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SOUTH AFRICAN RESERVE BANK
Prudential Authority

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To: All banks, controlling companies, branches of foreign institutions, 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 capital treatment of investments in insurance entities

Executive summary

This proposed Directive serves to inform banks, branches of foreign institutions and controlling companies (hereinafter collectively referred to as 'banks') as well as auditors of banks of the capital treatment of investments in insurance businesses.

To preserve the integrity of the capital structures of banks with investments in insurance businesses, it is important that the capital resources of the respective bank and insurance entities be appropriately separated. The Basel Committee on Banking Supervision (BCBS) gave effect to this by prescribing that investments in insurance entities and/or subsidiaries, among other entities, be outside the scope of regulatory consolidation for consolidated reporting purposes.

This proposed Directive specifies the manner in which the limited recognition framework provided for in regulations 38 of the Regulations relating to Banks (Regulations) must be applied by banks with significant investments in insurance entities, where the bank owns more than 10% of the issued common share capital or where the entity is an affiliate as envisaged in regulation 38(5)(b)(i) of the Regulations.

1. Introduction

1.1 Regulation 36(10)(c)(ii) of the Regulations that deals with the calculation of the consolidated amount of qualifying capital and reserve funds, requires that when a bank or controlling company calculates its consolidated amount of qualifying capital and reserve funds, the bank or controlling company must deduct from its consolidated amount of qualifying capital and reserve funds any equity or other regulatory amounts held in an insurance entity and remove from its balance sheet any relevant assets, liabilities or third-party investments relating to such insurance subsidiary or entity that conducts insurance business, or an insurance entity in which the said bank or controlling company holds a significant minority interest.

1.2 Regulation 38(5)(b) of the Regulations read with Circular 4 of 2013 provide for the use of the capital threshold deduction method by banks or controlling companies with respect to their investments in financial entities, including insurance entities. However, this method may only be applied by banks after obtaining the prior written approval of the Prudential Authority (PA) in respect of significant investments in terms of regulation 38(5)(a)(i)(M) of the Regulations. The threshold deduction method was introduced by the BCBS in a document titled *Basel III: A global regulatory framework for more resilient banks and banking systems,* which was published in June 2011.[1]

1.3 To preserve the integrity of the qualifying regulatory capital and reserve funds of banking groups, the potential contagion between the banking and insurance sectors must be prevented. To achieve this, banks and banking groups are required to completely remove from their balance sheets all amounts that relate to investments in licenced insurance businesses and subsidiaries, including cell captive arrangements that give rise to insurance liabilities. When banks invest in insurance businesses, stresses or other activity within such insurance entities can affect the financial performance of the investing bank, and vice versa. The deconsolidation of insurance businesses' balance sheets aims to address this problem.

1.4 The Regulations, which are aligned to the BCBS Basel III framework, prescribe the treatment of investments in entities that are outside the scope of regulatory consolidation. Regulation 38(5)(b) of the Regulations states that instead of a full deduction, specified items shall each receive limited recognition when a bank or controlling company calculates its common equity tier 1 (CET1) capital and reserve funds, with recognition being capped at 10% of the bank or controlling company's common equity or CET1 capital and reserve funds. The items are:

1.4.1 significant investments in the common shares or CET1 capital of unconsolidated financial institutions such as banks, insurance and other financial entities;

1.4.2 any relevant amount related to mortgage servicing rights; and

1.4.3 any relevant amount related to deferred tax assets that arise from temporary differences.

1.5 Circular 4 of 2013 mitigates any potential ambiguity surrounding the limited recognition of investments in insurance entities by banks as set out in regulations 38(5)(i)(L) and 38(a)(i)(M) of the Regulations, read with regulation 38(5)(b) of the Regulations.

1.6 This proposed Directive deals specifically with the threshold deduction method to be utilised in respect of investments in insurance entities or activities by banks, subject to the prior written approval and conditions as may be specified in writing by the PA. An application to apply the threshold deduction method must contain details of the insurance entity or activity to which the limited recognition will be applied, the envisaged capital impact, and a benchmark of the application against the provisions of Circular 4 of 2013 to demonstrate the eligibility of the investment to be threshold deducted.

1.7 Notwithstanding the inherent complexity of the limited recognition framework and the resultant capital concession, the PA will continue to apply the framework in alignment with the Regulations and the BCBS Basel III framework.

[1] Available online at: https://www.bis.org/publ/bcbs189.htm

2. Proposed Directive

2.1 Based on the aforesaid and in accordance with the provisions of section 6(6) of the Banks Act, 1990 banks are hereby directed as follows:

2.1.1 A bank shall not apply the threshold deduction method to investments in insurance entities or businesses without the prior written approval of the PA.

2.1.2 A bank shall not include any post-acquisition reserves related to insurance investments, subsidiaries and cell captive arrangements that are outside the scope of regulatory consolidation in either the bank solo or group consolidated capital. That is, post-acquisition reserves from insurance investments, subsidiaries and cell captive arrangements shall not be included in the consolidated capital of banks and banking groups that have investments in such entities or businesses.

2.1.3 A bank shall apply the threshold deduction method to the value of the initial investment, with such initial investment being held at historic cost (i.e. the initial investment shall never be revalued upwards) to prevent banking groups from including any insurer's post-acquisition reserves in their CET1 capital.

2.1.4 Banks with investments in insurance businesses and cell captive arrangements may adjust the value of the initial investment where an impairment is raised against such an investment in order not to hold capital on an initial value that has subsequently been adjusted downwards. Banks may also adjust the value of the initial investment when share capital is adjusted permanently in the form of recapitalisations and/or share buy-backs, for example.

2.1.5 A bank shall report variations to the value of the initial investment to the PA biannually using the template attached hereto as Annexure A. The template must be submitted by no later than 30 business days following the June and December reporting periods respectively. The completed templates must be approved and signed off by the Group Treasurer.

2.1.6 Banking groups may include distributions such as actual dividends declared in their qualifying CET1 capital and reserve funds from such insurance businesses once declared by the insurers' board of directors or related governance structures.

2.2 Banks not in compliance with this directive at the date of issuance may approach the PA, in terms of Section 279 of the Financial Sector Regulation Act of 2017, to bilaterally agree on a transition period (that is not longer than 12 months) in terms of the derecognition of post-acquisition reserves currently included in CET1 capital.

3. Invitation for comment

3.1 Banks and other interested persons are hereby invited to submit their comments on the proposed Directive to SARB-PA@resbank.co.za, copying vukosi.msindo@resbank.co.za, by 17 May 2023 for the attention of Mr Vukosi Msindo.

3.2 The comments received may be published on the PA's website, unless a respondent specifically requests confidential treatment.

Fundi Tshazibana

Fundi Tshazibana
Chief Executive Officer

Date: 05/04/23