South African Reserve Bank

From the Office of
the Registrar of Banks

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

Directive 5/2014 issued in terms of section 6(6) of the Banks Act, 1990 (Act No. 94 of 1990)

Matters related to transfers from retained earnings, appropriated profits and qualifying reserve funds

Executive summary

Regulation 38(18) of the Regulations relating to Banks (the Regulations) requires that written approval of the Office of the Registrar of Banks (this Office) be obtained prior to the repayment or redemption of qualifying capital instruments of banks, controlling companies or branches of foreign institutions (hereinafter collectively referred to as 'banks'). This requirement has resulted in different applications by banks pertaining to a reduction in qualifying reserve funds. The purpose of this directive is to inform all banks and auditors of banks of this Office's requirement regarding reductions in qualifying reserve funds, including transfers out of appropriated profits, which would lead to a reduction in the qualifying capital and reserve funds of banks.

1. Introduction

1.1 This Office has noted that different interpretations exist among banks pertaining to transfers from qualifying reserve funds, including transfers from appropriated profits and whether the requirements of regulation 38(18) of the Regulations also apply to such transfers.

1.2 Regulation 39(16)(a) of the Regulations imposes a duty on the board of directors and the senior management of a bank to, *inter alia*, develop a system that relates the bank's risk exposures to the bank's capital and reserve funds, and to incorporate measures to ensure that the bank builds and maintains sufficient capital buffers during benign periods to ensure that the bank will be able to subsequently withstand severe and/or prolonged market downturns.

1.3 In line with the principles and requirements encapsulated in regulation 39(16)(a) of the Regulations, regulation 38(10) of the Regulations requires that a bank's current-year profits be formally appropriated by its board of directors by way of a board resolution to become part of the bank's retained earnings before such retained earnings can constitute qualifying capital and reserve funds of the bank. The intention behind these requirements contained in regulation 38(10) of the Regulations is to ensure that the board of directors formally sets aside (i.e. appropriates) a portion of the current year's profits to become part of retained earnings for inclusion as qualifying common equity tier 1 capital and reserve funds with the purpose of being available to absorb losses on a going-concern basis. This requirement therefore results in the nature of current-year profits, which may otherwise be available for distribution in that year by way of a dividend, becoming part of qualifying capital and reserve funds that are 'permanent' and available to absorb losses should they occur.

1.4 Regulation 38(18) of the Regulations states that a bank shall not, without the prior written approval of the Registrar of Banks (the Registrar) or otherwise than in accordance with the conditions approved by the Registrar in writing, repay any of its common equity tier 1 capital or additional tier 1 capital, or, before the maturity thereof, redeem any of the instruments issued that qualify as tier 2 capital. The purpose of this requirement is to ensure that the bank remains adequately capitalised after the repayment or redemption of instruments that were previously included as part of the bank's qualifying capital and reserve funds.

1.5 This Office is of the opinion that, in line with the requirements contained in the Regulations relating to a reduction in qualifying capital instruments as a result of the repayment or redemption of such instruments, a formal procedure has to be in place in respect of transfers from or reductions in appropriated profits to ensure that the bank remains adequately capitalised subsequent to such a transfer or reduction.

2. Directive

2.1 Based on the aforesaid, banks are hereby directed to submit a written application to this Office to obtain permission from the Registrar for a reduction in qualifying reserve funds, including any reduction in appropriated profits. This application shall contain written confirmation by the board of directors that:

2.1.1 the relevant capital adequacy ratios of the bank concerned shall be at least one percentage point higher than the relevant percentages determined in terms of regulations 38(8) and 38(9) of the Regulations after the reduction of the reserve funds without relying on any new capital issues; and

2.1.2 the remaining common equity tier 1 capital and reserve funds shall be sufficient to ensure the bank's continued compliance with the relevant requirements in regulation 38(9) of the Regulations, including that the bank's common equity tier 1 capital adequacy ratio shall exceed the relevant specified percentage.

2.2 This directive shall not apply to:

2.2.1 transfers between qualifying reserve funds;

2.2.2 reductions in reserve funds that arise due to the application of the International Financial Reporting Standards (IFRS); and

2.2.3 transfers by foreign branches of South African incorporated banks and non-bank subsidiaries of South African incorporated banks, insofar as they do not result in a reduction in the consolidated qualifying capital.

3. Future amendments to the Regulations

3.1 This Office hereby gives notice to banks that it will amend the provisions of regulation 38(18) of the Regulations during the next round of amendments to the Regulations to appropriately reflect the requirements contained in this directive.

4. Acknowledgement of receipt

4.1 Two additional copies of this directive 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 officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.

René van Wyk
Registrar of Banks

The previous directive issued was Directive 4/2014 dated 17 September 2014.