



BANK SUPERVISION DIVISION

Prudential Standard No. 01-2020/BSD

**FRAMEWORK FOR DEALING WITH
DOMESTIC SYSTEMICALLY IMPORTANT BANKING INSTITUTIONS**

APRIL 2020

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1. Introduction

- 1.1. The banking sector is comprised of institutions of varying sizes offering a diverse range of products and services, creating significant linkages between multiple economic players. The sheer size of some of the banking institutions and their unique product offerings make them systemically important thereby presenting potential risks to the entire system and the real economy, in the event of one of them getting into distress.
- 1.2. A domestic systemically important bank (D-SIB) is a local banking institution whose failure or distress might lead to market wide disruption in the provision of financial services thereby generating negative externalities. The negative externalities include economic or social costs to people beyond the shareholders, creditors and employees of the distressed systemically important banking institution. The spill over effects include the following:
 - a) disruption in the availability of financial services or supply of credit to the economy directly, to the extent that other banking institutions may not quickly fill the void;
 - b) loss of confidence and fear of contagion, which in turn leads to tightening of bank funding; and
 - c) disruption of financial markets if the D-SIB plays a pivotal role in the provision of critical services, such as payments, settlements and custody, to other financial institutions.
- 1.3. As such these banking institutions are sizable, highly interconnected, with less substitutable products or high complexity, whose failure can lead to the paralysis of the economy.
- 1.4. Cognisant of these negative externalities, the Reserve Bank has adopted a set of principles that constitute the D-SIB framework, in line with international best practice, namely the assessment methodology and higher loss absorbency (HLA) capacity for D-SIBs. The objective of this framework focuses on putting in place relevant regulatory measures for the identification, monitoring and management of systemic risks arising from the distress of local systemically important institutions.
- 1.5. The framework presents the following principles, among others:

- a) the assessment methodology for the identification of D-SIBs;
- b) the additional prudential measures covering additional capital and liquidity requirements;
- c) frequency of monitoring; and
- d) other supervisory requirements.

2. Legal Basis

- 2.1. This framework is issued in terms of the **Banking Act [Chapter 24:20]**, **Building Societies Act [Chapter 24:02]**, **Microfinance Act [Chapter 24:29]** and in line with **Section 6(1) (c) of the Reserve Bank of Zimbabwe Act [Chapter 22:15]**, which gives the Reserve Bank of Zimbabwe the mandate to foster the liquidity, solvency, stability and proper functioning of Zimbabwe's financial system.
- 2.2. The D-SIB framework should be read in conjunction with other relevant regulations and policy guidelines that may be issued by the Reserve Bank from time to time.

3. Scope of Application

- 3.1. The guideline shall apply to all banking institutions licensed by the Reserve Bank under the **Banking Act [Chapter 24:20]**, **Building Societies Act [Chapter 24:02]** and the **Microfinance Act [Chapter 24:29]** which are identified as systemically important.

4. Assessment Methodology for the Identification and Designation of D-SIBS

- 4.1. The D-SIB assessment framework aims to assess the degree to which banking institutions are systemically important in a domestic context by reference to the financial system and domestic economy in Zimbabwe. This means that the assessment focuses on addressing the impact that the distress or failure of a banking institution could cause at a local level.
- 4.2. The methodology used in this framework is based on the indicator approach focusing primarily on measures of impact of failure, as opposed to measures of risk of failure.
- 4.3. The D-SIB assessment is based on the following four factors as guided by the Basel Committee on Banking Supervision standards (BCBS):
 - a) size;
 - b) interconnectedness;
 - c) substitutability; and
 - d) complexity.
- 4.4. D-SIBs are identified using a three-phased process. The **first phase** involves the delimitation of the sample to be considered for the assessment. The **second phase** involves drawing up a preliminary indicative list of D-SIBs based on the quantitative scores calculated using a set of factors/indicators. The **third phase** involves the exercise of **supervisory judgement** that may serve as a complement to the quantitative assessment process based on additional qualitative measures.
- 4.5. **Size**
 - 4.5.1. The size factor broadly measures the volume of a D-SIB's banking activities within Zimbabwe's banking system and economy, therefore providing a good measure of potential systemic impact if and when the banking institution becomes distressed.
 - 4.5.2. The larger the bank and its share of domestic activity, the higher the likelihood that its distress or failure will negatively affect the domestic economy and financial markets.

4.5.3. The quantitative indicator used in the D-SIB framework to measure a banking institution's size is the banking institution's "total loans".

4.6. Interconnectedness

4.6.1. Financial distress at one institution can raise the likelihood of distress at other institutions given the network of contractual obligations in which these firms operate.

4.6.2. This measures the extent of a banking institution's interconnections with other financial institutions that could give rise to externalities affecting the financial system and the economy.

4.6.3. The indicators used to capture interconnectedness in interbank activities are:

- a) balances and placement with other banking institutions; and
- b) balances and deposits from other banking institutions.

4.6.4. Balances and placement with or from other banking institutions provide a broad sense of the extent of each banking institution's interconnectedness within the banking sector at an aggregate level.

4.7. Substitutability

4.7.1. The default of a financial institution can negative externalities on the financial system and real economy if certain critical services provided by the bank cannot be easily replaced by other banks.

4.7.2. The concept underlying substitutability as a factor for assessing systemic importance is the recognition that the greater the role of a banking institution in a particular business line or in acting as a service provider, the more difficult it will be to swiftly replace that banking institution. This also goes to the extent of the products and services it offers, in relation to the market infrastructure, which therefore poses more significant risk of disruption in the event that the banking institution becomes distressed or fails.

4.7.3. Locally, the share of payments received, by either volume or quantum made by a banking institution have been considered as a strong measure of substitutability.

4.8. Complexity

4.8.1. The degree of complexity of a bank is generally expected to be proportionately related to the systemic impact of the bank's distress, since the less complex a bank is, the more resolvable it is likely to be, and in turn the more likely the impact of its failure could be contained.

4.8.2. The quantitative indicators used to capture complexity includes:

- a) Cross border assets;
- b) Assets held for trading and available for sale; and
- c) Derivatives.

4.8.3. Complexity will also be assessed through Business, Structural and Operational qualitative factors.

4.9. Assessment approach and determination of score

4.9.1. The above four factors namely size, interconnectedness, complexity and substitutability have been assigned weights of 50%, 25%, 10% and 15% respectively.

4.9.2. The systemic score for each banking institution is obtained by dividing the individual banking institution's contribution to that indicator by the aggregate amount of the individual institution contributions across all banking institutions in the assessment pool. The banking institution's score for each indicator will then be weighted (based on the weights shown under the "Indicator weighting" column of Table 1). The overall systemic score for the banking institution equals the sum of its weighted scores for all the indicators.

Table 1: Factor / Indicator weighting

Factor (and weighting)	Quantitative Indicator	Indicator weighting
Size (50%)	Total loans	50%
Interconnectedness (25%)	Interconnectedness within the banking system: Balances from other banking institutions	15%
	Interconnectedness within the financial system: Loans to financial institutions	10%
Complexity (10%)	i. Cross border assets; ii. Held for trading and available for sale assets; and iii. Derivatives.	10%
Substitutability (15%)	Payments made by a banking institution	15%

- 4.9.3. A higher weighting is assigned to “size” because, in addition to being the single most dependable quantitative indicator in terms of data reliability and objectivity, size is an important measure of overall systemic importance than other factors and indicators.
- 4.9.4. Substitutability is also relevant for banking institutions that serve highly vulnerable segments of the market consisting of numerous small value accounts with widely spread branch networks.
- 4.9.5. A cut-off threshold above which banking institutions are considered systemically important is a combined index of above 130. The cut-off point will be reviewed annually in line with market changes.
- 4.9.6. To calculate the score for a given indicator, the bank’s reported value for that indicator is divided by the corresponding aggregate total across banking institutions for the specific indicator, and the resulting value is then expressed in basis points (bps).

$$\frac{\text{Bank indicator (ZWs)}}{\text{Aggregate Total (ZWs)}} \times 1,000^1 = \text{Indicator Score (bps)}$$

¹ A factor of 1,000 is used for D-SIBS rather than the 10,000 for G-SIBS

- 4.9.7. The scores for each individual category are the averages of the indicators that fall within the specific categories.
- 4.9.8. The list of D-SIBs will be revised at least annually using data at the end of the annual reporting cycle to ensure that there are continued incentives. In exceptional cases a banking institution may be identified as a D-SIB outside of the annual assessment exercise.
- 4.9.9. The methodology, including the indicators used will be subject to review at least every two years. This will ensure that the framework remains up to date with developments in the banking sector, and is reflective of evolving international practices in the methods and approaches for determining systemically important banking institutions.

5. Policy Measures for D-SIBS

5.1. The following policy measures and additional requirements shall be applied to D-SIBs in order to address the risks they pose to the financial system and economy at large:

- a) Higher Loss Absorbency (HLA) capital requirement;
- b) Liquidity Coverage Ratio (“LCR”) requirement²;
- c) Recovery and resolution planning; and
- d) Enhanced disclosure.

5.2. Higher Capital Requirements

5.2.1. Banking institutions designated as D-SIBs shall be required to maintain a minimum CAR of 12% plus a surcharge for HLA as in Table 2 which should be met with Tier 1 capital in line with the principles of D-SIBs of the BCBS. The aim of the additional loss absorbency requirement is to ensure that the D-SIBs have a higher share of their balance sheet funded by instruments that re-enforce the resilience of the institution as a going concern.

5.2.2. If and when a designated D-SIB’s Tier 1 capital ratio is equal to or below its buffer level, the D-SIB will be subject to restrictions on the discretionary distributions it may make. The discretionary distributions that may be restricted include dividend payments, share buybacks, discretionary coupon payments on capital instruments and discretionary bonus payments to staff. The effect of this is that, for so long a D-SIB’s Tier 1 capital ratio is equal to or below its buffer levels, the D-SIB will be required to retain earnings in order to boost its regulatory capital.

5.2.3. In a situation where a foreign subsidiary of a local bank is considered systemically important by the host authority, the Reserve Bank and the host authorities would make arrangements to coordinate and cooperate on the appropriate HLA requirement.

2 The Liquidity Coverage Ratio (“LCR”) Guideline is issued separately.

5.3. Allocation to HLA buckets

- 5.3.1. A graduated approach to the local HLA requirement for designated D-SIBs was considered suitable given the diversified nature and sizes of systemic importance of banking institutions in Zimbabwe.
- 5.3.2. This approach is also meant to provide appropriate incentives to designated D-SIBs to refrain from increasing their systemic importance over time.
- 5.3.3. All banking institutions identified as D-SIBs will be allocated to different buckets of HLA requirements based on the relative distribution of their systemic scores.
- 5.3.4. Each D-SIB will be allocated to a bucket corresponding to a required level of HLA ranging from 1% to 3.5% of total RWA.
- 5.3.5. Table 2 below sets out the buckets to which D-SIBs will be allocated together with the corresponding HLA requirement.

Table 2: Bucketing Approach for D-SIB HLA capital charge

Bucket	Score range	HLA requirement (Tier 1 as % of RWA)
5	530-629	3.5%
4	430-529	2.5%
3	330-429	2.0%
2	230-329	1.5%
1	130-229	1.0%

- 5.3.6. The HLA requirements for identified banking institutions will be implemented based on the following phased approach:

Table 3: Phased implementation of D-SIB HLA capital charge

Bucket	2020 HLA Requirement (Tier 1 as % of RWA)	2021 HLA Requirement (Tier 1 as % of RWA)	2022 HLA Requirement (Tier 1 as % of RWA)
5	1.17%	2.34%	3.5%
4	0.84%	1.67%	2.5%
3	0.67%	1.34%	2.0%
2	0.50%	1.00%	1.5%
1	0.34%	0.67%	1.0%

- 5.3.7. For the purposes of determining the thresholds for each bucket, the Reserve Bank will assess and draw reference from different “clusters” of systemic scores in the D-SIB identification assessment as set out in Tables 2 and 3 above.
- 5.3.8. The systemic importance of banking institutions may evolve over time as banking institutions may migrate in and out of D-SIB status, or move between “buckets” or categories of systemic importance. Where a locally incorporated banking institution is first designated or re-designated as a D-SIB, it will be required to build up its Common Equity Tier 1 capital for HLA purposes within 12 months from the Reserve Bank’s formal notification of its designation (or re-designation).
- 5.3.9. Similarly, if an increased HLA requirement is applied to a designated DSIB due to it moving up one or more buckets as a result of an increase in its degree of domestic systemic importance, it will also be subject to the increased HLA requirement at the end of 12 months henceforth.
- 5.3.10. However, if a lower HLA requirement is applied to a designated D-SIB due to a decrease in its degree of systemic importance and it moving down one or more buckets or it ceasing to be designated as a D-SIB at all, the D-SIB concerned may recognise the lower (or nil) HLA requirement immediately following the Reserve Bank’s formal notification.

5.4. Regulatory capital instruments used to meet HLA requirement

- 5.4.1. The HLA requirement must be fully met with core equity. This is to ensure that the capital held for HLA purposes will be available to absorb losses on a going concern basis and hence enhance the resilience of the relevant D-SIB by reducing its probability of default.

5.5. Supervisory approach for D-SIBs

- 5.5.1. The Reserve bank is cognisant of the differentiated supervisory requirements and intensity of supervision for D-SIBs based on the risks they pose to the financial system. In accordance with the risk based supervisory approach, the Reserve Bank will focus apply appropriate resources and higher degree of supervisory intensity according to the risk a given D-SIB poses.

5.6. Recovery and Resolution Planning

- 5.6.1. The Reserve Bank has issued a **Prudential Standard No:1-2018/BSD, Guidance on Recovery Planning** which sets out the key elements of effective recovery planning for banking institutions as well as regulatory approach and expectations in this area. In the context of recovery planning, D-SIBs are encouraged to adopt more than the minimum scenarios as prescribed therein to ensure the adequacy of their recovery plans.
- 5.6.2. The Reserve Bank subscribes to the principle of proportionality and the D-SIBs will be expected to implement the recovery and resolution planning in a proportionate manner.

5.7. Communication of D-SIBs status

- 5.7.1. The Reserve Bank will conduct an annual D-SIB identification exercise using data as at 31 December of each year. In exceptional cases, the Reserve Bank may also update the D-SIB list outside of the annual cycle if there are important developments and structural changes within the banking system, e.g. a merger or a substantial take-over.
- 5.7.2. The Reserve Bank will inform the affected banking institution of its intention and may discuss the proposed identification/designation and the reason for it. Once the Reserve Bank has finalised its decision, the identified/designated D-SIBs will be formally advised.

5.8. Disclosure requirement for D-SIBs

- 5.8.1. D-SIBs are required to disclose their specific HLA requirement in the standard capital disclosures on the composition of the banking institution's capital base.

6. Document Review

- 6.1.1. This document will be subject to review after every 2 years or earlier, as necessary.

7. Effective Date

- 7.1.1. This framework is effective from 1 April 2020.