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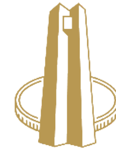

SOUTH AFRICAN RESERVE BANK
Prudential Authority

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

Loss absorbency requirements for additional tier 1 and tier 2 capital instruments

Executive summary

The Regulations relating to Banks (Regulations) set out, among other things, the prescribed minimum requirements for capital instruments to qualify as either additional tier 1 or tier 2 capital.

This proposed directive directs banks, controlling companies and branches of foreign institutions (hereinafter collectively referred to as 'banks') to comply with the requirements related to loss absorbency and the relevant trigger events for capital instruments, in addition to the respective requirements specified in the Regulations.

This proposed directive replaces Guidance Note 6 of 2017.

1. Introduction

1.1 The Basel III framework includes the amended minimum requirements for additional tier 1 and tier 2 capital instruments for banks and was implemented in South Africa with effect from 1 January 2013 via the Regulations.

1.2 The Prudential Authority (PA) provided initial guidance to banks in relation to loss absorption at the point of non-viability (PONV) in the following:

I. Guidance Note 2 of 2012, paragraph 2.2, issued on 8 February 2012;
II. Guidance Note 3 of 2013, issued on 11 June 2013;
III. Guidance Note 7 of 2013, issued on 18 August 2013; and
IV. Guidance Note 6 of 2017, issued on 14 August 2017.

1.3 This proposed directive replaces Guidance Note 6 of 2017 and banks are advised that the PA will continue to monitor international developments related to the loss absorption requirements of instruments qualifying as capital for banks and, should it become necessary, issue further guidance or directives to banks.

2. Background and context

2.1 Trigger event, conversion and write-off

2.1.1 Regulations 38(11)(b)(i), 38(11)(b)(iv)(H) and 38(12)(a)(i) of the Regulations prescribe that the contractual terms and conditions of the respective capital instruments must contain a provision that requires the instruments to either be converted to the most subordinated form of equity or written off at the discretion of the Chief Executive Officer (CEO) of the PA at the occurrence of a specified trigger event.

2.1.2 The trigger event for both additional tier 1, accounted as equity, and tier 2 capital instruments shall be at the discretion of the CEO of the PA as envisaged in regulations 38(11)(b)(i) and 38(12)(a)(i) of the Regulations.

2.1.3 The trigger event for additional tier 1 capital instruments, accounted as liabilities, shall be the earlier of the decision by the CEO of the PA as envisaged in regulation 38(11)(b)(i) of the Regulations or when a bank or controlling company's common equity tier 1 (CET1) ratio is equal to or below 5.875%.

2.1.4 Banks will be notified in writing by the CEO of the PA once it is deemed that the trigger event has occurred.

2.1.5 Conversion or write-off needs to occur only to the extent that the bank will be deemed to be viable again as specified in writing by the CEO of the PA. In terms of statutory ranking, additional tier 1 instruments will be converted or written off prior to any conversion or write-off of tier 2 instruments.

2.1.6 The instruments to be converted or written off will be determined by the CEO of the PA and shall be based on the nominal value of the instruments as reflected in the bank's financial statements or management accounts at the time of occurrence of the trigger event.

2.1.7 In the event that a bank has more than one type of capital instrument qualifying as tier 2 capital, containing either a conversion or write-off provision, such instruments will be treated pari passu, meaning that partial conversion or write-off would occur at the occurrence of the trigger event, up to the point that the bank is deemed viable again. The same would apply where a bank has more than one type of capital instrument qualifying as additional tier 1 capital.

2.2 Instruments written off

2.2.1 Instruments issued with a provision for write-off must be written off permanently with no provision for a write-back once the bank becomes viable again.

2.2.2 The value of the capital instruments to be repaid in the event of an early call or redemption for instruments partially converted or written-off, shall be irrevocably reduced by the amount of the instrument written off.

2.3 Group treatment

2.3.1 Capital instruments issued out of a fully consolidated foreign subsidiary included in the consolidated amount of qualifying capital shall, in accordance with

regulations 38(11)(b)(i) and 38(12)(a)(i) of the Regulations, be converted or written off at the occurrence of a trigger event that is the earlier of either the circumstances envisaged in paragraphs 2.1.2 and 2.1.3 above, or a decision by the relevant host regulator that a write-off without which the subsidiary would become non-viable is necessary.

2.4 Statutory requirements

2.4.1 The Financial Sector Laws Amendment Act 23 of 2021 (FSLAA) was enacted on 1 June 2023 and amended the Financial Sector Regulation Act. 9 of 2017 (FSR Act). In accordance with the amended FSR Act, the South African Reserve Bank (SARB) may decide to bail-in regulatory capital instruments of a designated institution in resolution. Furthermore, the aforementioned determination by the SARB as well as the trigger event, as described in paragraph 2.1 of this proposed directive, to be determined by the CEO of the PA, can only be triggered after concurrence with the SARB, as prescribed in section 166D of the FSR Act.

2.4.2 The required contractual terms and conditions regarding conversion or write-off of instruments qualifying as capital in accordance with the requirements respectively specified in regulation 38(11) and regulation 38(12) of the Regulations are required, notwithstanding the provisions of the FSR Act.

2.4.3 The statutory requirements may differ from the contractual terms and conditions of the instruments in that the book value of ordinary shares may fully or partially recover following the trigger event and in that the conversion of instruments may, in certain cases, be preferred over the write-off of instruments, among other preferences.

2.4.4 The point of resolution (POR) and PONV are considered as two separate points, even though in some instances they may occur simultaneously. The statutory requirements that relate to POR are not intended to replace the contractual requirements that relate to PONV which are stipulated in regulation 38 of the Regulations.

2.5 The determination of a contractual bail-in

2.5.1 The PA may consider, among other considerations, the following factors when applying its discretion to apply contractual bail-in:

2.5.1.1 The SARB's considerations, including financial stability, market confidence, the banking group's resolution plan and so forth.
2.5.1.2 The need for broader support measures.
2.5.1.3 The absorption of losses before taxpayers or ordinary depositors are exposed to loss.
2.5.1.4 The probability of success.

3. Proposed directive

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

3.1 Contractual and statutory requirements

3.1.1 Banks must clearly indicate in the contractual terms and conditions of additional tier 1 and tier 2 capital instruments issued, whether such instruments will either be written off or converted into the most subordinated form of equity, at the occurrence of a trigger event which is activated at the discretion of the CEO of the PA, as envisaged in regulations 38(11)(b)(i) and 38(12)(a)(i) of the Regulations.

3.1.2 Banks must clearly indicate in their respective issuing documentation or contractual terms and conditions of additional tier 1 and tier 2 capital instruments to be issued, that such instruments could either be statutorily or contractually bailed in at a specified trigger event.

3.2 Conversion to most subordinated form of equity

3.2.1 Banks must include in the contractual terms and conditions for additional tier 1 and tier 2 instruments, which provide for conversion into the most subordinated form of equity, the following information:

3.2.1.1 number of shares or a formula to determine the number of shares in the most subordinated form of equity to be received by additional tier 1 and tier 2 instrument holders at conversion; and

3.2.1.2 the conversion price, which must be determined as the greater of:

a. the arithmetic mean of the closing price of the shares on each of the five consecutive dealing days prior to the date of the trigger event; or
b. a floor price of 20% of the shares' closing price at the same date as issuance of the capital instrument.

3.2.2 In exceptional instances when, following a trigger event, the conversion of a capital instrument:

3.2.2.1 cannot be undertaken;
3.2.2.2 is not irrevocable; or
3.2.2.3 will not result in an immediate increase in CET1,

such instrument shall, instead of being converted into the most subordinated form of equity, be written off and result in an increase in the bank's CET1 capital.

3.2.3 Conversion shall occur in the form of listed ordinary shares of the relevant bank if such bank is listed on an exchange, or alternatively that of the bank's controlling company if the said bank is a wholly owned subsidiary.

3.2.4 In the event that neither a bank nor the bank's controlling company is listed on an exchange, the issuing bank must determine a conversion price at the date of issuance determined as 20% of the book value of the shares.

4. Invitation for comment

4.1 All banks and other interested persons are hereby invited to submit their comments on the proposed directive to SARB-PA@resbank.co.za for the attention of Ms S Mbebe by no later than 29 April 2024.

4.2 All comments received from banks and other interested persons may be published on the PA's website unless the respondent specifically requests confidential treatment.

Fundi Tshazibana
Chief Executive Officer

Date: