

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

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

Guidance Note G7/2016 issued in terms of section 6(5) of the Banks Act 94 of 1990

Capital arbitrage transactions

Executive summary

The Basel Committee on Banking Supervision (Basel Committee) has recently issued a statement on capital arbitrage transactions.

The purpose of this guidance note is to inform banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies (hereinafter collectively referred to as all interested persons) not to engage in transactions that aim to unduly offset regulatory adjustments.

1. Background and documents issued by the Basel Committee relating to capital arbitrage transactions

1.1 The Basel Committee has issued Newsletter 18 during June 2016.¹

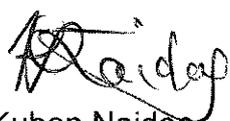
1.2 In the Newsletter, it is stated that since the publication of the Basel III framework in 2010, Basel Committee members have received numerous requests to review or approve transactions that seek to alter the form or substance of items subject to regulatory adjustments, which are outlined in paragraphs 66 to 90 of the Basel III standard. These include, for example, proposals for structured transactions that result in deferred tax assets being reclassified as a way of seeking to avoid their deduction from the calculation of regulatory capital.

¹ Available online at https://www.bis.org/publ/bcbs_n118.htm

- 1.3 Transactions that are designed to offset regulatory adjustments employ a variety of strategies. For example, these may include: (1) the issuance of senior or subordinated securities with or without contingent write off mechanisms; (2) sales contracts that transfer insufficient risk to be deemed sales for accounting purposes; (3) fully-collateralised derivative contracts; and (4) guarantees or insurance policies. These types of transactions pose a number of risks, and they can be complex, artificial and opaque. They can include legal risk and be untested in their ability to fully address the underlying rationale for the regulatory adjustment. Furthermore, such transactions can have the effect of overestimating eligible capital or reducing capital requirements, without commensurately reducing the risk in the financial system, thus undermining the calibration of minimum regulatory capital requirements.
- 1.4 Based on the aforesaid, this Office hereby informs all interested persons that banks should not engage in transactions that aim to unduly offset regulatory adjustments. Any such transactions will be subject to careful scrutiny by this Office in the evaluation of risk transfer and the assessment of the capital adequacy of banks and controlling companies.

2. Acknowledgement of receipt

- 2.1 Two additional copies of this guidance note are enclosed for use by 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

The previous guidance note issued was Guidance Note 6/2016, dated 14 July 2016.