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South African Reserve Bank
Prudential Authority

Ref.: 15/8/1/3

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

Proposed Directive issued in terms of section 6(6) of the Banks Act 94 of 1990

Matters related to the issuance of additional tier 1 capital instruments that contain contingent 'must-pay' clauses

Executive summary

Regulation 38(11)(b)(ii) of the Regulations relating to Banks (the Regulations) requires the prior written approval of the Prudential Authority (PA) for the issuances of instruments qualifying as additional tier 1 capital (AT1) by banks, controlling companies and branches of foreign institutions (hereinafter collectively referred to as 'banks').

The PA has noted the South African (SA) banking sector's efforts to further explore offshore capital markets as part of the regulatory capital optimisation strategies. The PA also acknowledges banks' proposed inclusion of contingent 'must-pay' clauses in the terms and conditions of AT1 instruments, which clauses would enable banks to achieve, amongst other objectives, the classification of AT1 instruments as liabilities for accounting purposes, thereby alleviating the potential profit or loss volatility as a result of foreign exchange adjustments related to foreign currency (FC) denominated AT1 issuances.

The purpose of this proposed directive is to direct banks in terms of the PA's requirements in relation to the provisions of regulation 38(11) of the Regulations for all applications by banks for the issuance of both local and FC denominated AT1 instruments containing contingent 'must-pay' provisions.

1. Introduction

1.1 It has come to the PA's attention that SA banks are seeking to include a contingent settlement provision in the terms and conditions of their AT1 capital instruments.

1.2 The aforementioned contingent settlement provision, hereinafter referred to as the contingent 'must-pay' clause, would require that coupon payments on the AT1 instruments become mandatory in the event that the instruments cease to be recognised as, or lose their status as, AT1 as a result of a capital disqualification event, which may result from among others, a change in the regulatory framework for qualifying capital.

1.3 The main rationale provided by banks for the proposed inclusion of the contingent 'must-pay' clause in the terms and conditions of AT1 capital issuances is that FC denominated AT1 instruments would result in significant profit or loss volatility, due to the accounting treatment of existing AT1 instruments (i.e. AT1 instruments are classified as equity), which does not allow for the revaluation of equity subsequent to initial recognition. Therefore, in order for banks to issue FC denominated AT1 instruments without the consequences of significant profit or loss volatility, it has necessitated that such instruments be designed to achieve a liability classification through the inclusion of a contingent settlement provision (i.e. the must-pay clause) in the terms of the AT1 instruments to be issued by banks in the future.

2. Proposed Directive relating to general requirements pertaining to contingent 'must-pay' clauses

2.1 The PA is not opposed to banks including the aforementioned contingent 'must-pay' clause in the terms and conditions of both local and foreign currency denominated AT1 instruments. However, banks that elect to utilise the contingent 'must-pay' clause as part of the AT1 instruments' terms and conditions must note that the PA will not approve the issuance of AT1 instruments unless it is also stated in the terms of the instrument that, in the event that the point of non-viability is triggered by the PA, such a decision would not constitute a capital disqualification event.

2.2 Furthermore, the inclusion of the contingent 'must-pay' clause shall neither amend nor revise the current terms and conditions of AT1 instruments in terms of regulation 38(11)(b) of the Regulations or the guidance provided in Guidance Note 6 of 2017 insofar as they relate to AT1 capital. Therefore, the rights of the holders of the AT1 instruments and the powers of the PA should a capital disqualification event occur and the contingent 'must-pay' clause is invoked as a result of the occurrence of a capital disqualification event, shall be fully disclosed within the contractual pricing supplement or prospectus of the instrument.

2.3 The issuance of all AT1 instruments is subject to the PA's prior written approval, in terms of regulation 38(11)(b)(ii) of the Regulations. When the PA considers an application for approval for the issuance of AT1 instruments, the PA will assess whether or not the following requirements, among others, are met:

i. the coupons that are payable under the contingent 'must-pay' clause must only be those coupons accruing after the instrument has been disqualified from regulatory capital in its entirety (i.e. partial disqualification that results in a portion of the instrument qualifying as regulatory capital, while the remainder is disqualified, does not constitute a capital disqualification event);

ii. the coupon payment obligation becomes mandatory on each interest payment date once the instrument has been derecognised in full from qualifying capital;

iii. the total value of AT1 instruments with a contingent 'must-pay' clause shall be limited to 25 per cent of qualifying tier 1 capital and reserve funds.

3. Further action

3.1 The PA will continue to monitor the issuance of regulatory instruments by banks and banking groups and will issue further directives or any additional measures as and when necessary.

4. Invitation for comments

4.1 Banks and all other interested persons are hereby invited to submit their comments in respect of the proposed directive to SARB-PA@resbank.co.za and to Jacqueline.Legong@resbank.co.za, for attention of Ms J Legong, by no later than 12 February 2021.

Kuben Naidoo
Deputy Governor and CEO: Prudential Authority

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