65 Credit-to-GDP is defined as "the deviation of the credit-to-GDP ratio from its long-term trend". For this, see Operationalising the election and application of macroprudential instruments 2012 https://www.bis.org/publ/cgfs48.pdf (last accessed 2023-03-23).
66 Guidance for national authorities operating the countercyclical capital buffer 2.
67 As above.

their jurisdictions and that the application of such CCyB is subject to the principle of reciprocity.[68] The principle of reciprocity requires home authorities to ensure that their internationally active banks calculate their bank-specific CCyB as a weighted average of the CCyB requirements deployed across all the host jurisdictions to which they have credit exposures.[69] Nonetheless, the power to set the CCyB for banks with credit exposures in host authorities is vested in their home authorities.[70] The home authorities cannot however implement the lower CCyB rate in respect of their banks' credit exposures to the host jurisdictions in order to discourage the competitive disadvantage of foreign banks over domestic banks.[71]

The Basel Committee is of the view that the quarterly setting of the CCyB is preferable because it corresponds with the financial reporting time for banks, further, the Committee recommends the setting of the CCyB on a more frequent basis.[72] If a decision regarding the activation of the CCyB is reached, the *Basel III Capital Framework* requires a notification to be issued twelve months in advance of its application to allow banks to adjust their capital planning during the transition period.[73] A decision to decrease the level of the CCyB will take effect immediately.[74]

2 4 The D-SIB buffer regime

The *Basel III Capital Framework* indicates that systemically important banks were major transmitters of systemic shocks during the 2008 GFC because of their interconnectedness in the financial system and economy.[75] As noted in the *Basel D-SIB-Framework*, the financial distress or failure of D-SIBs could potentially have a negative impact on the domestic economy compared to non-systemic banks, due to their heightened systemic risk reflected in their size, interconnectedness, substitutability and complexity, or cross-jurisdictional activity in instances where they are also internationally active banks.[76] The *Basel D-SIB Framework* thus introduced the D-SIB buffer regime as the primary stringent prudential instrument that implements the HLA requirement for D-SIBs in order to address their elevated systemic risk, which is not presented by banks that are not systemically important.[77] The primary objective of the D-SIB buffer is to enhance the loss-absorbing capacity of D-SIBs in order to reduce their probability of default during financial

68 As above.
69 Para 143 The Basel III capital framework.
70 Guidance for national authorities operating the countercyclical capital buffer 5.
71 As above.
72 As above.
73 Para 141 The Basel III capital framework.
74 As above.
75 Para 32 The Basel III capital framework.
76 Para 22 The Basel D-SIB framework.
77 Para 29 The Basel D-SIB framework.

market distress.[78] Therefore, the Basel Committee recommends that CET1 capital, as the simple and most effective capital that increases the going-concern loss-absorbing capacity of a bank, should be deployed to fully meet the D-SIB buffer requirement.[79] This CET1 capital is intended to facilitate a maximum degree of consistency and comparability of the application of the D-SIB buffer requirement in terms of the effective loss-absorbing capacity of D-SIBs across jurisdictions.[80]

Given that they have the capacity to set capital requirements for banks operating within their jurisdictions, the home authorities and the host authorities are authorised to impose the D-SIB buffer on D-SIBs that are in their respective jurisdictions.[81] To that end, national authorities are required to apply a D-SIB buffer on the consolidated level of D-SIBs to regulate the systemic risk that they pose on the home authority's financial system. Host authorities should thus calibrate the D-SIB buffer on a sub-consolidated level of D-SIBs to address the negative externalities that they create on their financial system. As such, supervisory cooperation and coordination between home and host authorities is fundamental when imposing the D-SIB buffer on subsidiaries of foreign banks, within the constraints that are imposed by relevant laws in their host jurisdictions.[82]

In the case where the national authority identifies as a G-SIB, a bank that has also been identified as a D-SIB, because it is systemically important on both a domestic and global level, the higher of either the G-SIB buffer (surcharge) or the D-SIB buffer, should be applied to such D-SIB.[83] As stated by the Basel Committee, this approach underpins the "minima" opposed to the "maxima", regulatory approach in applying prudential standards, which permits national authorities to impose prudential standards that are more stringent than those prescribed by the Basel Committee.[84] As indicated by the *Basel D-SIB Framework*, a parent bank is expected to be sufficiently capitalised on a stand-alone basis, regardless of whether it is a D-SIB or not, and even in cases where its subsidiary has been identified as a D-SIB.[85] National authorities are

78 Para 29f The Basel D-SIB framework.
79 Para 44 The Basel D-SIB framework.
80 Para 44 The Basel D-SIB framework.
81 Para 36 The Basel D-SIB framework.
82 Paras 42, 43 The Basel D-SIB framework.
83 Paras 39, 40 The Basel D-SIB framework; Under para 41 of the Basel D-SIB framework, the Basel Committee pronounces the view that the D-SIB buffer and the G-SIB buffer should not be additive to avoid double counting in order to ensure consistency between the Basel D-SIB framework and the Basel G-SIB framework and to recognise the complementary perspective of the Basel D-SIB framework to the Basel G-SIB framework.
84 As above.
85 Para 38 The Basel D-SIB framework; Para 23 of the Basel II Framework reads: "further, as one of the principal objectives of supervision is the protection of depositors, it is essential to ensure that capital recognised in capital adequacy measures is readily available for those depositors. Accordingly, supervisors should test that individual banks are adequately capitalised on a stand-alone basis."

required to subject D-SIBs that are identical in terms of their degree of systemic importance to the same D-SIB buffer, *ceteris paribus,* regardless of whether they are domestic banks, subsidiaries of foreign banking groups or subsidiaries of G-SIBs.[86]

The calibration of the appropriate level of the application of the D-SIB buffer should be based on analytical frameworks informed by the national authorities' policy judgments that are guided by country-specific factors, which could include the size of the banking sector relative to the country's GDP and the degree of concentration of the banking sector.[87] This means that the systemic impact of the distress or failure of a bank with a bigger size relative to its country's GDP will be expected to be more severe than that of a bank of a comparable size that is not huge compared to the GDP in another jurisdiction, while a concentrated banking system may occasion greater losses than a dispersed banking sector, and therefore, justify a more stringent D-SIB buffer. Accordingly, banks with comparable systemic importance may be subject to varying levels of the D-SIB buffer across different jurisdictions.[88] However, the overarching principle of the *Basel D-SIB Framework* stipulates that the D-SIB buffer should be commensurate with the degree of the systemic profile of individual D-SIBs, the rationale being to incentivise D-SIBs to reduce their systemic footprint.[89]

The D-SIB buffer augments the CCvB, and the CCyB, if is it activated.[90] The capital distributions constraints rules that apply to a bank when it breaches the CCvB requirement, are similarly applied to a D-SIB that contravenes the D-SIB buffer requirement.[91] The capital that is deployed to meet the D-SIB buffer requirement should not be used to comply with Pillar 2 requirements. Pillar 2 requirements entail the *Supervisory Review and Evaluation Process* (SREP) in terms of which risk-management and governance frameworks of banks are assessed to ensure prudent and effective risk assessment and compliance with minimum regulatory capital requirements under the Pillar 1 requirements of the *Basel II Framework*.[92] It was pointed out that while the D-SIB buffer itself

86 Para 37 The Basel D-SIB framework; *Ceteris paribus* is a Latin concept that is literally translated "all other things being equal". For this, see Reutlinger "*Ceteris paribus* laws" Stanford Encyclopaedia of Philosophy 2019 https://plato.stanford.edu/entries/ceteris-paribus/ (last accessed 2023-03-23). Therefore, in this context, it is used to imply that the same D-SIB buffer must be applicable to all D-SIBs with comparable systemic profile unless the relevant national authorities provide a justification for the varying buffer rate. Specifically, the sub-consolidated application of the D-SIB buffer to subsidiaries seeks to mitigate their systemic significance on their host countries, even though the particular bank may not be systemically important at the parent level.

87 Para 32 The Basel D-SIB framework.

88 Paras 30, 31, 32, 33 The Basel D-SIB framework.

89 Para 35 The Basel D-SIB framework.

90 Para 45 The Basel D-SIB framework.

91 Paras 45, 49 The Basel D-SIB framework; Para 147 The Basel III capital framework.

92 Para 720 of the Basel II framework.

regulates systemic risk emanating from D-SIBs, it is also concurrently deployed with the CCvB and the CCyB, which are applied to banks in general, for the pursuit of financial stability and safety and soundness objectives.

3 South Africa's implementation of the Basel capital buffer framework

South Africa has implemented the capital buffer regime through *The Regulations Relating to Banks* which came into force from January 2013,[93] as now also required by section 30 of the FSR Act. *The Regulations Relating to Banks* implemented the *Basel III Capital Framework,* incorporating the CCvB and the CCyB applying generally to all banks as well as the *Basel D-SIB Framework,* incorporating the D-SIB buffer specifically applying to D-SIBs.[94]

3 1 Minimum regulatory capital requirement

All South African banks are required to hold minimum regulatory capital composed of 8 per cent of CET1 capital and reserve funds, AT1 capital and reserve funds and Tier 2 capital and reserve funds, of which not less than 4.5 per cent of a bank's RWAs must comprise CET1 capital whereas the sum of CET1 capital and AT1 capital must be 6 per cent of RWAs.[95]

3 2 The implementation of the CCvB requirement

Under the South African capital buffer framework, the CCvB consisting of 2.5 per cent of the CET1 capital of a bank's RWAs,[96] ranges above the minimum regulatory capital to act as a cushion for systemic shocks. It is

93 The Regulations Relating to Banks 2012 http://www.treasury.gov.za/legislation/35950_12-12_ReserveBankCV01.pdf (last accessed 2023-03-23); The Amendment of Regulations 2016 https://www.gov.za/sites/default/files/gcis_document/201605/40002gen297.pdf (last accessed 2023-03-23).

94 Reg 38(8)(e) The Regulations Relating to Banks; See further, Assessment of Basel III risk-based capital regulations – South Africa 2015 https://www.bis.org/bcbs/publ/d322.pdf (last accessed 2023-03-23). The implementation of the Basel III capital framework and the Basel D-SIB framework was initially captured in the following Directives; Directive 5/2013 – Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2013/5686 (last accessed 2023-03-23); Directive 6/2016 – Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2016/7573 (last accessed 2023-03-23).

95 S70 The Banks Act; Regs 38(d), 38(e)(i) The Regulations Relating to banks.

96 Regs 38(8)(e) (iv), 38(8)(f) The Regulations Relating to Banks; See further, Circular 4/2016 – Matters relating to the implementation of the capital conservation buffer https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-circulars/2016/7251 (last accessed 2023-03-23).

imposed on all banks, including SIFI-banks/D-SIBs. The breach of this requirement restricts discretionary payments such as dividends and bonuses until there is capital restoration.[97]

In order to provide temporary relief measures enabling banks to continue their credit intermediation role while absorbing losses imposed on them by the global Covid-19 pandemic, the PA, in April 2020, reduced the required minimum prudential requirements and directed banks to deploy the CCvB as a cushion against shocks, as part of these relief measures.[98] Further, the PA issued a guidance recommending all banks to limit dividend and bonus payments to conserve capital for loss-absorption and continued funding.[99]

In February 2021, the PA subsequently recommended the reinstatement of the CCvB requirement and provided guidance regarding the relaxation of the restriction on distribution of dividends and bonus payments for purposes of stable capital levels of banks.[100] The PA, nonetheless, cautioned that the distributions of dividends on ordinary shares and/or payments of cash bonuses should be prudent and commensurate with the banks' assessments of the Covid-19 conditions

97 Regs 38(8)(e) (iv), 38(8)(f) The Regulations Relating to Banks.

98 Directive 2/2020: Matters related to temporary capital relief in light of COVID 19 https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2020/9843 (last accessed 2023-03-2023); See further, The Financial Stability Review May 2020 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2020/9956 (last accessed 2023-03-23). In this edition of the Financial Stability Review, the SARB notes that when banks approach the required minimum capital requirements, they are likely to reduce risk-weighted exposures or the size of those exposures and this results in reduced lending. The SARB notes that reducing the required minimum capital requirements, thus enables banks to continue lending. Covid-19 was characterised as a pandemic by the WHO and the Covid health crisis caused lockdowns in various countries that heavily compromised economic growth across the globe. For this, see WHO Covid-19 – China https://www.who.int/emergencies/disease-outbreak-news/item/2020-DON229 (last accessed 2023-03-23). Following this, South Africa declared Covid-19 outbreak as a national disaster, and as a result a national lockdown was imposed from that time throughout 2021. See Government Notice R 313 The Disaster Management Act 57 of 2002 https://www.gov.za/sites/default/files/gcis_document/202003/43096gon313.pdf (last accessed 2023-03-23); See further, Scott "The banking Regulation Review: South Africa" 2022 https://thelawreviews.co.uk/title/the-banking-regulation-review/south-africa (last accessed 2023-03-23).

99 Guidance Note 4/2020 – Dividends-and-bonus-payments-in-response-to-Covid19.pdf https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-guidance-notes/2020/9845 (last accessed 2023-03-23).

100 Guidance Note 3/2021 – Distribution of dividends on ordinary shares and payment of cash bonuses to executive officers https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-guidance-notes/2021/G3---2021-Distribution-of-dividends-on-ordinary-shares-and-payment-of-cash-bonuses-to-executive-officers (last accessed 2023-03-23).

and potential future uncertainty.[101] The CCvB requirement was subsequently reinstated by *Directive 5/2021*.[102]

In the *Financial Stability Review*, published in May 2021, the SARB noted that South African banks remained adequately capitalised despite lower profitability.[103] In its *Financial Stability Review* issued in May 2022, the SARB however indicated that the banking sector's regulatory capital in the form of CET1 capital increased steadily throughout 2021 to levels higher than the pre-Covid period.[104]

3 3 The implementation of the countercyclical capital buffer (CCyB)

The CCyB regime is designed to regulate the cyclical systemic risk posed by banks in the South African banking sector and it augments the CCvB.[105] The Financial Stability Committee (FSC) is the South African national designated authority[106] that is tasked with the setting of the CCyB rate comprising of CET1 capital of up to 2.5 per cent of RWAs. This committee is a non-statutory body that forms part of the SARB Financial Stability Department that was established in 2000,[107] and it formulated the *SARB macroprudential framework* as part of its duties.[108] In line with

101 Guidance Note 2/2022 – Dividends and bonus payments in response to Covid19 https://www.resbank.co.za/content/dam/sarb/publications/prudential-authority/pa-deposit-takers/banks-guidance-notes/2022/G2-2022%20-%20Dividends%20and%20bonus%20payments%20in%20response%20to%20Covid%2019.pdf (last accessed 2023-03-23).

102 Directive 5/2021 – Capital Framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2021/D5---2021---Capital-Framework-for-South-Africa-based-on-the-Basel-III-framework (last accessed 2023-03-23).

103 The Financial Stability Review May 2021 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2021/First-edition-2021-Financial-Stability-Review0 (last accessed 2023-03-23).

104 The Financial Stability Review May 2022 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2022/First-edition-2022-Financial-Stability-Review (last accessed 2023-03-23).

105 Regs 38(8)(e)(v), 38(8)(g) The Regulations Relating to Banks; Circular 8/2015 – Countercyclical capital buffer for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-circulars/2015/7005 (last accessed 2023-03-23).

106 The Financial Stability Review May 2017 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2017/7786 (last accessed 2023-03-23).

107 The Financial Stability Review May 2020 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2020/9956 (last accessed 2023-03-23). In this Financial Stability Review, the SARB notes that the Financial Stability Committee plays a pivotal role in helping the SARB to fulfil the financial stability functions on every day-to-day basis.

108 A new macroprudential policy framework for South Africa 2016 https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/2016/7547 (last accessed 2023-03-23).

internationally agreed principles, the FSC is guided by the credit-to-GDP ratio and other credit expansion indicators to assess the level of systemic risk build-up in the South African financial system.[109] Notably, the FSC reciprocates the CCyB in other jurisdictions based on the materiality principle by only recognising credit exposures exceeding a specified threshold.[110] The breach of the South African CCyB also subjects banks to constraints on capital distributions until their capital is restored to the required levels.[111]

It is mentioned in the first edition of the *Financial Stability Review* of 2019, that the Financial Stability Committee reported that the CCyB would, for the time being, remain at zero per cent because of the decreased rate of credit growth in South Africa.[112] According to the first *Financial Stability Review* edition of 2020, this rate of the CCyB remained unchanged as of May 2020.[113] Subsequently, the SARB reported in the *Financial Stability Review*, published in May 2021, that the FSC deemed it appropriate to maintain the CCyB at zero per cent given the (then) current economic downturn.[114] In April 2022, the FSC further maintained the CCyB at zero per cent on grounds of mild credit growth[115] and this rate remained unchanged as also mentioned in the October 2022 *Financial Stability Review*.[116] Going forward, it is recorded in the second edition of the 2023 *Financial Stability Review* that the SARB

109 Directive 2/2018 – Materiality threshold in respect of exposure to a foreign jurisdiction in applying jurisdictional reciprocity in the countercyclical capital buffer calculation https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2018/8705 (last accessed 2023-03-23); See further, Burra P, De Jongh, Raubenheimer, van Vuuren "Implementing the countercyclical capital buffer in South Africa: Practical considerations" 2015 *South Africa Journal of Economic and Management Sciences* 105 109.

110 Directive 2/2018 – Materiality threshold in respect of exposure to a foreign jurisdiction in applying jurisdictional reciprocity in the countercyclical capital buffer calculation https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2018/8705 (last accessed 023-03-23).

111 Directive 6/2016 – Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2016/7573 (last accessed 2023-03-23).

112 The Financial Stability Review May 2019 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2019/9276 (last accessed 2023-03-23); The Financial Stability Review November 2018 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2018/8904 (last accessed 2023-03-23).

113 The Financial Stability Review November 2020 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2020/Second_edition_Financial_Stability_Review (last accessed 2023-03-23).

114 The Financial Stability Review May 2021 https://www.resbank.co.za/en/home/publications/review/financial-stability-review/First-Edition-2021-Financial-Stability-Review (last accessed 2023-03-23).

115 The Financial Stability Review May 2022 https://www.resbank.co.za/content/dam/sarb/publications/reviews/finstab-review/2022/financial-stability-review/first-edition-2022-financial-stability-review/FSR%20May%202022%201st%20edition.pdf (last accessed 2023-03-23).

activated the CCyB with 1 per cent for South African banks to maintain a positive cycle-neutral CCyB which will commence on January 2025 and will be fully implemented in December 2025.[117] The justification that is provided for this increase is that jurisdictions that have a positive CCyB are more likely to address cyclical systemic risks to the financial system from uncertain future shocks (such as was demonstrated during Covid-19 pandemic) than those with a zero per cent level.[118] During the first half of 2024, the SARB continued to monitor the developments in the build-up to the increase in the CCyB from zero per cent to one per cent.[119]

3 4 The implementation of the D-SIB buffer

Consistent with the *Basel D-SIB Framework, The Regulations relating to banks* subjects South African D-SIBs to a D-SIB buffer requirement.[120] According to *Directive 5/2021*, the combined total capital adequacy requirement in respect of the D-SIB buffer, as discussed below, must not exceed 3.5 per cent of a bank's RWAs composed of qualifying CET1 capital and reserve funds, Additional Tier 1 (AT1) and reserve funds and Tier 2 capital and reserve funds.[121] It is further stated that the aggregate requirement must not exceed 2 per cent for CET1 capital and 2.5 per cent for Tier 1 capital.[122] The rationale for this regulatory restriction is to prevent the excessive accumulation of capital requirements designed to

116 The Financial Stability Review November 2022 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2022/second-edition-2022-financial-stability-review (last accessed 2023-03-23).

117 The Financial Stability Review November 2023 https://www.resbank.co.za/content/dam/sarb/publications/reviews/finstab-review/2023/financial-stability-review/second-edition-2023-financial-stability-review/Second%20Edition%202023%20Financial%20Stability%20Review1.pdf (last accessed 2024-05-13).

118 As above.

119 The Financial Stability Review June 2024 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2024/first-edition-2024-financial-stability-review (last accessed 2024-09-01).

120 Reg 38(8)(e)(vi) The Regulations Relating to Banks.

121 Directive 5/2021 – Capital Framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2021/D5---2021---Capital-Framework-for-South-Africa-based-on-the-Basel-III-framework (last accessed 2023-03-23); Directive 6/2016 – Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2016/7573 (last accessed 2023-03-23).

122 Directive 5/2021 – Capital Framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2021/D5---2021---Capital-Framework-for-South-Africa-based-on-the-Basel-III-framework (last accessed 2023-03-23).

address the systemic risk emanating from SIFI-banks/D-SIBs.[123] In other words, there is a need to reduce the rate of the simultaneous application of Pillar 2A requirements, as discussed below, and the D-SIB buffer to avoid the double-counting of capital requirements.

Further, excluding the CCyB discussed above, and the bank-specific individual capital requirement (Pillar 2B), as discussed below, the highest minimum total capital adequacy requirement to be met by a bank receiving the highest possible D-SIB buffer, must not exceed 14 per cent of its RWAs.[124]

The D-SIB buffer is applied to D-SIBs according to a bucketing approach and the PA determines the D-SIB buffer on a continuous basis.[125] The buffer will vary between individual SIFI-banks/D-SIBs corresponding to their systemic profile. The first 1 per cent requirement of the D-SIB buffer, up to a maximum of 1 per cent of a banks' RWAs, must be fully met with CET1 capital.[126] Any additional requirement, up to the first 1.5 per cent of a bank's RWAs may be fulfilled by Tier 1 capital. And any additional requirement, up to 2.5 per cent of a bank's RWAs, may be met with total capital and reserve funds. Most notably, the requirement that South African D-SIBs should meet the D-SIB buffer with half of the CET1 capital, and not fully with CET1 capital, significantly departs from the Basel Committee's recommendation that the composition of the D-SIB buffer should be 100 per cent of CET1 capital for reasons of consistency and comparability in respect of its application to D-SIBs across jurisdictions. The PA does not explain the grounds for this deviation.

Consistent with the Basel Committee approach,[127] the South African D-SIB buffer regime is an extension of the CCvB. The rules that apply to the contravention of the required amount of the CCvB also apply to the violation of the combined total CCvB and the D-SIB buffer, meaning that a D-SIB would be subject to capital distributions constraints in the case of contravention of the D-SIB buffer requirement until such time when

123 Circular 4/2016 – Matters relating to the implementation of the capital conservation buffer https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-circulars/2016/7251 (last accessed 2023-03-23).

124 Directive 5/2021 - Capital Framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2021/D5---2021---Capital-Framework-for-South-Africa-based-on-the-Basel-III-framework (last accessed 2023-03-23).

125 As above.

126 As above. See para 2.1 above for the discussion of CET1 capital.

127 Paras 45 The Basel D-SIB framework.

compliance is restored.[128] The PA requires D-SIBs to disclose their D-SIB buffers to foster transparency of the D-SIB Framework.[129]

The Regulations Relating to Banks implemented the D-SIB buffer regime parallel with the CCvB and the CCyB regime between January 2016 and December 2018, and the D-SIB buffer was then expected to have been fully implemented by January 2019.[130] To facilitate the smooth transition of the D-SIB buffer regime that had to take place by January 2016, D-SIBs were informed of their different levels of applicable D-SIB buffers since January 2013.[131] In its 2023/2024 Annual Report, the PA indicated that SIFI-banks remained adequately capitalised throughout the past years.[132]

3 5 Pillar 2A and Pillar 2B

Beyond the minimum capital and buffer framework discussed above, South African banks are required to maintain sufficient capital to address systemic risk, otherwise known as Pillar 2A.[133] Pillar 2A generally applies to all banks from time to time to mitigate macro-prudential risks emanating from the South African financial system.[134] Whereas Pillar 2A is set to be a minimum of 1 per cent of a bank's RWAs, its combined

128 Directive 6/2016 – Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2016/7573 (last accessed 2023-03023); Guidance Note 9/2012 – Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-guidance-notes/2012/5154 (last accessed 2023-03-23).

129 Circular 3/2020 – Disclosure of capital related matters https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-banks/banks-circulars/2020/10203 (last accessed 2023-03-23); Prudential Authority Annual Report 2020/2021.pdf https://www.resbank.co.za/en/home/publications/publication-detail-pages/reports/pa-annual-reports/2021/Prudential-Authority-Annual-Report-2020-2021 (last accessed 2023-03-23).

130 The South African D-SIB buffer regime is implemented in Reg 38(8)(e)(vi); See further, Circular 4/2016 – Matters relating to the implementation of the capital conservation buffer https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-circulars/2016/7251 (last accessed 2023-03-23).

131 The Financial Stability Review September 2013 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2013/5961 (last accessed 2023-03-23); Bank Supervision Department Annual Report 2015 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reports/pa-annual-reports/2016/7309 (last accessed 2023-03-23).

132 Prudential Authority Annual Report 2023/2024 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reports/pa-annual-reports/2024/Prudential-Authority-Annual-Report-2023-24 (last accessed 2023-03-23).

133 Regulation 38(8)e(ii) The Regulations Relating to Banks.

134 Regulation 38(8)(e)(ii) The Regulations relating to banks; as amended by the Amendment of Regulations.

application with the D-SIB buffer cannot exceed a maximum of 3.5 per cent of a bank's RWAs,[135] as noted above. The rationale for this regulatory restriction is to prevent the excessive accumulation of capital requirements designed to address the systemic risk emanating from SIFI-banks.[136] In other words, there is a need to reduce the rate of simultaneous application of Pillar 2A and the D-SIB buffer to avoid the double-counting of capital requirements.

In April 2020, the PA adjusted the Pillar 2A requirement from 1 per cent of RWAs to zero per cent to ease the capital requirements for banks amid the Covid19 pandemic.[137] In February 2021, the PA subsequently recommended the reinstatement of Pillar 2A to 1 per cent of RWAs due to banks' strong capital ratios and the anticipated economic recovery.[138] Pillar 2A, together with other capital requirements, were accordingly reinstated by *Directive 5/2021*.[139]

Apart from Pillar 2A, the Regulations subjects all banks to bank-specific individual capital requirements, referred to as Pillar 2B, which addresses idiosyncratic risk, being the type of risk that affect each individual bank.[140] Pillar 2B forms part of the South African SREP, addressing risks that are not covered under Pillar 1 requirements and the level of its application may be based on a bank's regulatory and

135 Circular 4/2016 – Matters relating to the implementation of the capital conservation buffer https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-circulars/2016/7251 (last accessed 2023-03-23).

136 Circular 4/2016 – Matters relating to the implementation of the capital conservation buffer https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-circulars/2016/7251 (last accessed 2023-03-23).

137 Directive 4/2020: Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2020/10202 (last accessed 2023-03-23); The Financial Stability Review May 2020 https://www.resbank.co.za/en/home/publications/publication-detail-pages/reviews/finstab-review/2020/9956 (last accessed 2023-03-23).

138 Proposed directive issued in terms of section 6(6) of the Banks Act 94 of 1990: Capital framework for South Africa based on the Basel III framework Proposed directive - Capital Framework https://www.resbank.co.za/content/dam/sarb/publications/prudential-authority/pa-documents-issued-for-consultation/2021/Proposed%20directive_Capital%20Framework.pdf (last accessed 2024-09-01).

139 Directive 5/2021 – Capital Framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2021/D5---2021---Capital-Framework-for-South-Africa-based-on-the-Basel-III-framework (last accessed 2023-03-23).

140 Regs 38(8)(e)(iii), 38(4) The Regulations relating to banks.

economic capital.[141] Banks are not subject to public disclosure of compliance with the Pillar 2B requirement as it is based on qualitative and quantitative factors that vary across jurisdictions.[142]

4 Conclusion

South Africa's implementation of the CCvB, the CCyB and the D-SIB buffer, as respectively incorporated in the *Basel III Capital Framework* and the *Basel D-SIB Framework*, constitutes a crucial step that is well-recognised to strengthen the resilience of the South African banking sector by giving effect to the G20 financial stability reforms. This implementation which occurred with effect from 2013 through *The Regulations Relating to Banks* also seeks to enforce section 30 of the FSR Act,[143] which outlines capital buffers as part of stringent prudential requirements for banks that have been designated as SIFIs/D-SIBs in terms of section 29 of the Act.

Notably, the PA's minimum regulatory capital and buffer regime is robust and generally consistent with the *Basel III Capital Framework*. However, the PA's partial compliance with the Basel D-SIB buffer regime may potentially raise systemic concerns originating from D-SIBs. It is thus recommended that the PA should consider requiring SIFI-banks/D-SIBs to fully meet the D-SIB buffer regime with CET1 capital, being the most effective capital in increasing the loss absorbency capacity of D-SIBs to minimise their probability of default during material financial distress in order to safeguard financial stability.

141 Directive 5/2021 - Capital Framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2021/D5---2021---Capital-Framework-for-South-Africa-based-on-the-Basel-III-framework (last accessed 2023-03-23); Directive 7/2017 – Submission of regulatory and economic capital information by domestic systemically important banks and controlling companies (D-SIBs) on a bi-annual basis https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2017/8113 (accessed 20 August 2018). In line with Reg 6(3) The Regulations Relating to Banks, D-SIBs are required to electronically complete regulatory and economic capital data on a solo and consolidated basis bi-annually to evaluate compliance with the capital requirements, and if they are not compliant, D-SIBs are required to take remedial actions to restore capital requirement ratios to avoid distributions restrictions. See further, Directive 6/2016 – Capital framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2016/7573 (last accessed 2023-03-23).

142 Directive 5/2021 – Capital Framework for South Africa based on the Basel III framework https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-deposit-takers/banks-directives/2021/D5---2021---Capital-Framework-for-South-Africa-based-on-the-Basel-III-framework (last accessed 2023-03-23).

143 See para 3 above.