South African Reserve Bank
From the Office of
the Registrar of Banks

Ref: 15/8/3

D3/2017

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

Directive D3/2017 of 2017 issued in terms of section 6(6) of the Banks Act 94 of 1990

Assets lodged or pledged to secure liabilities

Executive summary

In terms of the provisions of regulation 38(5)(a)(i)(N) of the Regulations relating to Banks (Regulations), based on the relevant requirements specified in sections 70 and 70A of the Banks Act 94 of 1990 (Banks Act), a bank has to deduct from its common equity tier 1 capital and reserve funds the value of assets lodged or pledged to secure liabilities incurred under any other law. This is to be done when the effect of such lodging or pledging is such that the assets are not available for the purpose of meeting the liabilities of the bank in terms of the Banks Act. The Registrar of Banks (Registrar) may, however, subject to such conditions and treatment as may be specified in writing by the Registrar, determine cases in which the value of the assets lodged or pledged to secure the liabilities of the bank does not constitute a deduction against the common equity tier 1 capital and reserve funds of said bank.

In order to provide certainty regarding the various types of transactions in terms of which assets may be lodged or pledged to secure liabilities, but which should not be deducted from banks' common equity tier 1 capital and reserve funds, the Office of the Registrar of Banks (this Office) hereby specifies such transactions by means of the directive.

This directive replaces Directive 1 of 2014.

1. Introduction

1.1 In terms of the provisions of regulation 38(5)(a)(i)(N) of the Regulations, based on the relevant requirements specified in sections 70 and 70A of the Banks Act, a bank has to deduct from its common equity tier 1 capital and reserve funds the value of assets lodged or pledged to secure liabilities incurred under any other law. This is to be done when the effect of such lodging or pledging is such that the assets are not available for the purpose of meeting the liabilities of the bank in terms of the Banks Act. The Registrar may, however, subject to such conditions and treatment as may be specified in writing by the Registrar, determine cases in which the value of the assets lodged or pledged to secure

the liabilities of the bank does not constitute a deduction against the common equity tier 1 capital and reserve funds of said bank.

1.2 A 'pledged asset' is an asset that is transferred to the lender for the purposes of securing a debt. The lender maintains possession of the pledged asset, but does not have ownership unless a default occurs.

1.3 The borrower remains the owner of the pledged asset and it is therefore reflected in their balance sheet as an asset; in the 'normal' course of their business this would not affect their Net Asset Value. However, in reality, it is an encumbered asset.

1.4 When a default occurs, the lender has the right to take ownership of the pledged asset or to liquidate it in order to settle the debt. Section 83 of the Insolvency Act 24 of 1936 (Insolvency Act) provides for the realisation of securities for claims; section 95 of the Insolvency Act provides for the application of the proceeds of securities. In insolvency proceedings, a claim secured by a pledged asset is therefore regarded as a preference claim to be paid out prior to the determination of the so-called 'free residue' of the estate.

1.5 Section 2 of the Insolvency Act defines:

1.5.1 'free residue', in relation to an insolvent estate, as that portion of the estate which is not subject to any right of preference by reason of any special mortgage, legal hypothec, pledge or right of retention; and

1.5.2 'security', in relation to the claim of a creditor of an insolvent estate, as property of that estate over which the creditor has a preferent right by virtue of any special mortgage, landlord's legal hypothec, pledge or right of retention.

1.6 When a bank is liquidated, its pledged assets are utilised to the benefit of specific secured liability holders, which could result in unsecured liability holders suffering losses.

1.7 In exercising its discretion to determine cases in which the value of the assets lodged or pledged to secure the liabilities of a bank do not constitute a deduction against the common equity tier 1 capital and reserve funds of said bank, this Office takes into consideration, among other things:

1.7.1 the fact that banks are public companies that accept, solicit and/or advertise for deposits from the general public;

1.7.2 matters related to the safety and soundness of banks individually as well as the banking system as a whole;

1.7.3 the smooth functioning of institutions and markets; and

1.7.4 protecting the interests of all depositors and liability holders, including specific secured liability holders as well as unsecured liability holders.

1.8 In recent years, the Basel Committee on Banking Supervision (Basel Committee) issued various new and revised requirements impacting on the regulation and supervision of banks, including matters related to, or that require, the lodging or pledging of banks' assets to secure liabilities.

1.9 In order to provide certainty regarding the various types of transactions in terms of which assets may be lodged or pledged to secure liabilities, but which should not be deducted from banks' common equity tier 1 capital and reserve funds, this Office hereby specifies such transactions by means of the directive.

1.10 This directive replaces Directive 1 of 2014.

2. Securities financing transactions

2.1 In terms of the relevant requirements specified in the Financial Reporting Standards issued from time to time, when a bank, for example, sells a financial asset in terms of a repurchase agreement – i.e. when a bank sells a financial asset subject to an agreement to repurchase the asset at a future date – the transfer of that asset does not qualify for derecognition and, as such, the bank shall continue to recognise (a) the transferred asset in its entirety and (b) a financial liability for the relevant consideration received. In such cases, the financial asset thus sold normally serves as collateral or security for the related financial liability so created.

2.2 Securities financing transactions, which include repurchase and resale agreements, form an integral part of the business of a bank and play an important role to provide ongoing liquidity to banks. In this regard, for example, banks pledge assets as collateral in favour of the South African Reserve Bank (SARB) in terms of repurchase agreements concluded through the South African Multiple Option Settlement (SAMOS) system, as part of the SARB's monetary policy framework. Further information regarding the SARB's system of accommodation as well as the eligble collateral in respect of the above, is available online at www.resbank.co.za.

2.3 The relevant requirements related to securities financing transactions, including repurchase and resale agreements, have been incorporated into the Regulations.

3. Basel III liquidity coverage ratio

3.1 On 7 January 2013, the Basel Committee issued a revised version of the Basel III liquidity coverage ratio (LCR) framework[1].

3.2 Part of the revised framework relates to the provision of alternative liquidity approaches (ALAs) for jurisdictions that may have an insufficient supply of Level 1 High Quality Liquid Assets (HQLA) or of both Level 1 and Level 2 HQLA, including the provision of a contractual Committed Liquidity Facility (CLF) from the relevant central bank.

[1] Available online at http://www.bis.org/publ/bcbs238.htm

3.3 On 12 January 2014, the Basel Committee issued revisions to the LCR's definition of HQLA to make provision for a restricted version of a Committed Liquidity Facility (RCLF) that may be provided by central banks[2].

3.4 In all relevant cases, the CLFs and RCLFs have to be supported by unencumbered collateral of a type specified by the central bank.

3.5 Normally, assets which qualify as HQLA that have been pre-positioned, deposited with or pledged to the central bank but that have not been used to generate liquidity may be included in the stock, equivalent to unencumbered collateral or assets.

3.6 The relevant requirements related to CLFs and RCLFs have been incorporated into the Regulations as well as subsequent directives and guidance notes issued by this Office.

4. Collateralised transactions as part of eligible credit risk mitigation techniques

4.1 The Basel II framework makes provision for collateralised transactions as part of eligible credit risk mitigation techniques.

4.2 When a bank provides eligible collateral to another bank in order to mitigate that bank's exposure to risk, the bank that received the collateral is allowed to reduce its relevant exposure to credit risk when calculating its capital requirements to take account of the risk-mitigating effect of the collateral.

4.3 Essentially, the specified requirements in the Regulations relate to legal certainty and the legal mechanism by which collateral is pledged or transferred to ensure that a bank has the right to liquidate or take legal possession of the collateral in the event of a default, insolvency or bankruptcy, of one or more otherwise-defined credit events set out in the transaction documentation of the counterparty, or, where applicable, of the custodian holding the collateral.

5. Exposures to central counterparties

5.1 On 10 April 2014, the Basel Committee issued a revised capital framework for bank exposures to central counterparties.[3]

5.2 The intention of the revised capital framework is to promote central clearing for most standardised derivative instruments.

5.3 Central counterparties require margin to be posted to mitigate their exposure to counterparty credit risk.

5.4 In this regard, in terms of the revised capital framework, for example in the case of trade exposures to qualifying central counterparties, any assets or collateral posted will be assigned the same risk weights that otherwise apply to such assets or collateral under the capital adequacy framework, irrespective of the fact that such assets have been posted as collateral.

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[2] Available online at http://www.bis.org/publ/bcbs274.htm

[3] Available online at http://www.bis.org/publ/bcbs282.htm

6. Margin requirements for non-centrally cleared derivatives

6.1 On 18 March 2015, the Basel Committee issued margin requirements for non-centrally cleared derivatives.[4]

6.2 The intention of imposing margin requirements for non-centrally cleared derivatives is to, among other things, reduce systemic risk.

6.3 Assets lodged or pledged as collateral in terms of such non-centrally cleared derivative transactions normally involve liquid high-quality collateral that will be available to the margin collector to offset losses caused by the default of its derivative counterparty.

7. Securitisation exposures

7.1 Following the commencement of the global financial crisis in 2007, the Basel Committee finalised and issued various amendments and refinements to the Basel II securitisation framework; it also strengthened the capital standards related to securitisation exposures.

7.2 Furthermore, extensive requirements related to special-purpose entities (SPEs) and consolidated financial statements, as well as related disclosure requirements, have been incorporated into the Financial Reporting Standards.

7.3 Securitisation plays an important role in banks' risk management processes, including capital and liquidity management.

7.4 The relevant requirements related to securitisation exposures have been incorporated into the Regulations.

8. Directive

8.1 Based on the aforesaid, and in accordance with the provisions of section 6(6) of the Banks Act, banks and controlling companies are hereby directed:

8.1.1 to ensure that all:

8.1.1.1 securities financing transactions, including any repurchase and resale agreements, entered into between them and their clients at all times comply fully with all the relevant requirements specified in the Regulations and in the applicable Financial Reporting Standards issued from time to time, including any relevant requirements related to measurement and disclosure; and

8.1.1.2 securitisation exposures and the treatment of SPEs at all times comply fully with all the relevant requirements specified in the Exemption Notice relating to Securitisation Schemes, in the Regulations, and in the applicable Financial Reporting Standards issued from time to time, including any relevant requirements related to consolidation and disclosure;

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[4] Available online at http://www.bis.org/bcbs/publ/d317.htm

8.1.2 to ensure that assets lodged or pledged as collateral as part of:

8.1.2.1 any securities financing transactions, including any repurchase or resale agreements, at all times comply fully with all the relevant requirements specified in the Regulations and in the applicable Financial Reporting Standards issued from time to time;

8.1.2.2 eligible credit risk mitigation techniques at all times comply fully with all the relevant requirements specified in the Regulations;

8.1.2.3 any CLFs and RCLFs that may be granted by the SARB at all times comply fully with all the relevant requirements specified in the Regulations and in any relevant directive and/or guidance note that may be issued by this Office from time to time;

8.1.2.4 any margin requirements related to an exposure to a central counterparty at all times comply fully with all the relevant requirements specified in the Regulations and in any relevant directive and/or guidance note that may be issued by this Office from time to time;

8.1.2.5 any margin requirements related to non-centrally cleared derivative transactions at all times comply fully with all the relevant requirements specified in the Regulations and in any relevant directive and/or guidance note that may be issued by this Office from time to time; and

8.1.2.6 any securitisation scheme or structure in terms of which assets origined by the bank that were subsequently securitised but that are still reflected on-balance sheet or in the condolidated financial statements at all times comply fully with all the relevant requirements specified in the Exemption Notice relating to Securitisation Schemes, in the Regulations, and in the applicable Financial Reporting Standards issued from time to time;

8.1.3 not to deduct from their common equity tier 1 capital and reserve funds the value of the assets lodged or pledged to secure liabilities or potential liabilities that relate to:

8.1.3.1 any securities financing transactions, including any repurchase or resale agreements envisaged hereinbefore, accounted for in accordance with the relevant Financial Reporting Standards issued from time to time;

8.1.3.2 any CLFs and RCLFs that may be granted by the SARB;

8.1.3.3 eligible credit risk mitigation techniques specified in the Regulations;

8.1.3.4 transactions with central counterparties;

8.1.3.5 transactions in respect of non-centrally cleared derivative transactions;

8.1.3.6 any relevant securitisation scheme or structure,

as envisaged hereinbefore, at all times comply fully with all the relevant requirements specified in the Exemption Notice relating to Securitisation

Schemes, in the Regulations, and in any relevant directive and/or guidance note that may be issued by this Office from time to time; and

8.1.4 to deduct from their common equity tier 1 capital and reserve funds the value of the assets lodged or pledged to secure liabilities incurred under any other law, other than the assets lodged or pledged to secure liabilities that relate to transactions envisaged in paragraphs 8.1.2 and 8.1.3 above, when the effect of such lodging or pledging is that such assets are not available for the purpose of banks and controlling companies meeting their liabilities in terms of the Banks Act.

9. Acknowledgement of receipt

9.1 Kindly ensure that a copy of this directive is made available to 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.

Kuben Naidoo
Deputy Governor and Registrar of Banks

Date: 22/8/2017

The previous directive issued was Directive D2/2017, dated 20 July 2017.