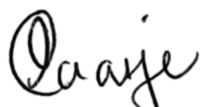
No: 1/24

CIRCULAR BIA 1/5 – NOTIFICATION ON THE REINSTATEMENT OF THE CAPITAL CONSERVATION BUFFER AND PHASE-OUT OF UNAUDITED PROFITS.

In my capacity as the Director of Banking Supervision and under the power vested in the Bank by virtue of section 3(1) of the Banking Institutions Act, 2023 (Act No 13 of 2023) ("the Act"), I hereby issue the **Circular BIA 1/5 – Reinstatement of the Capital Conservation Buffer and phase-out of unaudited profits.**



ANCOIS PLAATJE
DIRECTOR: BANKING SUPERVISION
09 AUGUST 2024

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CIRCULAR BIA 1/5

TO: ALL DOMESTIC SYSTEMICALLY IMPORTANT BANKS (DSIBS)

DATE: 9 August 2024

IMPLEMENTATION OF THE CAPITAL CONSERVATION BUFFER

1. PURPOSE

These Circular serves to provide clarifications on the Determination on the Measurement and Calculation of Capital Charges for Credit Risk, Operational Risk, and Market Risk for Domestically Systemically Important Banks (BID-5A), more specifically the reinstatement of the Capital Conservation Buffer and the phasing out of the tier 2 capital instrument of unaudited profits.

2. DEFINITIONS

Terms used in this Circular are as defined below, or as reasonably implied by the contextual usage in the said Circular:

i. **"DSIBs"** – means banking institutions that are critical for the uninterrupted availability of essential banking services to the country's real economy even during a crisis. A few banking institutions assume systemic importance due to their size, cross-jurisdictional activities, complexity, lack of substitutability, and interconnectedness. The disorderly failure of these banking institutions has the propensity to cause significant disruption to the essential services provided by the banking system, and in turn, to the overall economic activity.

ii. **"Non-DSIBs"** – means banking institutions whose distress or failure could not cause considerable disruption to the domestic financial system and the wider economy.

iii. **"Capital Conservation Buffer"** – means an additional layer of usable capital that can be drawn down during periods of economic downturn. The capital conservation buffer (CCB) aims at promoting the conservation of capital and the build-up of adequate buffers above the minimum during normal times (i.e. outside periods of stress) which can be drawn down as losses are incurred during a stressed period.

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3. INTRODUCTION

The Bank of Namibia introduced a mandatory "capital conservation buffer", equivalent to 2.5 percent of risk-weighted assets, which is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. The requirement is based on standard capital conservation rules designed to avoid breaches of minimum capital requirements.

The Bank has already adopted a risk-based supervision approach which has assessed the risk and impact of the different banking institutions within the Namibian jurisdiction. The risk-based supervision approach resulted in the classification of banks namely as Tier 1 banks (Domestic Systemically Important Banks (DSIBs)) and Tier 2 banks (Non-Domestic Systemically Important Banks (non-DSIBs)). Since the banking institutions in Namibia have already been classified and categorized as DSIBs and Non-DSIBs, the BID-5A and more specifically the capital conservation buffer will apply to DSIBs only.

4. REINSTATEMENT OF THE REQUIREMENTS OF BID5a

The Bank of Namibia (the Bank) has engaged all the DSIBs during August 2023 and as such, there were no concerns raised regarding the reinstatement of the Capital conservation buffer following the withdrawal of the relief measures to banking institutions under the Determination on Policy Changes in Response to Economic and Financial Stability Challenges as a result of the Covid-19 Pandemic (BID-33). The outcome of the engagements with the industry revealed that all DSIBs have already implemented the 2.5 percent capital conservation buffer and adopted the Basel III capital requirements after the change in regulation and no transition challenges experienced regarding the implementation of the Basel III capital requirements.

5. CAPITAL CONSERVATION BEST PRACTICE

The aim is that outside of periods of stress, banks should hold buffers of capital above the regulatory minimum. When buffers have been drawn down, one of the ways banks should look to rebuild them is through reducing discretionary distributions of earnings. This could include reducing dividend payments, share buy-backs, and staff bonus payments. Banks may also choose to raise new capital from the private sector as an alternative to conserving internally

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generated capital. The balance between these options should be discussed with supervisors as part of the capital planning process.

Greater efforts should be made to rebuild buffers the more they have been depleted. Therefore, in the absence of raising capital in the capital markets, the share of earnings retained by banks to rebuild their capital buffers should proportionately increase the closer their actual capital levels are to the minimum capital requirement. It is not an acceptable norm for banks that have depleted their capital buffers to use future projections of recovery to serve as justification for maintaining generous distributions to shareholders, other capital providers, and employees. These stakeholders, rather than depositors, must bear the risk that recovery might not be forthcoming.

It is also not an acceptable practice for banks that have depleted their capital buffers to try and use the distribution of capital to signal their financial strength. Not only is this irresponsible from the perspective of an individual bank, putting shareholder's interests above depositors, but it may also encourage other banks to follow suit. Consequently, banks in aggregate can end up increasing distributions at the exact point in time when they should be conserving earnings.

The framework reduces the discretion of banks that have depleted their capital buffers to further reduce them through generous distributions of earnings. In doing so, the framework will strengthen the banks ability to withstand adverse environments. Implementation of the framework through internationally agreed capital conservation rules will help increase sector resilience both when going into a downturn and provide the mechanism for rebuilding capital during the early stages of economic recovery. Retaining a greater proportion of earnings during economic prosperity will help ensure that capital remains available to support the ongoing business operations of banks through the period of stress. In this way, the framework should help reduce procyclicality.

6. CAPITAL CONSERVATION FRAMEWORK

A capital conservation buffer of 2.5 percent, comprised of Common Equity Tier 1 (CET1), is established above the regulatory minimum capital requirement. Different capital distribution constraints will be imposed on a bank as outlined in table 1 below when the bank's capital levels fall below the 8.5 percent CET1 threshold. Banks will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank.

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Distribution constraints imposed on banks when their capital levels fall into the range increase as the banks' capital levels approach the minimum requirements. By design, the constraints imposed on banks with capital levels at the top of the range would be minimal. This reflects an expectation that banks' capital levels will from time to time fall into this range. The Bank does not wish to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement.

Table 1 below shows the minimum capital conservation ratios a bank must meet at various levels of CET1 capital ratios once the capital buffers are fully implemented. For example, a bank with a CET1 capital ratio in the range of 6.625 percent to 7.25 percent is required to conserve 80.0 percent of its earnings in the subsequent financial year (i.e. pay-out no more than the remaining 20.0 percent of the bank's earnings in terms of dividends, share buybacks and discretionary bonuses after taking into account the required 80.0 percent conservation) as per section 14 of the Determination on the Measurement and Calculation of Capital Charges for Credit Risk, Operational Risk and Market Risk for Domestic Systemically Important Banks (BID-5A). If the bank wants to make payments in excess of the constraints imposed by this regime, it will have the option of raising capital in the private sector equal to the amount above the constraint which it wishes to distribute.

The CET1 ratio includes amounts used to meet the 6.0 percent minimum CET1 requirement but excludes any additional CET1 needed to meet the 6.5 percent of Tier 1 and 10.0 percent Total Capital requirements. For example, a bank with 10.0 percent CET1 and no Additional Tier 1 or Tier 2 capital would meet all minimum capital requirements but would have a zero-conservation buffer and therefore be subjected to the 100.0 percent constraint on capital distributions.

Table 1: Minimum Capital Conservation Ratios

Common Equity Tier 1 Ratio	**Minimum Capital Conservation Ratios (Expressed as a % of earnings)**
Minimum Capital Conservation Ratios	
6.0% - 6.625%	100%
> 6.625% - 7.25%	80%
> 7.25% - 7.875%	60%
> 7.875% - 8.5%	40%
> 8.5%	0%

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Set out below are a number of other key aspects of the requirements:

(a) **Elements subject to the restriction on distributions**: Items considered to be restricted distributions include dividends and share buybacks, discretionary payments on other Tier 1 capital instruments, and discretionary bonus payments to staff. Payments that do not result in a depletion of Common Equity Tier 1, which may for example include certain scrip dividends[1] are not considered as restricted distributions.

(b) **Definition of earnings**: Earnings are defined as distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. Earnings are calculated after the tax which would have been reported had none of the distributable items been paid. As such, any tax impact of making such distributions is reversed. Where a bank does not have positive earnings and has a Common Equity Tier 1 ratio of less than 8.5 percent, it would be restricted from making positive net distributions.

(c) **Solo or consolidated application**: The framework should be applied at the consolidated level, i.e. restrictions would be imposed on distributions out of the consolidated group. The Bank, however, has an option of applying the regime at the solo level to conserve resources in specific parts of the group.

(d) **Additional supervisory discretion**: Although the buffer must be capable of being drawn down, banks should not choose in normal times to operate in the buffer range simply to compete with other banks and win market share. To ensure that this does not happen, the Bank has additional discretion to impose time limits on banks operating within the buffer range on a case-by-case basis. In any case, the Bank will ensure that the capital plans of banks seek to rebuild buffers over an appropriate timeframe.

7. UNAUDITED INTERIM PROFITS

As per the guidance provided by the Bank during the industry consultations and in the template under Tier 2 Capital Instruments - Basel III, it was indicated that unaudited interim profits will be phased out over a period of five years from the implementation date of Basel III, starting early 2019. As such, the complete phase-out of unaudited profits will come into effect in line with the effective date of this Circular.

[1] Scrip dividends, also known as dividend reinvestment plans ,are a form of dividend payment in which a company offers shareholders the option to receive additional shares of stock instead of cash dividends.

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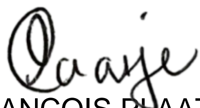
8. AMENDMENT OF THE CIRCULAR

This circular comes into effect on 30 September 2024. The Bank may at any time amend, delete, vary, add, or change any provision of this circular.

Questions relating to this circular should be addressed to the Director, Banking Supervision Department, Bank of Namibia, Tel: +264 61 283 5256 or email: ancois.plaatje@bon.com.na.

9. COPIES OF THE CIRCULAR

Two copies of this circular are enclosed for the use of your banking institution's independent auditors. The attached acknowledgment of receipt should be returned to the Bank as soon as possible, duly completed and signed by both the Chief Executive Officer/Managing Director and the auditors of the banking institution.



ANCOIS PLAATJE
DIRECTOR
09 August 2024

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