2004-12-13

TO ALL BANKS, BRANCHES OF FOREIGN BANKS AND MUTUAL BANKS

BANKS ACT CIRCULAR 19/2004

MATTERS RELATING TO THE QUALIFYING CAPITAL AND RESERVE FUNDS OF BANKS, INCLUDING HYBRID DEBT INSTRUMENTS

EXECUTIVE SUMMARY

During the past number of years, internationally active banks have issued a range of innovative capital instruments, such as instruments with step-up or call features, with the objective of raising further qualifying capital for regulatory and supervisory purposes, in a cost-effective manner.

The aim of such instruments issued by banks is to combine certain features of equity instruments and debt instruments, resulting in so-called hybrid instruments.

From a regulatory and supervisory perspective, various matters need to be considered, in order to determine the extent to which such innovative hybrid instruments meet the criteria to qualify as primary or secondary capital of a bank.

Furthermore, supervisors are required to review, firstly, the target levels of capital, in order to ensure that the capital requirements are relevant to the environment in which the banks operate, and, secondly, the composition of capital, in order to ensure that the composition is appropriate for the nature and the scale of banks' business.

This Office hereby gives notice of its intention to amend the provisions of section 70 of the Banks Act, 1990, and regulation 21 of the Regulations relating to Banks, in order for the legislative framework to remain in line with international regulatory and supervisory requirements and developments, including developments relating to hybrid debt instruments.

All interested parties are invited to submit comments on the proposed amendments to this Office, by not later than 28 February 2005.

1. Background

During the past number of years, internationally active banks have issued a range of innovative capital instruments, such as instruments with step-up or call features, with the objective of raising further qualifying capital for regulatory and supervisory purposes, in a cost-effective manner.

The aim of such instruments issued by banks is to combine certain features of equity instruments and debt instruments, resulting in so-called hybrid instruments. In other words, from the perspective of qualifying capital, banks wish to demonstrate that the instruments are deeply subordinated, non-cumulative and perpetual, whereas from a tax (cost) perspective, banks wish to deduct the cost relating to the instruments from tax, resulting in interest, instead of dividends, being paid.

From a regulatory and supervisory perspective, various matters need to be considered, in order to determine the extent to which such innovative hybrid instruments meet the criteria to qualify as primary or secondary capital of a bank.

2. Purpose of capital

It is generally recognised that, as a minimum, the capital and reserve funds of a bank serve as:

(a) A basis for the bank's future growth, and

(b) A cushion against any unexpected loss, without adversely affecting the interests of the depositors of the bank.

It is also recognised that adequately capitalised and well-managed banks are better able to withstand losses and to provide credit to their clients, even during economic downturns.

Often, banks choose to maintain capital levels substantially higher than the minimum requirements prescribed by regulators, since banks prefer to be highly rated by recognised rating agencies, for example, in order to reduce banks' cost of funding.

Contrary to the above-mentioned position of adequately capitalised banks, banks with low levels of capital and reserve funds may be unable to absorb unexpected losses, thereby increasing the risk of bank failure and a potential loss of depositors' money.

3. Typical characteristics of capital

Normally, the best sources of capital have five distinct characteristics, namely:

3.1 Ability to absorb loss

A key characteristic of a capital instrument is the extent to which the instrument allows a bank to absorb losses on an ongoing basis, while remaining able to pay creditors and repay depositors.

Furthermore, the ability of such an instrument to absorb losses when a bank is no longer a going concern is also important, since the instrument provides protection against losses to depositors and general creditors.

3.2 Permanence

A capital instrument is perpetual, that is, the instrument does not have a termination date and is therefore continuously available to a bank to absorb losses, including in times of financial distress.

3.3 Absence of a fixed charge

A capital instrument provides a bank with maximum flexibility to conserve the bank's resources, in the sense that the instrument provides the bank with full discretion in respect of the amount and the timing of distribution.

3.4 Provision for market discipline, that is, a voting right

A capital instrument makes provision for voting rights on a continuous basis. These voting rights provide an important source of market discipline over the bank's management and its board of directors.

3.5 Ability to share in the residual value of an entity

The reserves and the retained earnings of a bank accrue for the benefit of the holders of or investors in a capital instrument.

An instrument that meets all five of the above-mentioned requirements is the best source of capital. On the other hand, an instrument with a fixed maturity date, or an instrument that is not as deeply subordinated as an equity instrument, is a weaker form of capital.

4. 1988 Capital Accord

During July 1988, the Basel Committee on Banking Supervision ("Basel Committee") published a document, titled "International Convergence of Capital Measurement and Capital Standards" and generally referred to as the 1988 Capital Accord, to secure international convergence of supervisory regulations governing the capital adequacy of internationally active banks.

The 1988 Capital Accord had two fundamental objectives, namely, to:

(a) Strengthen the soundness and stability of the international banking system, and

(b) Be fair and have a high degree of consistency in its application to banks in different countries.

The 1988 Capital Accord was implemented by many countries throughout the world.

The 1988 Capital Accord distinguishes between two constituents of capital, namely:

(a) Primary capital, consisting of:

- (i) Equity capital, and
- (ii) Disclosed reserves.

(b) Secondary capital, consisting of:

- (i) Undisclosed reserves, and
- (ii) Revaluation reserves, and
- (iii) General provisions/general loan-loss reserves, and
- **(iv) Hybrid debt capital instruments**

  This category includes a number of capital instruments that combine certain characteristics of equity and of debt. Each of the instruments has particular features that can be considered to affect its quality as capital. It has been agreed that, when these instruments are closely similar to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be **included in secondary capital**.

The qualifying criteria for such an instrument may differ from country to country, but the instrument should meet at least the following requirements:

(aa) It should be unsecured.

(bb) It should be subordinated.

(cc) It should be fully paid up.

(dd) It should not be redeemable at the initiative of the holder, or without the prior consent of the supervisory authority.

(ee) It should be available to participate in losses without a bank being obliged to cease trading (unlike conventional subordinated debt).

(ff) Although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), the instrument should allow service obligations to be deferred (in a manner similar to cumulative preference shares) when the profitability of the bank would not support payment.

In addition to perpetual preference shares carrying a cumulative fixed charge, the following instruments, for example, may in terms of the 1988 Capital Accord qualify for inclusion:

(aa) Long-term preferred shares in Canada.

(bb) Perpetual debt instruments in the United Kingdom.

(cc) Mandatory convertible debt instruments in the United States of America.

Debt capital instruments that do not meet the above-mentioned criteria may be eligible for inclusion in the undermentioned category.

(v) Subordinated term debt.

Subordinated term-debt instruments have significant deficiencies as constituents of capital in view of their fixed maturity and inability to absorb losses, except in liquidation. These deficiencies justify an additional restriction on the amount of such debt capital that may be eligible for inclusion in the capital base.

Consequently, the Basel Committee agreed that it was permissible for subordinated term-debt instruments with a minimum original term to maturity of more than five years to be included as secondary capital, but only to a maximum of 50 per cent of primary share capital and subject to adequate amortisation arrangements.

Finally, the 1988 Capital Accord stresses the following, amongst other things:

(a) The agreed framework was **designed to establish minimum levels of capital** for internationally active banks.

(b) National supervisors **may determine higher requirements**.

(c) **At least** 50 per cent of a bank's capital base has to consist of **primary share capital** comprising equity capital and disclosed reserves from retained earnings, that is, the absolute minimum requirement in respect of primary share capital shall be 50 per cent of the bank's capital base.

(d) Secondary capital may be taken into consideration **up to** an amount equal to the primary share capital of the bank.

(e) Subordinated term debt may be included in secondary capital to a **maximum** of 50 per cent of the primary-capital elements.

5. Core Principles for Effective Banking Supervision

During September 1997, the Basel Committee issued the Core Principles for Effective Banking Supervision ("Core Principles"), which have become the most authoritative global standard for prudential regulation and supervision.

Principle 6 of the Core Principles states that supervisors of banks have to set minimum capital-adequacy requirements for banks that reflect the risks that banks undertake and that supervisors have to **define the components of capital, bearing in mind the ability of the various types of instruments to absorb losses**. For internationally active banks, the requirements may not be less than those established in the 1988 Capital Accord.

One of the criteria listed under principle 6 of the Core Principles for measuring the compliance of a country with the said principle is that the capital-adequacy requirements have to take into account the conditions under which the banking system operates and that **the minimum requirements may be higher than the requirements specified in the 1988 Capital Accord**.

6. Press release on hybrid capital instruments

Innovative instruments qualifying as primary capital for banks have proved to be a controversial matter since the first issue of such instruments more than a decade ago.

On 27 October 1998, in response to market innovations to issue certain hybrid debt instruments and after several debates amongst various supervisory authorities about the acceptability of certain innovative hybrid debt instruments as primary capital of a bank, as well as following uncertainty in the financial markets, the Basel Committee issued a press release on innovative capital instruments. The Committee stated that it had decided to:

(a) Limit the acceptance of innovative capital instruments for inclusion in primary capital, and

(b) Subject innovative instruments to stringent conditions and to limit such instruments to a maximum of 15 per cent of primary capital.

In the press release, the Basel Committee reaffirmed the following:

(a) Common shareholder funds consisting of equity shares and disclosed reserves or retained earnings remained the key elements of capital.

(b) National supervisors had to ensure that banks met the minimum capital requirements without undue reliance on innovative instruments.

In the Basel Committee's press release, reference was also made to minority interests in the equity accounts of consolidated subsidiaries in the form of special-purpose institutions, which minority interests, under certain circumstances, were allowed to be included in the primary capital of a bank.

This Office has decided not to allow any minority interest arising from the consolidation of certain special-purpose institutions to be included in the primary capital of a bank and that only direct issues of instruments by a bank may qualify as capital.

7. New Basel Capital Accord ("Basel II")

On 26 June 2004, the Basel Committee issued a document, titled "International Convergence of Capital Measurement and Capital Standards: a Revised Framework" ("New Capital Accord") and generally referred to as Basel II.

Basel II is more reflective of the underlying risks to which banks and banking groups are exposed and provides incentives for banks to improve their risk-management standards.

The overall objective of Basel II is to promote the adequate capitalisation of banks and banking groups and to encourage improvements in the risk-management processes of banks, thereby strengthening the stability of the financial system. It is envisaged that the aforementioned objective will be accomplished through the introduction of three pillars, which reinforce each other, namely:

(a) Pillar 1: Minimum capital requirements.

(b) Pillar 2: Supervisory review.

(c) Pillar 3: Market discipline.

Furthermore, the Basel Committee has decided to retain certain key elements of the 1988 Capital Accord, such as the definitions of eligible capital and reserve funds.

Finally, the New Capital Accord stresses the following:

(a) The revised framework is **designed to establish minimum levels of capital** for internationally active banks, and national authorities may set higher levels of minimum capital.

(b) Supervisors should **review the target levels of capital** in order to ensure that capital requirements are relevant to the operating environment.

(c) Supervisors should **review the composition of capital** in order to ensure that **the composition is appropriate** for the nature and the scale of banks' business.

8. Increase in the required minimum capital-adequacy ratio to 10 per cent

Based on the above-mentioned requirements of the 1988 Capital Accord, the Core Principles and earlier draft versions of the New Capital Accord, it was determined in *Government Gazette* No. 22737 of 5 October 2001 that the percentage for purposes of the calculation of the minimum capital and reserve funds to be maintained by banks in terms of section 70 of the Banks Act, 1990, had to be 10 per cent with effect from 1 October 2001.

9. Banks Act circular on the composition of capital

During the past number of years, this Office informed all banks, branches of foreign banks and mutual banks of its intention to amend the minimum required ratio of primary capital and reserve funds to secondary capital and reserve funds to a ratio of 75:25. That is, at least 75 per cent of the minimum required capital-adequacy ratio of 10 per cent has to consist of primary capital and reserve funds.

The above-mentioned requirement implies that the limit prescribed by the Basel Committee for the secondary capital and reserve funds of a bank not to exceed the primary capital and reserve funds of the bank will apply only when the capital-adequacy ratio of a bank is equal to or higher than 15 per cent.

On 22 April 2003, in Banks Act Circular 8/2003, this Office informed all banks, branches of foreign banks and mutual banks of its policy decision to amend the Banks Act, 1990 (Act No. 94 of 1990 – “the Banks Act”), and the Regulations relating to Banks (“the Regulations”), in order to ensure that:

(a) The ratio of ordinary shares to non-redeemable non-cumulative preference shares forming part of the total primary share capital and primary unimpaired reserve funds of a bank would at no time be less than 80:20.

(b) The ratio of primary share capital and reserve funds to secondary capital and reserve funds would at no time be less than 75:25.

Furthermore, this Office informed all banks, branches of foreign banks and mutual banks that further circulars would set out details of the types of instruments that would qualify, a description of the instruments and the extent to which the instruments would be permitted to be taken into consideration when a bank calculated its compliance with the envisaged ratios indicated above.

10. Section 70 of the Banks Act

Currently section 70 of the Banks Act provides that, in the calculation of the aggregate amount of capital that a bank is required to maintain:

(a) The sum of a bank's primary share capital and primary unimpaired reserve funds shall be calculated by deducting from the amount thereof such amounts as may be prescribed.

(b) The sum of a bank's secondary capital and secondary unimpaired reserve funds shall be-

(i) calculated by deducting from the amount thereof such amounts as may be prescribed; and

(ii) taken into account to an amount not exceeding the sum of the bank's allocated and qualifying primary share capital and allocated and qualifying primary unimpaired reserve funds.

The aforementioned requirements of section 70 of the Banks Act imply that banks' qualifying secondary capital and reserve funds may not exceed qualifying primary share capital and reserve funds, that is, the split may be 50:50.

In order for the legislative framework to remain in line with international regulatory and supervisory requirements and developments, it has become necessary to amend the provisions of section 70 of the Banks Act.

11. Regulation 21 of the Regulations

Currently-

(a) Regulation 21(6A) of the Regulations prescribes the percentages of capital obtained through the issue of certain shares and debt instruments that may qualify as secondary capital. For example, in terms of the provisions of regulation 21(6A) of the Regulations, issued cumulative preference shares may rank as secondary capital to the extent of 100 per cent thereof whilst cumulative preference shares issued in pursuance of the capitalization of reserves resulting from a revaluation of assets may rank as secondary capital to the extent of 50 per cent thereof.

(b) Regulation 21(7) of the Regulations prescribes the conditions for the issue of subordinated term debt of which the proceeds rank as secondary capital of a bank.

In order for the legislative framework to remain in line with international regulatory and supervisory requirements and developments, it has become necessary to amend the provisions of regulations 21(6A) and 21(7) of the Regulations.

12. Further information on this Office's policy decision on the qualifying capital of a bank

Based on the above information, the following decisions have been made:

(a) Instead of-

(i) tainting the definition of primary share capital; or

(ii) diluting the primary capital base of a bank,

with the inclusion of hybrid debt instruments in the definition of primary share capital, the previously determined ratio of 75:25 in respect of primary and secondary capital and reserve funds will be amended to give recognition to the fact that a hybrid debt instrument is a better form of capital than subordinated term debt, but a weaker form of capital than equity instruments.

(b) To amend the provisions of-

(i) section 70 of the Banks Act;

(ii) regulation 21(6A) of the Regulations; and

(iii) regulation 21(7) of the Regulations.

The requirement that at least 75 per cent of the minimum required capital-adequacy ratio of 10 per cent has to consist of primary share capital and reserve funds will be reduced to 60 per cent. Consequently, the provisions of the press release of the Basel Committee in respect of innovative instruments, which press release limits the innovative instruments to 15 per cent of primary capital, are accommodated by amending the previously required ratio of 75:25 to 60:40, instead of the definition of primary share capital being expanded to include hybrid debt instruments.

The above means that at least 60 per cent of the minimum required capital-adequacy ratio of 10 per cent has to consist of primary share capital and primary reserve funds **without any reliance being placed on hybrid debt instruments**. Since innovative instruments will not form part of the definition of primary share capital, a limitation with regard to hybrid debt instruments will not be imposed upon banks. Consequently, banks will be able to issue innovative instruments and structure their capital bases as they deem appropriate.

This Office is of the opinion that the above-mentioned decision to adjust the minimum requirement relating to primary capital and reserve funds to 60 per cent of the minimum required capital-adequacy ratio and to address hybrid debt instruments separately-

(a) Is a better outcome than maintenance of the previously determined ratio of 75 per cent of the minimum required capital-adequacy ratio of 10 per cent to consist of primary share capital and reserve funds and amendment of the definition of primary share capital to include hybrid debt instruments subject to a limitation of 15 per cent of the primary capital and reserve funds in respect of the innovative instruments.

(b) Means that banks are in a position similar to or better than they would have been had this Office maintained the previously determined position of 75:25 and had this Office allowed hybrid debt instruments to be included in the 75 per cent limit subject to a maximum of 15 per cent of primary capital and reserve funds.

(c) Is prudent and eliminates unnecessary complexity from a regulatory, tax and accounting perspective with regard to the split between equity instruments and debt (liability) instruments.

(d) Sufficiently accommodates international developments with innovative instruments.

(e) Meets industry requirements with regard to flexibility.

In order to achieve the aforementioned objectives, the provisions of section 70 of the Banks Act will be amended to provide for the following:

(a) In the calculation of the aggregate amount of capital that a bank is required to maintain, the sum of a bank's primary share capital and primary unimpaired reserve funds shall be-

    (i) taken into account to an amount as may be prescribed; and

    (ii) calculated by deducting from the amount thereof such amounts as may be prescribed.

(b) In the calculation of the aggregate amount of capital that a bank is required to maintain, the sum of a bank's secondary capital and secondary unimpaired reserve funds shall be-

    (i) taken into account to an amount as may be prescribed; and

    (ii) calculated by deducting from the amount thereof such amounts as may be prescribed, provided that, after the deduction of such amounts as may be prescribed, the sum of the bank's secondary capital and secondary unimpaired reserve funds shall in no case be taken into account to an amount in excess of the sum of the bank's allocated and qualifying primary share capital and allocated and qualifying primary unimpaired reserve funds.

(c) The above-mentioned amendment to section 70 of the Banks Act will accommodate-

(i) The 80:20 split in respect of primary share capital.

(ii) The 60:40 split between primary share capital and reserve funds, and secondary capital and reserve funds.

(iii) The limit of 50 per cent of primary share capital and reserve funds in respect of subordinated term debt.

(d) The above-mentioned limits will apply to the issued capital and reserve funds, as well as the qualifying capital and reserve funds, of a bank.

(e) The above-mentioned split in the regulatory capital and reserve funds of a bank will provide, for example:

(i) Banks with a further option to strengthen their capital bases in a cost-effective manner, thereby reducing the average cost of capital and diversifying their sources of capital.

(ii) Investors in the capital instruments of banks with a range of investment opportunities consisting of a choice between ordinary shares, non-redeemable non-cumulative preference shares, redeemable cumulative preference shares, hybrid debt instruments and subordinated term debt. In particular, hybrid debt instruments provide investors with an option of a yield pick-up over subordinated term debt.

(iii) Depositors and creditors of banks with better protection, in the sense that a further source of capital will be available to absorb any potential future loss suffered by banks.

Furthermore, the provisions of-

(a) Regulation 21(6A) of the Regulations will be amended to provide for innovative instruments to rank as secondary capital to the extent of 100 per cent thereof.

(b) Regulation 21(7) of the Regulations will be amended to-

   (i) Distinguish between hybrid debt instruments and term debt.

   (ii) Prescribe minimum conditions for the issue of hybrid debt instruments of which the proceeds rank as secondary capital.

   (iii) Limit the amount of subordinated term debt qualifying as secondary capital to 50 per cent of the primary share capital and reserve funds of a bank.

This Office also wishes to clarify its position on the standard practice of some international supervisory authorities to determine “target” and “trigger” capital-adequacy ratios **per bank or banking group**, including, for example, minimum primary capital target ratios, which ratios often **exclude** hybrid instruments.

This Office has decided that, as a general rule, the above-mentioned minimum requirements relating to the levels and the composition of the capital and reserve funds of banks will apply equally to all banks, and this Office will not specify minimum target and trigger capital ratios per bank. As in the past, however, this Office may in certain cases determine a higher minimum capital requirement than the standard requirement for a specific bank should the circumstances of that particular bank warrant a higher capital requirement.

Finally, this Office wishes to confirm that the objectives of the aforementioned decisions and the proposed amendments include to:

(a) Promote a safe and sound banking system.

(b) Remain in line with international regulatory and supervisory developments and market practice.

(c) Improve the quality of a bank’s capital.

(d) Maintain the integrity of capital.

(e) Allow banks to raise further capital in a cost-effective manner.

(f) Protect the interests of depositors and general creditors of banks.

13. Capital position as at 30 June 2004

Selected information as at 30 June 2004 on the capital and reserve funds of the total banking sector, excluding the endowment capital of branches of foreign banks, is provided below.

Description	30 June 2004 R million
Qualifying capital and reserve funds (after impairments)	
• Primary	65 130
• Secondary	33 789
Of which: Term debt instruments (before impairments)	*28 333*
• Tertiary and other items	1 394
• Total	100 313
Capital requirements	
• Banking	71 370
• Trading	3 956
• Total	75 326
Total risk-weighted exposure (credit risk plus market risk)	753 260
Capital-adequacy ratios (%)	
• Primary	8,6%
• Secondary	4,5%
Of which: Term debt instruments (before impairments)	*3,8%*
• Tertiary and other items	0,2%
• Total	13,3%
Composition of capital and reserve funds	
• Primary	64,9%
• Secondary	33,7%
Of which: Term debt instruments	*28,2%*
Term debt instruments as a percentage of primary	*43,5%*
• Tertiary and other items	1,4%
• Total	100,0%

Conclusion

Banks are in compliance with the following:

(a) The required 60:40 split in respect of the ratio between primary share capital and reserve funds and secondary capital and reserve funds.

(b) The limit of 50 per cent in respect of qualifying term debt as a percentage of primary share capital and reserve funds.

Therefore, the proposed amendments envisaged in this circular will not require any changes to the current capital and reserve funds of the total banking sector.

14. Conditions for the issue of hybrid debt instruments of which the proceeds rank as secondary capital

The issue of hybrid debt instruments referred to in this circular shall be subject to the following conditions:

(a) The prior written approval of the Registrar of Banks ("the Registrar") is required before the instruments may be issued by a bank or a controlling company.

(b) Written confirmation has to be provided to the Registrar by the board of directors of a bank or controlling company that the bank's or controlling company's capital-adequacy ratio in respect of qualifying primary share capital and reserve funds is being and will continue to be maintained in excess of 6 per cent of the bank's or controlling company's risk-weighted exposure.

(c) The features of the instruments shall be fully disclosed in the annual financial statements and other disclosures of the bank or controlling company to the general public.

(d) The main features of the instruments have to be easily understood by investors and the general public.

(e) The hybrid debt instruments-

    (i) shall not be payable to bearer;

    (ii) shall be paid in full by the investors on the date of issue and the proceeds of the instruments shall be available to the issuing bank or controlling company without any limitation;

    (iii) shall be non-cumulative;

(iv) shall enable the bank or controlling company to absorb losses on a going-concern basis;

(v) shall be issued without a maturity date;

(vi) may make provision for a call option in terms of which the issuing bank or controlling company may redeem the instruments after a minimum initial period of ten years, provided that the instruments will be replaced with instruments of a similar or better quality, unless the Registrar determines that the bank is adequately capitalised;

(vii) may be redeemed only at the option of the bank or controlling company concerned and with the prior written approval of the Registrar;

(viii) may make provision for one step-up in the initial rate payable in terms of the instrument after a minimum initial period of ten years, in addition to any call option in respect of the instrument. Normally, the call option and step-up feature are regarded as a synthetic redemption feature embedded in the instrument. The said step-up in the initial rate shall be restricted to an increase over the initial rate of not more than, either-

(aa) 100 basis points, less the swap spread referred to below; or

(bb) 50 per cent of the initial credit spread, less the swap spread referred to below.

The swap spread shall be determined at the pricing date of the instrument and shall relate to the differential in pricing at that date between the initial reference instrument or rate and the stepped-up reference instrument or rate;

(ix) shall be subordinated to any claims from the depositors, general creditors, and subordinated debt holders of the bank or controlling company;

(x) issued by the bank or controlling company to investors shall contain the wording “the proceeds obtained through the issue of this instrument qualify as capital for the issuing bank or controlling company in terms of the provisions of the Banks Act, 1990. Any direct or indirect acquisition of this instrument by a bank or a controlling company, as defined in the Banks Act, 1990, or by a non-bank subsidiary of a bank or controlling company, shall be regarded as an impairment against the capital of the acquiring bank or controlling company in question, in an amount equal to the book value of the said investment in the instrument”.

(f) The amount obtained by way of the issue of the instruments and which may rank as secondary capital shall be reduced by any direct or indirect funding provided by the reporting bank or a bank within the reporting banking group to the person investing in the said instruments.

(g) No asset of the bank or controlling company shall be pledged or otherwise encumbered as security for any liability in respect of the instrument.

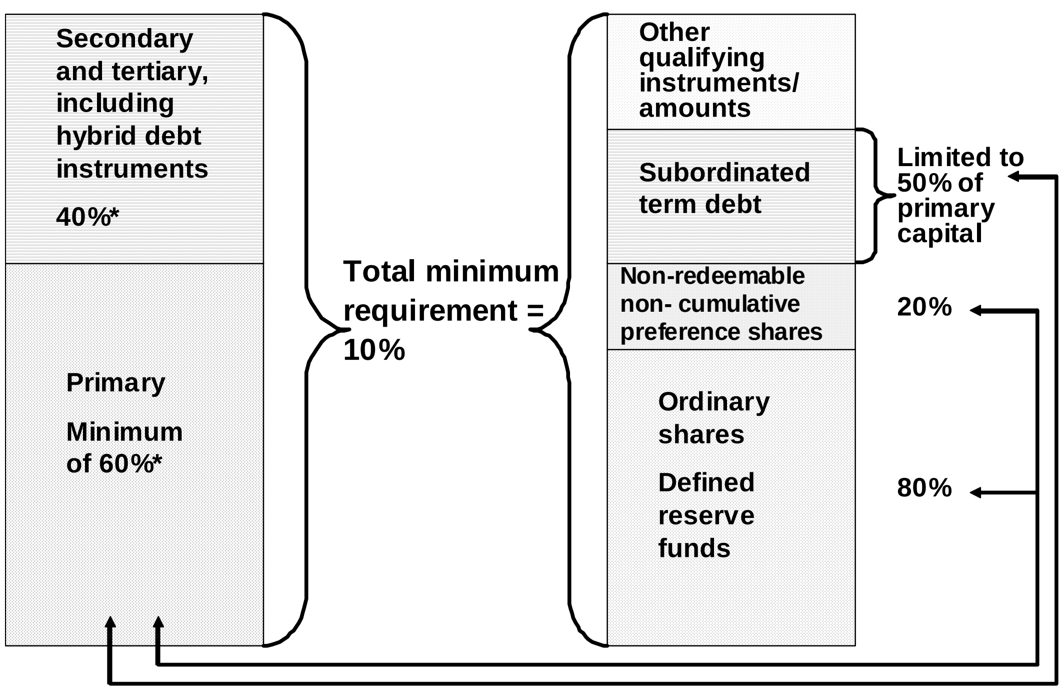
(h) The bank's or controlling company's liabilities in respect of the instruments shall not be covered by any guarantee issued by the bank or any related entity of the bank.

(i) No arrangement shall exist that legally or economically enhances the seniority of the ranking of the instruments.

(j) The bank may waive any payment in respect of the instruments, subject only to the prior waiver of distributions in respect of any ordinary shares or non-redeemable non-cumulative preference shares of the bank, and the bank shall have full access to the waived payments.

15. Graphical depiction of the proposed limits in respect of the capital structure of banks

<u>Composition of the capital and reserve funds of a bank</u>



*** Based on the minimum requirement of 10%**

16. Comparison between the various types of capital instruments

Based on a 10% capital-adequacy ratio	6%		4%			
Type of instrument						
Rank as	Primary	Primary	Secondary	Secondary	Secondary	Tertiary
Characteristic	**Ordinary shares**	**Non-redeemable non-cumulative preference shares**	**Perpetual cumulative preference shares**	**Hybrid debt instrument**	**Subordinated term debt**	**Short-term subordinated debt**
Ability to absorb loss	Unsecured and fully subordinated to all other instruments	Fully subordinated, but ranked before ordinary shares	Fully subordinated, but ranked before ordinary shares	Subordinated to the interests of depositors, general creditors and subordinated debt holders	Subordinated to the interests of depositors and general creditors	Subordinated to the interests of depositors and general creditors
Permanence	Perpetual	Perpetual	Perpetual	Synthetic redemption	Maturity date	Maturity date
Minimum original term to maturity	N/A	N/A	N/A	10 years in respect of the synthetic maturity date	5 years	2 years
Fixed charge	No	No	Cumulative	Non-cumulative - discretion over distribution subject only to the prior waiver of distributions in respect of any ordinary shares or non-redeemable non-cumulative preference shares	Yes	Yes
Market discipline/ voting rights	Yes	Certain circumstances	Certain circumstances	No	No	No
Share in the residual value of the company	Yes	Certain circumstances	Certain circumstances	No	No	No
Limited in category	No	20% of primary	No	No	Limited to 50% of primary	May support only market-risk exposure
Limited overall	No	20% of primary – any excess may qualify as secondary capital	May never exceed primary	May never exceed primary	Limited to 50% of primary	Sum of secondary and tertiary may not exceed primary

17. Proposed implementation date

This Office intends to implement the requirements contained in this Banks Act Circular with effect from 1 January 2006.

18. Notice of intention to amend the provisions of section 70 of the Banks Act and regulation 21 of the Regulations and invitation to provide comments

This Office hereby gives notice of its intention to amend the provisions of section 70 of the Banks Act and regulation 21 of the Regulations, as set out in this circular, in order for the legislative framework to remain in line with international regulatory and supervisory requirements and developments.

All interested parties are invited to submit comments on the proposed amendments set out in this circular to the following address, by not later than 28 February 2005:

ATTENTION: Mr Hugo Stark

The Registrar of Banks
P O Box 8432
PRETORIA
0001

19. Acknowledgement of receipt

Two additional copies of this circular are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.

E M Kruger
REGISTRAR OF BANKS

The previous circular issued was Banks Act Circular 18/2004 dated 10 December 2004.