Peer Review of South Africa

Review Report

16 March 2020

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Table of Contents

Foreword v

Abbreviations vi

Executive summary 1

1. Introduction 6

2. Framework for resolution of banks 7

Background 7

Steps taken and actions planned 8

Conclusions and recommendations 17

3. Deposit insurance framework 21

Background 21

Steps taken and actions planned 22

Conclusions and recommendations 28

Annex: South Africa’s implementation of G20 financial reforms (as of September 2019) 31

Foreword

Financial Stability Board (FSB) member jurisdictions have committed, under the FSB Charter and in the *FSB Framework for Strengthening Adherence to International Standards,*[1] to undergo periodic peer reviews. To fulfil this responsibility, the FSB has established a regular programme of country and thematic peer reviews of its member jurisdictions.

Country reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector policies in a specific FSB jurisdiction. They examine the steps taken or planned by national/regional authorities to address IMF-World Bank Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs) recommendations on financial regulation and supervision as well as on institutional and market infrastructure that are deemed most important and relevant to the FSB's core mandate of promoting financial stability. Country reviews can also focus on regulatory, supervisory or other financial sector policy issues not covered in the FSAP that are timely and topical for the jurisdiction and for the broader FSB membership. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, or its compliance with international financial standards.

FSB jurisdictions have committed to undergo an FSAP assessment every five years; peer reviews taking place typically two to three years following an FSAP will complement that cycle. As part of this commitment, South Africa volunteered to undergo a peer review in 2019.

This report describes the findings and conclusions of the South Africa peer review, including the key elements of the discussion in the FSB's Standing Committee on Standards Implementation (SCSI) in December 2019. It is the second FSB peer review of South Africa and is based on the objectives and guidelines for the conduct of peer reviews set forth in the *Handbook for FSB Peer Reviews.*[2]

The analysis and conclusions of this peer review are based on the responses to a questionnaire by financial authorities in South Africa and reflect information on the progress of relevant reforms as of December 2019. The review has also benefited from dialogue with the South African authorities as well as discussion in the FSB SCSI.

The draft report for discussion was prepared by a team chaired by Mike Mercer (Canada Deposit Insurance Corporation) and comprising Adam Cull (Bank of England), Kumudini Hajra (International Association of Deposit Insurers) and Rastko Vrbaski (Bank for International Settlements). Anca Grigorut (until August 2019), Michael Januska and Costas Stephanou (FSB Secretariat) and Rishanthi Pattiarachchi (Canada Deposit Insurance Corporation) provided support to the team and contributed to the preparation of the report.

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[1] See the *FSB Framework for Strengthening Adherence to International Standards* (January 2010).

[2] See the *Handbook for FSB Peer Reviews* (April 2017).

Abbreviations

AT1	Additional Tier 1 (capital)
BCBS	Basel Committee for Banking Supervision
CEO	Chief Executive Officer
CFIs	Cooperative financial institutions
CIS	Collective investment scheme
CMGs	Crisis Management Groups
CoAgs	Cooperation Agreements
CoDI	Corporation of Deposit Insurance
Core Principles	Core Principles for Effective Deposit Insurance Systems (IADI)
DIS	Deposit insurance system
ELA	Emergency liquidity assistance
FIC	Financial Intelligence Centre
FSAP	IMF-World Bank Financial Sector Assessment Program
FSB	Financial Stability Board
FSCA	Financial Sector Conduct Authority
FSLAB	Financial Sector Laws Amendment Bill 2018
FSOC	Financial Stability Oversight Committee
FSRA	Financial Sector Regulation Act
G-SIB	Global systemically important bank
HKMA	Hong Kong Monetary Authority
IADI	International Association of Deposit Insurers
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IT	Information technology
KAs	FSB Key Attributes of Effective Resolution Regimes for Financial Institutions
LAC	Loss absorbing capacity
MMF	Money market fund
MoU	Memorandum of Understanding
MREL	Minimum Requirement for own funds and Eligible Liabilities
NAV	Net asset value
NCR	National Credit Regulator
NT	National Treasury
OTC	Over-the-counter (derivatives)
PA	Prudential Authority
PONV	Point of non-viability
PoR	Point of resolution
R	South African Rand (ZAR)
ROSC	Reports on the Observance of Standards and Codes
RPP	Resolution Planning Panel
SARB	South African Reserve Bank
SCSI	Standing Committee on Standards Implementation (FSB)
SCV	Single customer view
SIFIs	Systemically important financial institutions
T2	Tier 2 (capital)
TLAC	Total loss-absorbing capacity

Executive summary

Background and objectives

This peer review examines the framework for bank resolution and deposit insurance in South Africa. It focuses on the steps taken by the authorities to implement reforms in these areas, including by following up on FSAP recommendations and G20/FSB commitments.

Main findings

Good progress has been made in recent years on both topics. The authorities have applied the lessons from recent bank failures to inform the proposals for adoption of a resolution regime broadly aligned with the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (*Key Attributes*), while proposals for the introduction of a deposit insurance system (DIS) demonstrate their commitment to implement the IADI *Core Principles for Effective Deposit Insurance Systems* (IADI Core Principles). Notwithstanding the progress made, more needs to be done to ensure the new measures can be implemented effectively. On the bank resolution framework, this involves setting a clear implementation roadmap, enhancing the operating model for the South African Reserve Bank (SARB) as resolution authority, reviewing the emergency liquidity framework, and introducing a mechanism for recovery of public funds used for resolution. For the DIS, this involves developing the functional expertise at the deposit insurer, launching a comprehensive public awareness campaign, reviewing the design features after the DIS is established, and enhancing the funding structure of the deposit insurance fund.

Framework for resolution of banks

South Africa's banking sector is relatively large and concentrated, with the six largest banks accounting for over 92% of sector assets. Although it is not a major host jurisdiction, the largest domestic banks are active – and systemically important – in a number of African countries.

The failure of banks can currently be dealt with under a curatorship model (commercial and mutual banks) or via liquidation (cooperative banks). Whilst curatorship has been used to deal with recent bank failures, it revealed certain constraints of the model, as the solutions found in these cases rested substantially on cooperation with creditors as well as the taxpayer guaranteed transfer of retail deposits. In light of these experiences, and as the curatorship framework has not been tested by the failure of a systemically important institution, the 2014 FSAP concluded that the crisis management and resolution framework should be substantively enhanced.

The framework for dealing with failing banks is being overhauled through the Financial Sector Laws Amendment Bill 2018 (FSLAB), which was published for comment in September 2018 and is currently before Cabinet. Under the proposed framework, the SARB will be the sole resolution authority for all banks, as well as for any non-bank financial institutions that are designated as systemically important (SIFIs) by the SARB Governor. In developing the proposals, the authorities have published public discussion papers on the design of the new framework and have consulted extensively with domestic stakeholders and the international regulatory community. Once implemented, the proposed FSLAB amendments will address past recommendations of the FSAP and FSB by providing the authorities with an enhanced framework to plan for and undertake resolution.

Notwithstanding the progress made and the plans for enhancing the existing regime for the failure of banks, further steps can be taken to strengthen the resolution framework and enhance the preparedness of the authorities.

- ***Setting a clear implementation roadmap:*** SARB has initiated a project to design the standards and processes to implement the new resolution framework. This includes the establishment of an internal Resolution Policy Panel (RPP) to deal with policy and planning issues and to assist the Governor in resolution responsibilities. To ensure the framework is embedded credibly and effectively, SARB should set clear internal priorities to maintain momentum on this project. It should also ensure strong coordination with other domestic financial sector regulators – particularly the Prudential Authority (PA) and Financial Sector Conduct Authority (FSCA) – and other authorities relevant for financial stability.

  In terms of resolution planning, a focus on banks designated as SIFIs will enable SARB to identify specific barriers to their resolvability and to develop suitable resolution strategies. Resolution planning should be proportional to the set-up and features of the domestic banking sector, and thus requires an early strategic decision about the resources devoted to non-SIFIs. Given recent failures in South Africa involved non-systemic banks, a certain level of planning for such firms may be warranted, allowing for the development of a credible and predictable set of strategies for standard cases.

  The FSLAB proposes amendments to the creditor hierarchy, including the creation of a new subordinated class of loss-absorbing instruments (so-called FLAC) to facilitate the application of the bail-in power. The design and calibration of FLAC for certain banks will be closely linked to resolution planning, and is instrumental to enhancing resolvability and confidence in authorities' capabilities to address the too-big-to-fail problem. It will be important for the authorities to examine industry concerns around the quantum, pricing and investor appetite for such instruments. Finalisation of the requirements and the transition period should be a priority to enable firms to adjust their funding structures accordingly.

  Given the cross-border presence of South African banks, it will also be important for SARB to engage with counterparts in relevant jurisdictions in the region, particularly where South African banks are systemically relevant to local economies, to inform the development of resolution strategies for these firms. The establishment of coordination fora on resolution should be considered a priority, as they will increase understanding of the new South African resolution regime amongst peer authorities with benefits for cooperation in crises.

  SARB should also assess resource and skills needs and develop a strategy for ensuring the right resources are available to support the implementation roadmap. The resourcing model – including whether and how to build, hire or outsource work – will need to be sufficiently flexible to address both normal and crisis periods.

- ***Enhancing the operating model for SARB as resolution authority:*** The FSLAB will place substantial new responsibilities on SARB. To make its resolution function operational and to maintain momentum once FSLAB has been successfully enacted, it will be important to follow through with: (i) a clear mandate on and empowerment of resolution related matters within SARB; (ii) promoting cooperation and information sharing with other functions of SARB, particularly the PA; and (iii) the build-up of a dedicated resolution division within SARB. Most importantly, the tone for empowering the resolution function should be set at the top, and made a strategic responsibility of SARB senior management. This includes regular communication of the importance, progress and requirements of the resolution function; and direct and regular access of the resolution function to senior decision makers.

- ***Reviewing emergency liquidity arrangements in light of the new resolution framework:*** The SARB's emergency liquidity framework dates from before resolution was available as an intervention tool for authorities to deal with a firm's failure. Once FSLAB is enacted and resolution tools are available, SARB will have powers to restore a potentially impaired solvency. In providing emergency liquidity to firms in difficulty, consideration will have to be given as to whether the causes of liquidity stress are merely operational or indicators of an impending failure, in which case resolution action should be taken. Several FSB jurisdictions have revised their central bank liquidity frameworks after the introduction of resolution powers. This may require updating internal SARB guidelines to align the existing emergency liquidity assistance (ELA) framework with the future resolution framework under FSLAB, which may also help prevent delayed internal escalation. Given the reliance of South African banks on wholesale funding markets, further clarity on this topic is viewed as a priority in relation to the credibility of the resolution regime.
- ***Introducing a mechanism for recovery of public funds used for resolution***: The proposed FSLAB framework does not include a mechanism that allows for the recovery of public funds to facilitate orderly resolution. This exposes the taxpayer to loss if such funds cannot be recouped from the firm in resolution. Introducing a mechanism for ex post recovery of public funds from the industry (e.g. through a levy) would alleviate such concerns.

Deposit insurance framework

South Africa is the only FSB jurisdiction without an explicit deposit insurance framework. The authorities have, over the past few years, been working to introduce an explicit DIS. The draft FSLAB includes provisions for the establishment of the Corporation of Deposit Insurance (CoDI) that will be responsible for the deposit insurance functions. SARB is working diligently to operationalise the CoDI when the FSLAB is promulgated. A number of good practices from the IADI Core Principles are included in the proposed CoDI framework, such as an explicit mandate of the DIS, governance arrangements and compulsory membership. Once implemented, the DIS is expected to further enhance the South African financial safety net while minimising the need for taxpayer supported rescue of retail deposits characterised by past failures. SARB followed a process of extensive consultation with market participants on the design of the DIS and studied practices in other jurisdictions.

In spite of these accomplishments, further work is needed to address potential misalignment in the proposed framework vis-à-vis the IADI Core Principles. This will further enhance the DIS credibility and thereby ensure that it meets its public policy objectives.

- ***Implementation and public communication:*** Successful implementation of the new scheme needs to be supported by appropriate staffing of the CoDI with expertise in a number of technical areas. The project plan is to develop the core functionality for CoDI by the end of 2021, and to introduce further enhancements to the system after 2021.

  For any scheme transitioning to an explicit deposit insurance, it is important that its objectives and main features are clearly communicated and well understood by depositors. The authorities note that CoDI's objectives will be incorporated into the regulatory standards for CoDI once the FSLAB is promulgated. Embedding these objectives in secondary legislation is good practice and consistent with the IADI Core Principles.

An extensive public awareness campaign is planned to be launched after CoDI is set up. However, it may be useful to inform depositors about the main features of the DIS at an even earlier stage, i.e. once FSLAB is promulgated and is publicly available. To this end, the authorities are encouraged to devise a comprehensive plan detailing the scope of public awareness efforts covering different stages (i.e. prior to the establishment of a DIS, at the launch of the DIS, and after the establishment of the DIS on a periodic basis).

- ***Design features:*** Membership of the DIS will be compulsory for all banks. Cooperative financial institutions (CFIs), which form a small share of overall deposits in the banking sector, will be excluded from the DIS although they will be considered in the future following additional analysis and conditional on enhancements in their prudential regulation and supervision. This will ensure that all deposit-taking institutions are in a position to be eventually covered by the DIS, as called for by the IADI Core Principles.

  The proposed coverage is capped at R100,000 per depositor per bank, a level aimed at providing adequate protection for the large majority of retail depositors in small and medium-sized banks. Based on the authorities' 2014 survey of banks, 98% of retail depositors and 83% of small and medium-sized enterprises would have their deposits fully covered under the proposed regime. The structure and composition of banks' deposit base reflects a high dependence on wholesale funding and the fact that most savings by residents are in the form of contractual savings (e.g. pension and retirement funds). Following the launch of the scheme, it is important that the authorities periodically review and reaffirm this coverage limit based on up-to-date depositor data and behaviours, as this has implications for the adequacy of coverage levels as well as the appropriate target fund size.

  Regulations are already in place for banks to prepare deposit/or data in a single customer view (SCV) format, and the planned framework will rely on SCV for the calculation of premiums paid by banks. While the use of a SCV represents good practice and will provide more accurate information in the event of a payout, waiting until SCV capabilities are in place should not unduly delay the collection of premiums and build-up of the ex ante fund. The authorities should consider interim solutions if covered institutions are unable to build the requisite systems within the timeframes specified, to avoid any such delays.

- ***Sources and uses of funds:*** CoDI will have several layers to meet funding requirements. They include an equity tranche built up over time through a flat premium assessed at 0.20% of covered deposits per annum; a liquidity tranche built from contractual deposits placed by banks equivalent to 3% of each bank's covered deposits; and an annual levy to cover operational costs. The SARB will provide emergency funding through a backup line of credit. The establishment cost of CoDI as an organisation is carried by the SARB.

  This funding structure – in particular the existence of a liquidity tranche – is unusual compared to international practice. The authorities acknowledge that the funding model is different from the conventional build-up of a fund through deposit insurance premiums alone. This multi-tiered approach aims to provide substantive upfront industry-based funding, backstopped by SARB, and allow the DIS fund to build equity over time sufficient to absorb any unexpected shortfalls in liquidation proceeds and reduce reliance on the liquidity tranche. However, it remains to be tested whether that tranche will perform as intended in the event of a bank failure.

The industry-funded liquidity tranche and SARB backstop may ensure that CoDI is able to meet immediate or extraordinary payout demands. Nevertheless, the proposed funding structure has a comparatively small equity component from industry-funded premiums, which is projected to reach 1% of covered deposits in five years in the absence of significant pay-outs. Consistent with the IADI Core Principles, this component needs to be gradually built up in order to protect the solvency of CoDI and to provide confidence to depositors.

At present, there is no long-term explicit target fund size beyond the initial 3% through the liquidity tranche and a plan to build the ex ante equity tranche to 1% of covered deposits over the first five years. A pre-specified target fund size would communicate clearly to the banking industry its expected contributions in the future beyond the initial establishment phase, while announcing it publicly may also enhance public confidence in the DIS.

Recommendations

In response to the aforementioned findings and issues, the peer review has identified the following recommendations to the South African authorities:

Framework for resolution of banks

1. SARB should develop a roadmap for the implementation of the resolution framework, including the identification and sequencing of key policies, timelines for delivery and resource requirements.
2. SARB should enhance its resolution function by strengthening resources; having a clear mandate for its resolution committee (RPP); promoting cooperation and information sharing with other internal functions; and building and maintaining operating structures and processes that ensure resolution work remains a priority for senior management.
3. SARB should review and, where necessary, update ELA arrangements to align them with the new resolution framework.
4. The authorities should introduce a mechanism for ex post recovery from the industry of public funds used for resolution.

Deposit insurance framework

5. Following swift passage of the enabling legislation, SARB should firm up the timeframe and resource plans to establish the CoDI. It should also clearly state the objectives of CoDI in legislation or documents supporting legislation, and implement an extensive public awareness program over the respective implementation phases.
6. The authorities should, once the DIS is established, review its design features periodically in order to: (a) ensure that all deposit taking institutions are eventually covered; (b) ensure coverage limits remain appropriate based on updated data; and (c) determine whether alternate approaches to estimate covered deposits can be used in cases where SCV systems may take longer to implement.
7. SARB should build up gradually the size of the equity tranche so that it represents an important component of CoDI's funding structure. It should also determine a long-term target fund size and set a reasonable time frame to achieve it.

1. Introduction

South Africa completed its first FSB peer review in 2013.[3] The review examined two topics (interagency coordination and the regulatory structure, and the regulation of over-the-counter (OTC) derivatives markets) and the steps taken or planned by the South African authorities in response to the recommendations on regulation and supervision in the 2008 FSAP.

South Africa subsequently underwent an FSAP Update in 2014, which included assessments of the Basel Committee for Banking Supervision (BCBS) *Basel Core Principles for Effective Banking Supervision,* International Association of Insurance Supervisors *Insurance Core Principles,* and International Organization of Securities Commissions (IOSCO) *Principles and Objective of Securities Regulation.*[4] The FSAP concluded that South Africa's financial sector operates in a challenging economic environment, including high unemployment and income inequality rates, slow economic growth since 2008, high household indebtedness, and the reliance of banks on money market funds for short-term wholesale funding. The FSAP also found that relatively high capital buffers as well as sound regulation and supervision have helped mitigate the risks, and that overall, financial sector risks and vulnerabilities are elevated but manageable. It noted that stress tests confirm the capital resiliency of banks and insurance companies to severe shocks but illustrate a vulnerability to liquidity shortfalls. Given significant downside risks to the economy, strong regulation and supervision are essential to ensure financial sector resilience.

The IMF's 2019 Article IV consultation concluded that subdued private investment and exports, and increased uncertainty have depressed growth and worsened social indicators.[5] On financial sector policy, the report noted that banks are sound but that pockets of vulnerability should be monitored, including those related to the recent pick-up in unsecured lending; the operations of small and medium-sized banks; and the strong bank interconnectedness with the broader financial system. It also noted that the early warning system and crisis management framework need buttressing by complementing stress-testing with interconnectedness assessments and by enhancing the resolution regime, including the deposit insurance scheme.

Implementation of the post-crisis G20 financial regulatory reforms in South Africa is most advanced for certain Basel III standards and for compensation rules. Implementation is less advanced for reforms aimed at making derivatives markets safer, ending too-big-to-fail, and enhancing the resilience of non-bank financial intermediation. The Annex provides an overview of South Africa's implementation status of G20 financial reforms as of September 2019, including the steps taken to date and actions planned by the authorities in core reform areas (not covered in this peer review) where implementation has not yet been completed.

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[3] See FSB *Peer Review of South Africa* (February 2013).

[4] See *South Africa: Financial System Stability Assessment* (December 2014, IMF Country Report No. 14/340). The detailed assessments on the observance of standards and codes and FSAP technical notes have been published on the IMF website (http://www.imf.org/external/np/fsap/fsap.aspx).

[5] See *South Africa: 2019 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for South Africa* (January 2020, IMF Country Report No. 20/33). Annex XI of the report provides an overview of the implementation of the key 2014 FSAP recommendations.

This peer review examines the framework for resolution of banks and deposit insurance in South Africa. Section 2 of the report focuses on the framework for bank resolution, while section 3 examines the design and planned implementation of deposit insurance reforms.

2. Framework for resolution of banks

Background

With total assets of 5.8 trillion Rand as at the end of June 2019 (114% of Gross Domestic Product), South Africa's banking sector accounts for almost 30% of national financial assets. The banking sector is concentrated, with the six largest banks designated as SIFIs and accounting for over 92% of sector assets.[6] Five of these banks form part of a financial conglomerate, typically comprising insurance, banking and securities services. Although it is not a major host jurisdiction for foreign banks, South Africa's largest domestic banks are active – and systemically important – in a number of other African countries.[7]

The failure of banks can currently be dealt with under a curatorship model (commercial and mutual banks) or via liquidation (cooperative banks, which can also be placed under judicial management according to the Cooperative Banks Act). Under this regime, the Minister of Finance makes the decision to put a bank into curatorship on the recommendation of the Chief Executive Officer (CEO) of the Prudential Authority (PA).[8] The curator, acting under the supervision and direction of the CEO of the PA, controls and manages the bank and its assets (including the transfer assets and liabilities without shareholder approval), seeking temporary relief from creditors, and taking decisions that would otherwise be subject to a special shareholder resolution. Whilst curatorship has been used to deal with recent bank failures (see Box 1 for a discussion of the failure of VBS Mutual Bank), it revealed certain constraints of the model, as the solutions found in these cases rested substantially on cooperation with creditors as well as the taxpayer guaranteed transfer of retail deposits, both of which only have a reasonable chance of success with relatively small banks.[9]

In light of these experiences, and as the curatorship framework has not been tested by the failure of a systemically important institution, the FSAP concluded that the crisis management and

[6] These are The Standard Bank of South Africa, ABSA, Investec, Nedbank, FirstRand and Capitec. See the SARB's *Financial Stability Review* (November 2019) for details. Local branches of foreign banks accounted for around 6% of total banking sector assets as of end September 2019, while smaller commercial banks, mutual banks and cooperative banks accounted for only 2% of total assets.

[7] For example, the World Bank report on *Financial Safety Nets and Bank Resolution Frameworks in Southern Africa: Key Issues and Challenges* (January 2019) noted that 'The major banks domiciled in South Africa (especially Standard Bank and Nedbank) have a strong and systemically important presence in most of the countries in the [Southern Africa] region, especially Botswana, Lesotho, Namibia, and Eswatini'. See also *Pan-African Banks: Opportunities and Challenges for Cross-Border Oversight* by Enoch et al. (April 2015, IMF Departmental paper No 15/04).

[8] The Financial Sector Regulation Act (FSRA) established the PA and the FSCA on 1 April 2018.

[9] In August 2014 African Bank, a boutique lender catering mainly to low-income households, was placed under curatorship after record losses from unsecured lending. The strategy of separating good and impaired banking business, and of imposing losses on and obtaining funding from certain private creditors, required the explicit consent of the bank's creditors. See Box 1 of *South Africa: Financial System Stability Assessment* (ibid).

resolution framework should be substantively enhanced. It recommended that the authorities introduce a resolution regime compliant with the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (*Key Attributes* or KAs) and make the SARB the resolution authority of all banks and SIFIs; and remove constraints to early intervention powers and improve legal protection for resolution officials.[10]

Drawing on the *Key Attributes* and supporting implementation guidance,[11] the section analyses the progress to date, implementation challenges and planned next steps with respect to the bank resolution framework in order to identify any gaps and lessons of experience for FSB members.

Box 1: The failure and liquidation of VBS Mutual Bank[12]

VBS Mutual Bank was a retail bank headquartered in Johannesburg and active mostly in the region of Limpopo, offering deposit-taking services mainly to stokvels (an informal South African form of a savings and borrowing society) and regional municipalities. It had about 30,000 customers and total assets of about R1.02 billion, or 0.05% of system assets, when in 2016 it started experiencing liquidity issues that culminated in its inability to settle certain payments in South Africa's interbank settlement system. As a result, VBS was placed in curatorship. At that point, VBS was also in breach of its regulatory minimum cash reserves and liquid asset requirements, but it was unclear whether the firm was solvent.

As an immediate measure, the curator put daily limits on the amount of deposits that could be withdrawn, in an attempt to preserve liquidity, and carried out an investigation into its books and accounts. The investigation revealed significant fraud which involved the management as well as certain shareholders and depositors of the bank. Following a decision that retail depositors would be compensated up to a limit of R100,000, with funding provided by the SARB, the curator selected Nedbank to act as payment agent, while VBS would be liquidated and depositors involved in fraudulent activity would bear the first losses incurred during the liquidation process (which is ongoing). Retail depositors had a choice of opening an account at Nedbank, transferring their deposits to another bank or taking their compensation in cash. SARB funded the transfer with R336 million and has a resultant claim against the liquidation proceeds of VBS. At the time of intervention, a significant number of accounts were dormant and their holders unknown; these were treated as income by the curator in line with the firm's pre-existing policy with regard to dormant accounts.

The case illustrated the need for an explicit deposit protection scheme and a reliable database to effect depositor payouts and account transfers. Multiple legal actions taken against SARB and the curator confirmed the need to enhance the legal protection of agents carrying out interventions. Other issues raised by this case pertain to competing attachments of assets by regulatory and other (e.g. criminal) authorities.

Steps taken and actions planned

Planned framework and institutional arrangements: The framework for dealing with failing banks and non-bank SIFIs is currently being overhauled. The South African authorities initiated

[10] See *South Africa: Financial Sector Assessment Program-Financial Safety Net, Bank Resolution, and Crisis Management Framework-Technical Note* (March 2015, IMF Country Report No. 15/53).

[11] See https://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/understanding-the-key-attributes/.

[12] See VBS Mutual Bank investigators report to the Prudential Authority (October 2018).

the process in 2015 with a discussion paper[13] that resulted in proposed legislation entitled the Financial Sector Laws Amendment Bill 2018 (FSLAB) which, once in force, will amend the Financial Sector Regulation Act (FSRA) of 2017. The FSLAB was published for comment in September 2018[14] and is currently before Cabinet, whereafter it will follow the Parliamentary process for passing legislation; it is expected to be promulgated in 2020.

Under the proposed framework, SARB will be the sole resolution authority for designated financial institutions in South Africa. All commercial banks, mutual banks, and cooperative banks, as well as financial conglomerates, will fall under the resolution authority of SARB as from promulgation of the FSLAB. The same will apply for non-bank financial institutions (and their holding companies) that are designated as SIFIs by the SARB Governor.[15]

The resolution planning mandate will be carried out by the Resolution Planning Division of SARB. The division is currently part of the Financial Stability Department, which reports to the Deputy Governor for Financial Stability. As such, it is operationally distinct from the PA, whose CEO is another Deputy Governor in charge of supervision of financial institutions. The Resolution Planning Division includes a resolution unit and a crisis management unit that also currently operate the project to establish CoDI (see section 3). Excluding staff who will be transferred to CoDI, once it is established, the division employs a staff of four, and has three vacancies for recently approved positions.

As resolution authority, SARB will be in charge of planning for resolution of individual institutions, assessing their resolvability, and carrying out resolution interventions. The main resolution powers will lie with the Governor, with actual resolution being invoked by the Minister of Finance upon the recommendation of the Governor. To deal with policy and planning issues and to assist the Governor in his resolution responsibilities, SARB is setting up a Resolution Policy Panel (RPP). The RPP will be chaired by the Deputy Governor responsible for financial stability and comprise the CEO of CoDI (when established) and the heads of the: Resolution Planning, and Legislation and Financial Law divisions; Policy, Statistics and Industry Support Department, Financial Conglomerate Supervision Department, and Banking, Insurance, Market Infrastructure and CFI Supervision in the PA; and National Payment System, Financial Markets, and Financial Stability departments. The resolution unit would act as the Secretariat to the RPP. The RPP will have a largely formalised decision-making process and convene on a regular basis to discuss resolution planning progress, resolvability assessments, early warning indicators, resolution policy issues, coordination regarding resolution activities, and SARB's policy framework for ELA. The RPP will be governed by its by-laws, although any breach of those provisions cannot be invoked by third parties to challenge resolution actions that the RPP recommended.

Resolution interventions will be carried out by a resolution practitioner, or controller, appointed by SARB to execute the chosen resolution strategy. SARB envisages that the practitioner will

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[13] See *Strengthening South Africa's Resolution Framework for Financial Institutions* (2015) by the National Treasury, SARB and South Africa's Financial Services Board.

[14] See http://www.treasury.gov.za/Twinpeaks/#.

[15] In February 2019 SARB published a discussion paper setting out the framework for making a SIFI determination and the methodology that will be used for banks. See *A methodology to determine which banks are systemically important within the South African context*. Separate methodologies are being developed for insurance firms and financial market infrastructures respectively.

have been chosen and instructed sufficiently in advance of entry into resolution to be able to adequately prepare. Courts will not have resolution powers under FSLAB, nor will resolution actions depend on court approval. However, courts will remain charged with ordering the winding up of a bank upon the application of SARB, and to grant reliefs to creditors and other stakeholders in the event the SARB has acted beyond its powers during resolution.

Entry into resolution: The South African authorities have broad discretion when invoking resolution. The resolution trigger, also referred to as point of resolution (PoR) under the FSLAB, is defined as the point where a firm, at the discretion of SARB, is unable to meet, or will be unable to meet, its obligations and resolution action is required to maintain or protect financial stability. Obligations include regulatory requirements in general, and the reference to financial stability allows public interests to be taken into account more broadly. The trigger is not tied to specific metrics or indicators and can be exercised on a prospective basis (e.g. to pre-empt a liquidity crisis following an idiosyncratic reputational event), allowing for early entry into resolution prior to balance sheet insolvency. When assessing the financial position of a firm, authorities may base their decision on a preliminary internal valuation, rather than having to rely on a definitive valuation carried out by an external examiner. Moreover, resolution action may be taken when specific triggers defined in a firm's recovery plan are met and the SARB is of a view that the bank's recovery options would be insufficient or not feasible. Such triggers may include the need to draw on pre-established liquidity facilities, including facilities from the SARB outside its normal operations. Other than that, public financial support is not considered for purposes of determining whether resolution action should be taken. A firm may challenge resolution action taken against it in court, but only on limited grounds. However, even if such a challenge succeeds, the resolution actions cannot be reversed.

In terms of process, the PA is tasked to monitor potential resolution indicators, including those that are defined in firms' own recovery plans, and notify the SARB as resolution authority via the RPP of potential concerns. The RPP will assist the Governor in making the decision whether to recommend resolution actions to the Minister.

The South African authorities envisage resolution as a two-step process. In a first step, immediately following entry into resolution, stabilisation actions shall be taken to bolster public confidence and to contain panic. For SIFIs, this will likely include recapitalisation through a write down of shares and a write down, or conversion into equity, of debt instruments, combined with liquidity support from the SARB to pre-empt any liquidity shortages while the firm is being stabilised. In a second step, the firm will typically be either restructured more thoroughly in order to address the underlying causes of its failure, or liquidated, depending on its size, complexity and systemic footprint.

Resolution powers and tools**:** The FSLAB would provide SARB with additional bank resolution powers. It proposes powers for SARB to transfer assets and/or liabilities without creditor consent, establish a bridge institution, and write down or convert liabilities into equity.[16] The bail-in power must be used in accordance with the creditor hierarchy and prioritise the pari passu (equal) treatment of creditors within the same class (see below). It will

[16] The statutory bail-in power may be used to write-down or convert liabilities, except for unsettled exchange traded transactions, certain derivatives instruments, deposits owed to the Corporation for Public Deposits and unsecured transactions between certain settlement systems.

be in addition to the existing powers for the PA to write down capital instruments at the point of non-viability and, as such, will require coordination between the prudential and resolution authorities (see Box 2). The FSLAB does, however, permit SARB to treat claims differently if necessary to effect the resolution of the institution. No criteria are prescribed for the circumstances in which SARB may exercise this power. Should such a departure be required, then creditors will be due compensation if they are left worse off than in liquidation.

Box 2: Point of Non-Viability and Point of Resolution in South Africa

In South Africa, the PA currently has the power to trigger contractual write-down or conversion of Additional Tier 1 (AT1) and Tier 2 (T2) regulatory capital instruments at the point of non-viability (PONV), i.e. where the PA determines it necessary to prevent the firm from becoming non-viable or when public sector support would be required to prevent failure; such "regulatory bail-in" is executed outside resolution.[17] The FSLAB introduces a power that will subject most types of debt to bail-in, in accordance with their statutory hierarchy and provided resolution is invoked ("statutory bail-in"). As a result, losses for investors may differ depending on whether regulatory bail-in, statutory bail-in or both powers are applied and the sequence in which they are applied. In particular, in a scenario where AT1 and T2 investors are first subject to regulatory and subsequently to statutory bail-in, this may lead to resolution action being challenged on the grounds that such investors would have been better off had a liquidation been invoked.

The South African authorities intend to address this issue in two ways. First, the FSLAB requires the PA to consult with SARB as a resolution authority before using the regulatory bail-in power. Second, SARB considers that regulatory bail-in outside of resolution is unlikely to be a successful recovery option for a systemically important bank, and consequently that resolution and statutory bail-in should be triggered whenever the PONV under AT1 and T2 instruments is reached. Reasons include, inter alia, that regulatory bail-in changes the composition of capital from debt instruments to equity but does not increase the total amount of capital, whereas statutory bail-in restores total capital; that any bail-in, whether regulatory or statutory, is likely to make access to funding difficult for the bank involved and should therefore be accompanied by a comprehensive resolution strategy, including potentially official liquidity support; and that two distinct frameworks may increase investor uncertainty. However, SARB considers that regulatory bail-in may be appropriate as a recovery tool for non-SIFI banks.

Consistent with the *Key Attributes*, the FSLAB proposes that SARB has the powers and authority to manage and control the affairs of the firm in resolution, and to exercise any of the powers of the governing body and the shareholders. Whilst these legal powers vest with SARB, the FSLAB also requires – as part of the first resolution step described above – the appointment of a 'resolution controller' to assist SARB in the execution of the resolution strategy.

The creditor hierarchy under the Insolvency Act currently separates between three classes of creditors: secured, preferred and unsecured creditors. The FSLAB proposes amendments to the creditor hierarchy (see Table 1), notably preferring deposits covered by the deposit insurance system (DIS) to unsecured creditors and providing a new subordinated class of loss-absorbing instruments (so-called 'FLAC'[18] – see below and Box 3). The FSLAB amendments should facilitate the application of the bail-in power, especially following the introduction of an

[17] Regulatory bail-in may also be used when public sector support is required to prevent the bank from failing. See 'Box 1: Regulatory and statutory bail-in' in SARB's discussion paper on *Ending too big to fail: South Africa's intended approach to bank resolution* (2019).

[18] FLAC instruments are defined in s.33 of the draft Financial Sector Laws Amendment Bill.

appropriately calibrated FLAC requirement for certain banks (see below). In the absence of FLAC, SARB may be required to apply the bail-in power to unsecured creditors. Given the broad scope of the bail-in power, SARB may therefore be required to exercise judgement as to whether any unsecured creditors should be excluded in order to effect the resolution.

Table 1: Proposed revisions to the creditor hierarchy in insolvency under FSLAB

Current creditor hierarchy	Proposed creditor hierarchy
Secured creditors (up to value of security)	Secured creditors (up to value of security)
Preferred creditors	Preferred creditors
	Covered deposits
Unsecured creditors	Unsecured creditors (including uncovered deposits and non-qualifying debt instruments)
	FLAC instruments
	Regulatory debt (in the order determined in the regulatory framework)

To enable SARB to conduct an open bank[19] resolution (see below), the FSLAB will prevent the act of an institution entering into resolution by itself from being an event of default. This provision applies both to agreements to which the institution is a party and the exercise of cross-default rights. Additionally, the FSLAB introduces a temporary stay on early termination rights due to the non-performance of obligations by the institution in resolution. The FSLAB does not provide details of how this power will be exercised. It is anticipated that the details and guidance will be issued by SARB following promulgation of the FSLAB.

***Safeguards*:** The current framework lacks a number of critical components of the *Key Attributes* and an overriding objective of financial stability and the protection of public funds. The FSLAB proposes a number of enhancements. First, it proposes that SARB should exercise its resolution functions in a way to impose losses on the failing institution's own creditors and shareholders before relying on public funds. Second, it requires actions taken by the authorities to be subject to the creditor hierarchy and a 'no creditor worse off' safeguard.

The FSLAB will require SARB to conduct a valuation of the firm's assets and liabilities before taking a resolution action. To provide operational flexibility, a provisional valuation may be used for this purpose. A second valuation must be undertaken, as soon as practicable after a firm ceases to be in resolution, to assess whether creditors have been left worse off by resolution than they would have been had the firm been placed in liquidation. The FSLAB would require SARB to specify the assumptions the valuer must make in conducting the valuation and provides a power for SARB, after consulting the PA, to prescribe requirements for this purpose and the capabilities firms require to facilitate valuation in resolution.

[19] Under an open bank resolution strategy, the bank continues to function in its existing form under its own license. In contrast, under a closed bank resolution strategy the bank ceases to exist in its current form under its own license.

The FSLAB provides for a creditor to recover compensation from the firm in resolution should SARB determine the treatment in resolution is worse than it would have been had the firm entered liquidation. There is no alternative source specified for the provision of compensation to creditors, which may potentially reduce the strength of the safeguard.

Legal remedies and judicial actions: A number of provisions in the Banks Act currently create legal uncertainty or have the potential to constrain the resolution authority; for example, the courts can reverse SARB decisions. The FSAP recommended to remove constraints to early intervention powers and improve legal protection for resolution officials. This is necessary to implement KA 5.5, under which redress should be limited to compensation (if justified). The FSLAB limits the rights of affected parties to apply to the court by widening the SARB's powers and by prescribing processes to be followed when it takes certain actions.[20]

The FSAP recommended that the immunity from personal liability provided to SARB officials under the Banks Act should be extended to non-SARB employees appointed to undertake or assist with resolution. Furthermore, it proposed that relevant officials should also be indemnified for the cost of defending legal actions. The FSLAB provides immunity for resolution practitioners and other persons appointed by a financial sector legislator appointed by SARB to exercise or perform resolution functions.

Cooperation and information sharing: A Financial Stability Oversight Committee (FSOC) was established in 2017 as a forum to coordinate and share information between relevant South African authorities. To support this, the SARB and the PA have concluded memoranda of understanding (MoUs) with the FSCA, Financial Intelligence Centre (FIC)[21] and the National Credit Regulator (NCR)[22] setting out processes for cooperation and coordination. The FSLAB proposes to amend the FSRA to require the authorities to also set out the details of how they will cooperate and share information regarding SARB's resolution functions. Similarly, the existing policy framework agreed between the Minister of Finance and the SARB Governor relating to the identification and management of systemic events is expected to be updated after the promulgation of FSLAB to replace existing arrangements relating to curatorship with the new resolution functions of SARB.

The PA has a number of MoUs for coordination of cross-border bank supervision with foreign authorities.[23] Given the presence and systemic importance of South African banks in other countries, the FSAP technical note recommended that these be extended to cover resolution and crisis management, including mechanisms for information exchange, decision-making powers and burden-sharing. The FSLAB enables SARB to conclude MoUs relating to resolution with foreign authorities. SARB anticipates 13 such MoUs.

[20] There are two specific processes that would continue to require court approval: a request by SARB to perform the winding-up of an institution and the suspension of legal proceedings to which the firm is a party.

[21] The FIC was established by the Financial Intelligence Centre Act, 2001 to identify the proceeds of crime, combat money laundering and terror financing.

[22] The NCR was established under the National Credit Act 2005, and is responsible for the regulation of the credit industry in South Africa.

[23] See *Cross-border resolution cooperation and information-sharing: an overview of home and host authority experience* by Baudino et al (FSI Insights on policy implementation No 22, January 2020).

The PA has set up supervisory colleges with some host supervisors of South African banks. SARB plans to establish Crisis Management Groups (CMGs), consistent with KA 8. Firm-specific Cooperation Agreements (CoAgs) will be necessary, in addition to the MoUs, to underpin the operation of the CMGs. The development of MoUs and CMGs may be challenging given South Africa's relatively advanced development of resolution capabilities compared to host jurisdictions in the region. In 2019 the World Bank recommended SARB leads regional initiatives to promote a dialogue on cross-border cooperation and coordination on resolution and crisis preparedness.[24]

The *Key Attributes* state resolution authorities should be empowered and strongly encouraged to act cooperatively with foreign resolution authorities. Consistent with this, the FSLAB would permit SARB to consider the possible impact that its action may have on the financial stability of a foreign jurisdiction where a firm in resolution is designated. KA 7.6 requires jurisdictions to have transparent and expedited processes to give effect to foreign resolution measures, contingent on the equitable treatment of creditors in the foreign resolution proceeding. Recognition of foreign resolution actions in South Africa can be achieved through an application to the court (if there is no local entity that meets the FSLAB criteria for resolution) but it is unclear whether this meets the 'expedited' standard in the *Key Attributes*.

Recovery and resolution planning: The authorities do not currently have sufficient powers to develop resolution plans or to require firms to take steps to enhance their resolvability. The FSAP recommended South Africa introduce a clear statutory basis for recovery and resolution plans and comprehensive guidelines for recovery plans. Furthermore, it noted that giving the PA explicit powers to require changes in group structures and operations would enhance resolvability. Some of these recommendations are also reflected in recent FSB peer reviews.[25]

The PA requires all banks and systemically important banking groups to develop recovery plans to ensure they are prepared to deal with periods of severe stress in a wide range of stress events and scenarios. Recovery plans cannot assume the availability of any recovery actions that are not under the control of the bank's management.

If enacted, the FSLAB will require SARB to undertake resolution planning for all 'designated institutions'.[26] In the case of financial groups, SARB will identify whether any entities should be excluded from the definition of designated institution and consequently the group's resolution plan (as resolution powers may only be applied to designated institutions). Consistent with the FSAP recommendations, the FSLAB will enable SARB to direct the PA to issue standards requiring SIFIs to undertake recovery and resolution planning. SARB anticipates consulting on requirements for resolution plans in due course.

Resolvability assessments form a critical part of resolution planning. SARB plans for these to be a joint exercise between the SARB and firms, with designated institutions required to undertake a self-assessment of their resolvability. The FSLAB will enhance the power for the

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[24] See *Financial Safety Nets and Bank Resolution Frameworks in Southern Africa: Key Issues and Challenges* by the World Bank Group (ibid).

[25] See, for example, the FSB *Second Thematic Review on Resolution Regimes* (March 2016) and the FSB *Thematic Peer Review on Bank Resolution Planning* (April 2019).

[26] 'Designated institutions' means all banks, a SIFI, a payment system operator, a company which is a holding company of any of the former and the members of a financial conglomerate if it includes a bank or a SIFI as a member, unless the SARB Governor explicitly excludes certain entities.

authorities to require firms to take steps to remove impediments to their resolvability. Before directing a firm to act, SARB must consult the PA. There are no explicit constraints on the use of this power but it is subject to the condition that it must be done to mitigate the risk that systemic events may occur and the general financial stability and resolution objectives.

Resolution strategies for banks: The SARB is currently in the process of defining resolution strategies tailored for specific types of institutions. Strategies will differ depending on whether firms are designated as SIFIs or their failure may otherwise have an impact on financial stability, e.g. due to the regional importance of a firm.

For banks designated as SIFIs, the authorities indicate that open-bank bail-in is likely to be the preferred resolution strategy.[27] The authorities have a preference for bail-in to be applied at the level of the holding company, on the basis that South African banks' foreign operations are relatively small compared to the group. Recapitalisation will occur at the parent company with resources downstreamed to foreign operations through internal arrangements, if necessary.[28]

Smaller and less complex firms will likely have closed-bank resolution strategies, where the firm ceases to exist in its current form. These strategies will focus on minimising losses to creditors and depositors as well as minimising contagion. This could be done, for example, by selling parts of the business to private sector purchasers or transferring activities to another bank or a bridge bank under purchase and assumption transactions, following which the residual bank will be wound down. Liquidation of an entity will be the default option to deal with the failure of non-SIFI banks, unless circumstances and features of the failing institution offer an opportunity for a different approach. The two-step approach applied by SARB means that while these strategies will differ in terms of the content of the restructuring carried out in the second phase of the intervention, in the first step firms will always be put in official resolution proceedings, including the appointment of a resolution controller.

SARB recognises that open-bank resolution strategies require resources to be available to absorb going-concern losses and to recapitalise the institution in resolution. The FSLAB would require designated institutions to hold a minimum level of FLAC instruments that can be bailed in during resolution to recapitalise a bank, and to specify the characteristics of such instruments (see Box 3). As noted above, amendments to the creditor hierarchy establish a new class of FLAC instrument that is subordinated to unsecured liabilities for this purpose. The design and calibration of FLAC is being supported by an impact study which will inform SARB's decisions on the timeframe required to phase in FLAC requirements. These requirements will also be influenced by assumptions about residual levels of going-concern capital at the point of resolution, the level and composition of regulatory capital required for a bank to maintain its authorisation between the entry to and exit from resolution, and an estimate of the level of capitalisation that will be required to restore market confidence. Consistent with SARB's preference for applying the bail-in power at the holding company level, SARB recognises the benefits of requiring FLAC instruments to be issued by the holding company. SARB

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27 SARB has designated six financial institutions as SIFIs. The PA may also identify financial institutions as D-SIBs for supervisory purposes, which allow it to set higher going-concern loss absorbency requirements and to subject the identified banks to enhanced supervision. The PA does not publish its list of D-SIBs.

28 See 'Box 5: Some context on single point of entry and multiple point of entry' in SARB's discussion paper on *Ending too big to fail: South Africa's intended approach to bank resolution* (2019).

acknowledges, however, that the current funding structure of banking groups may mean this is difficult to achieve in the short term.

Box 3: FLAC as a long-term debt requirement

Whilst the FSLAB will allow the bail-in of almost all types of debt, SARB recognises that bailing in certain types of debt (e.g. deposits) may be detrimental to financial stability and defeat the purpose of resolution. To overcome this difficulty, the FSLAB will authorise SARB to require firms to issue a certain type of instruments which would be available for bail-in in resolution.

The proposed main features of such instruments, referred to as FLAC, will be that:

- they are fully paid in, unsecured, and not subject to set-off;
- they are contractually subordinated under the terms of the instrument;
- they have a minimum remaining maturity of 12 months;
- they are not redeemable and not subject to acceleration prior to maturity;
- there is no funding, market making or delegation of issuance by the relevant firm;
- they have a minimum denomination of at least R 1 million; and
- their issuance is to be approved by SARB.

SARB has commissioned an impact study (with technical assistance by the World Bank) to finalise the characteristics of FLAC instruments, and determine the likely cost impact for banks, which will inform decisions about the location of FLAC holdings and the phase-in period. Calibration will be informed, inter alia, by assumptions about the level and composition of regulatory capital and other own funds at the point of resolution and minimum prudential capital requirements, including potentially Pillar 2 requirements. Discussions with SARB indicate that there is domestic and foreign market appetite for such instruments.

FLAC is designed as a stand-alone long-term debt requirement. This differs from the FSB's TLAC principles for G-SIBs, which permit firms to also count regulatory capital to TLAC (subject to specific conditions) but with an expectation that a minimum amount of the requirement is met with long-term debt.[29] Hong Kong, Japan, Switzerland and the US expect a minimum level of TLAC resources to be met in form of debt.[30] Whilst there is no specific EU requirement for firms to hold long-term debt, this may be required if needed to remove impediments to resolvability.

Resolution funding: The open bank resolution strategy pursued by SARB requires banks to continue with their operations, and thus assumes they will have access to funding throughout the resolution process. SARB requires firms to assess their funding needs in resolution and to have instruments and processes available to monitor, report and estimate those needs. Specifically, plans will need to identify a firm's assets and private sources of funding that may be available in resolution and identify the process to access such funding, including the mobilisation of assets as collateral and the distribution of funding throughout the group.

SARB considers private funding to be the preferred option even in resolution. It should be noted that the FSLAB will enable the DIS to apply deposit insurance funds to support a given resolution strategy, e.g. to fund the transfer of deposits to a third party institution rather than pay out depositors. However, SARB acknowledges that, given South Africa's concentrated

[29] See the FSB *Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet* (November 2015).

[30] See the FSB *Review of the Technical Implementation of the Total Loss-Absorbing Capacity (TLAC) Standard* (July 2019).

financial system, a firm in resolution may have to resort to central bank facilities. The SARB Act of 1989 authorises SARB to provide ELA. While the Act requires that such emergency funding be made on a collateralised basis, it is open as to the solvency of the recipient firm. SARB does not intend to make solvency a formal requirement of extending emergency liquidity and is prepared to grant ELA at the point of resolution. Rather, SARB intends to rely on the stabilisation measures, including bail-in, to restore a firm's solvency, and on sufficient collateral. It should also be noted that the SARB Act allows for the provision of emergency liquidity if required to preserve financial stability.

In terms of loss recovery, while the FSLAB will allow recovery of resolution costs incurred by SARB from a firm in resolution, it does not provide for recovery of losses from extending public funds in resolution from other parties, such as shareholders and creditors of the failing firm, or the financial sector more widely.

Conclusions and recommendations

The authorities have handled recent cases of bank failure pragmatically, within the constraints of the existing legislative framework, and have applied the lessons learnt to inform the FSLAB proposals for the adoption of a resolution regime. The proposed regime appears to be broadly aligned with the *Key Attributes*. In developing the proposals, the authorities have published discussion papers on the design of the new framework and have consulted extensively with domestic stakeholders and the international regulatory community. Once implemented, the proposed FSLAB amendments will address past recommendations of the FSAP and FSB by providing the authorities with an enhanced framework to plan for and undertake resolution.

Notwithstanding the progress made and the plans for enhancing the existing regime for the failure of banks, further steps can be taken to strengthen the resolution framework and enhance the preparedness of the authorities. This includes, in particular, setting a clear implementation roadmap; enhancing the operating model for SARB as resolution authority; reviewing emergency liquidity arrangements in light of the new resolution framework; and introducing a mechanism for recovery of public funds used for resolution.

Setting a clear implementation roadmap: The timetable for the adoption of the FSLAB remains uncertain. In its absence, SARB has initiated a project to design the standards and processes to implement the framework. The first step of this work was completed in July 2019, when SARB published a discussion paper on its intended approach for developing resolution plans and conducting a resolution.[31] The next stages are expected to include:

- developing frameworks and establishing processes for resolution plans and resolvability assessments, including: (i) resolution strategies tailored to different types of institutions; (ii) a framework for resolution valuations, including guidance on the assumptions that a valuer should apply and the capabilities banks will require to facilitate valuation in resolution; (iii) details and guidance on temporary stays on early termination rights; and (iv) the design and calibration of FLAC;
- negotiating MoUs with host authorities and establishing CMGs and institution-specific CoAgs; and

[31] See the SARB paper *Ending too big to fail: South Africa's intended approach to bank resolution* (July 2019).

- working on possible liquidity facilities that can be used during a resolution.

To ensure the new resolution framework is embedded credibly and effectively, SARB should set clear internal priorities across departments to maintain momentum on these projects, including explicit timelines for delivery and resource requirements. This is necessary to ensure the resolution agenda remains a priority within SARB and to reinforce the credibility of the new regime to firms, investors and the public. In implementing the framework, SARB should also be mindful of the need for strong coordination with the other domestic financial sector regulators – particularly the PA and FSCA – and other authorities relevant for financial stability, including through the FSOC. In this regard, the authorities should ensure the resolution and going-concern requirements take account of one another, so that they avoid unnecessary duplication and inconsistency. Examples of where this consideration is likely to arise include the interaction of the PONV and point of resolution, the interaction of FLAC with regulatory capital and of bail-in with securities requirements, as well as the frameworks for designating domestic systemically important banks (D-SIBs) and SIFIs.

In terms of resolution planning, other countries' experience and FSB peer reviews suggest that resolution planning should include banks designated as SIFIs as a high priority.[32] Some jurisdictions (e.g. EU) require resolution planning for the entire banking sector; others primarily concentrate on systemic firms (e.g. Hong Kong and Switzerland); and yet others apply a mixed approach where planning of different intensity is undertaken for different types of institutions (e.g. United States). Focusing on SIFIs will enable SARB to identify specific barriers to their resolvability as well as to develop operational capacity for the development of resolution strategies suited to them. Conducting resolvability assessments on a peer group basis will support SARB to identify examples of best practice in implementation and support the effective prioritisation of engagement with firms to address shortcomings.

An early strategic decision should be taken about the resources devoted to resolution planning for non-SIFIs. To inform such a decision, SARB will need to consider the materiality and substitutability of critical functions and the level at which disruption would impact financial stability; SARB could develop criteria and indicative thresholds to guide this decision-making process.[33] Given recent failures in South Africa involved non-systemic banks, a certain level of planning for such firms may be warranted. This would allow the development of a credible and predictable set of strategies for standard cases, e.g. an intervention that combines purchase-and-assumption transactions with a subsequent liquidation. A clear roadmap for developing different resolution strategies will also help coordinate the engagement of external advice, e.g. valuation experts for SIFI strategies and liquidation practitioners for these and other strategies.

The design and calibration of FLAC will be closely linked to resolution planning. Experience in other jurisdictions demonstrates that progress on LAC implementation is instrumental to enhancing resolvability and confidence in authorities' capabilities to address the too-big-to-fail problem. As such, it will be important to address industry concerns around the quantum, pricing and investor appetite for such instruments. Finalisation of the requirements and the transition

[32] The FSB recommended in its *Thematic Peer Review on Bank Resolution Planning* (April 2019) that all FSB jurisdictions should introduce a resolution planning framework as a matter of priority, since it would facilitate the effective use of powers and tools in their resolution regime and, where applicable, on a cross-border basis.

[33] See, for example, Graph 3 of the July 2019 SARB paper (ibid) on the distribution and magnitude of critical functions across South African banks.

period (informed by the conclusions of the World Bank study) should therefore be a priority and will enable firms to begin adjusting their funding structures accordingly. In calibrating FLAC, SARB should be mindful of the challenges of bailing in senior creditors and departing from the pari passu treatment of creditors, not least given the absence of clear criteria in FSLAB to inform such departures when applying the bail-in power. To support the smooth implementation of FLAC, SARB could consider setting a phase-in period for FLAC requirements. Experience in other jurisdictions suggests this will enhance the credibility and feasibility of resolution strategies by preventing firms from backloading issuance.[34] If the calibration study identifies concerns about the depth of the market for FLAC instruments, SARB could also consider committing to review end-state calibration before the final implementation deadline. This would provide an opportunity to identify any challenges in issuing FLAC and any consequences for resolution planning.[35]

Given the cross-border presence of South African banks, it will be important for SARB to engage with counterparts in relevant jurisdictions in the region, particularly where South African banks are systemically relevant to local economies, to inform the development of resolution strategies for these firms. The establishment of CMGs and CoAgs to support the exchange of confidential information with material host jurisdictions should be considered a priority, not least as they will increase understanding of the new South African resolution regime amongst peer authorities with benefits for cooperation in crises. In this context, SARB could also consider using resolution simulations to deepen understanding and identify operational and legal risks to the implementation of resolution strategies.

It will be important for SARB to assess resource and skills needs and to develop a strategy for ensuring the right resources are available at the right time to support the implementation roadmap. Experience in other jurisdictions suggests a broad mix of skills is required to develop policy, undertake resolution planning and execute resolutions. As part of the implementation roadmap, SARB should consider how to balance the needs of implementing the resolution regime with the unpredictable demands of heightened contingency planning for firms at risk of failure. The resourcing model will need to be sufficiently flexible to address this issue.

- ***Recommendation 1**: SARB should develop a roadmap for the implementation of the resolution framework, including the identification and sequencing of key policies, timelines for delivery and resource requirements.*

Enhancing the operating model for SARB as resolution authority: The FSLAB will place substantial new responsibilities on SARB and, more specifically, its resolution function. To make this function operational and to maintain momentum once FSLAB has been successfully

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34 This would be consistent with the implementation of TLAC, where G-SIBs must meet minimum external TLAC by 1 January 2019 and end state requirements by 2022. Interim LAC requirements have been set in several jurisdictions, including the EU, Hong Kong, Japan and UK. For further information see the FSB *Review of the Technical Implementation of the Total Loss-Absorbing Capacity (TLAC) Standard* (July 2019).

35 In the EU, the European Banking Authority has published reports on the implementation of Minimum Requirement for own funds and Eligible Liabilities (MREL) – see, for example, the 2017 *Quantitative Update of the EBA MREL Report*. In the UK, the Bank of England's June 2018 *MREL Statement of Policy* notes it will, before the end of 2020, review the calibration of MREL and the final compliance date prior to setting end-state MRELs. In doing so, the Bank of England will have particular regard to any intervening changes in the UK regulatory framework as well as institutions' experience in issuing liabilities to meet their interim MRELs.

enacted, it will be important to follow through with: (i) a clear mandate on and empowerment of resolution related matters within SARB; (ii) promoting cooperation and information sharing with other functions of SARB, particularly the PA; and (iii) the build-up of a dedicated resolution division within SARB.

In terms of designing processes, the currently envisaged process around the RPP ensures regular involvement of all critical functions and sufficient seniority of membership. It will be important to maintain strict adherence to its by-laws and other guidelines, even at times when such discipline does not appear to be warranted due to few potential failure cases or other priorities, so as to ensure well-rehearsed processes and habitual practices are established once the need for resolution action arises. This includes avoiding erosion of formality and seniority.

Information sharing and cooperation between the supervisory and resolution functions should be strongly encouraged. Both formal and informal measures should be considered to foster such cooperation. Formal measures are particularly important during the early stages of the implementation of the new resolution function and may include setting specific objectives and performance indicators to supervisory departments or automatic escalation triggers requiring a decision by the RPP. These should be accompanied by informal measures, which may include regular bilateral information sessions that promote mutual understanding and cooperation.

Recruiting qualified staff will remain a top priority, since the current staffing level of the resolution division will require identified vacancies to be filled by the time the FSLAB comes into force. Given the size of the division, and to strengthen the resolution function of the SARB, priority should be given to the recruitment of dedicated resolution staff. That said, important synergies can be achieved by, in addition to direct recruitment, allowing the resolution division access to staff secondments and exchanges from other SARB units, including the PA. As noted above, SARB should consider how to balance resolution resource needs – including whether and how to build, hire or outsource work – during normal and crisis periods.

Most importantly, the tone for empowering the resolution function should be set at the top, and made a strategic responsibility of SARB senior management. This includes regular communication of the importance, progress and requirements of the resolution function; and direct and regular access of the resolution function to senior decision makers.

- ***Recommendation 2**: SARB should enhance its resolution function by strengthening resources; having a clear mandate for its resolution committee (RPP); promoting cooperation and information sharing with other internal functions; and building and maintaining operating structures and processes that ensure resolution work remains a priority for senior management.*

Reviewing emergency liquidity arrangements in light of the new resolution framework: The SARB's emergency liquidity framework dates from before resolution was available as an intervention tool for authorities to deal with a firm's failure. While solvency is a criterion for extending ELA, it is not a legal requirement under the SARB Act provided that SARB's actions are taken in support of its mandate. The FSAP stated that a framework that allows emergency liquidity even in case of doubtful solvency "opens the door to quasi-fiscal operations".

Once FSLAB is enacted and resolution tools are available, SARB will have powers to restore a potentially impaired solvency. In providing emergency liquidity to firms in difficulty, consideration will therefore have to be given as to whether the causes of liquidity stress are merely operational or indicators of an impending failure (including because of potentially impaired solvency), in which case resolution action should be taken. Indeed, several FSB jurisdictions have already revised their central bank liquidity frameworks following the introduction of resolution powers.[36] This may require updating internal SARB guidelines to align the existing ELA framework with the future resolution framework under FSLAB, which may also help prevent delayed internal escalation. Given the reliance of South African banks on wholesale funding markets, further clarity on this topic is viewed as a priority in relation to the credibility of the resolution regime.

- ***Recommendation 3**: SARB should review and, where necessary, update ELA arrangements to align them with the new resolution framework.*

Introducing a mechanism for recovery of public funds used for resolution: Key Attribute 6.2 requires that authorities should have the power to recover from shareholders and unsecured creditors, or from the financial system more widely, the losses incurred under any temporary public funding used to facilitate orderly resolution. Such a provision is missing in the proposed FSLAB framework and thus exposes the taxpayer to loss if public funds that were expended for resolution purposes cannot be recouped from the firm in resolution. Extending recovery powers to shareholders and to the financial system more widely (e.g. through an ex post levy) would alleviate such concerns.

- ***Recommendation 4**: The authorities should introduce a mechanism for ex post recovery from the industry of public funds used for resolution.*

3. Deposit insurance framework

Background

South Africa is the only FSB jurisdiction without an explicit deposit insurance framework. The 2014 FSAP reiterated the recommendation from the previous FSAP (2008) for South Africa to establish an ex ante[37] funded DIS with a back-up credit line from the National Treasury (NT). The FSAP noted that the ex ante fund should be large enough to pay out depositors of a number of small and medium-sized banks and be available for use in funding bank resolution as well as in liquidations, subject to safeguards. The FSAP also recommended adopting depositor preference in South Africa.

This section analyses the progress to date, challenges and planned next steps with respect to the adoption of a DIS in South Africa. In particular, it examines the proposed objectives, scope,

[36] For instance, the Hong Kong Monetary Authority (HKMA) has introduced the Resolution Facility, which provides liquidity to a firm in resolution until such time as the firm is able to access market funding; similar revisions have been done in Canada, and also in the UK under the Resolution Liquidity Framework. Importantly, the HKMA and Bank of England resolution facilities include arrangements for the recovery of losses from the financial sector.

[37] According to the IADI Core Principles, "ex ante funding" is defined as the regular collection of premiums, with the aim of accumulating a fund to meet future obligations (e.g. reimbursing depositors) and cover the operational and related costs of the deposit insurer.

coverage and funding of the system drawing on available international guidance in this area, particularly the IADI Core Principles.[38]

Steps taken and actions planned

Introduction of the deposit insurance system: The authorities have, over the past few years, been working to introduce an explicit DIS and have consulted widely with relevant domestic stakeholders and international institutions in its design. The authorities' 2015 consultation paper provided high-level proposals on the main design features of the DIS, including scope and level of coverage, as well as funding and reimbursement mechanisms.[39] SARB published a discussion paper in 2017 which stressed the need for an explicit, privately-funded DIS in South Africa and presented proposals on its key design features.[40]

The draft FSLAB includes provisions for the establishment of the CoDI that will be responsible for the deposit insurance functions, including the administration of the Deposit Insurance Fund. Since December 2018, SARB has held discussions with individual banks to ensure that they are aware of the proposals for deposit insurance. These discussions have also served as a way to obtain information about banks' system capabilities to meet the requirements of the DIS. SARB has also consulted with the IMF, the World Bank and international standard-setting bodies on the design of the DIS.

Mandate and governance: The public policy objective of the DIS is to support the Reserve Bank in fulfilling its objective of and responsibility for protecting and maintaining financial stability in terms of section 3(2) of the Reserve Bank Act and for protecting and enhancing and restoring or maintaining financial stability in terms of section 11 of this Act. The DIS will be established as a subsidiary of the SARB with a "pay box plus" mandate[41] allowing it to provide funding to support open-bank resolution strategies in addition to the payout of depositors when a bank fails. CoDI may enter into agreement to make payments for: (a) a secured loan to the bank in resolution; (b) a loss sharing agreement between CoDI and the bank in resolution or a person assuming liability for covered deposits of the bank in resolution; or (c) a guarantee in favour of the bank in resolution, the Reserve Bank or another person in respect of the bank's obligations in relation to the covered deposits of the bank in resolution. The proposed legislation includes relevant safeguards including that, in supporting open-bank resolutions, the amount of funds used may never exceed the total amount of covered deposits held by the bank in resolution.

The DIS will be governed by a Board consisting of a maximum of eight Directors, namely: (a) a representative from the NT; (b) the CEO of the PA; (c) the Commissioner of the FSCA; (d) the CEO of CoDI; (e) the Group Chief Financial Officer of SARB; (f) a Deputy Governor of SARB; and (g) no more than two persons appointed by the SARB Governor with the

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[38] See http://www.iadi.org/docs/cprevised2014nov.pdf. The Core Principles were developed by IADI in 2009 (jointly with the BCBS) and revised in November 2014 to incorporate lessons from the global financial crisis.

[39] See *Strengthening South Africa's Resolution Framework for Financial Institutions* by the National Treasury, SARB and South Africa's Financial Services Board (ibid).

[40] See *Designing a deposit insurance scheme for South Africa – a discussion paper* by the SARB (May 2017).

[41] A "pay box plus" mandate is one where the deposit insurer has additional responsibilities, such as certain resolution functions (e.g. financial support).

concurrence of the Minister. It is not clear whether banks' representatives may also be appointed on the Board; however, Directors would have to disclose any potential conflicts of interest.

The fundamental elements of the DIS, including coverage, fund size, and banks' contributions to the fund, will be reviewed at maximum intervals of five years from its date of establishment to introduce amendments to improve the relevance and the effectiveness of the proposed DIS.

Operational set up: SARB launched a strategic project in July 2018 for establishing the CoDI, staffed initially by the resolution unit of the Financial Stability Department of the SARB. A number of workstreams are underway to establish the CoDI's operational framework. After the approval of FSLAB, CoDI will be established as an independent corporation. The current plan is to develop the core functionality for CoDI by the end of 2021 guided by an initial roadmap and to introduce further enhancements to the system after 2021. The SARB will support CoDI in areas such as human resources, legal services, investments, finance and reporting, information technology (IT) support, audit, and other services.

Membership and coverage: Membership of the DIS will be compulsory for all (commercial, mutual, and cooperative) banks. However, CFIs will be excluded since they are not covered by the FSLAB. CFIs are deposit-taking institutions that form a small share of overall deposits in the banking sector, but may represent an important financial service in the communities they serve.[42] According to SARB, the inclusion of CFIs under deposit insurance poses several policy dilemmas: they are largely informal and characterised by common ownership, with limited information about their members or depositors and assets; and they are not prudentially supervised like banks.[43] SARB will undertake a study once the basic operability of CoDI is achieved, to determine whether and how these institutions could be covered by CoDI, as an enhancement to the DIS. This analysis will also benefit from work planned for 2020 by the FSB on the resolution of cooperatives.

Under the proposed DIS, all qualifying deposits would be covered up to R100,000 (approximately USD 6,800) per depositor per bank, which is estimated to fully cover approximately 98% of depositors in South Africa (with 60% of the value of retail deposits covered). Overall, the coverage is less than 20% in terms of value of all deposits and corresponds to 1.1 times per capita GDP, with both variables below those of other FSB jurisdictions.[44] This could be because a large part of the deposit base in the South African banking sector belongs to corporates and institutional investors, and because most retail depositors maintain small amounts in their bank accounts.[45] The introduction of an explicit

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42 As at February 2019, there were 20 CFIs with total deposits of R150 million, representing less than 0.005% of the total sector's deposits.

43 A new regulatory and supervisory framework for CFIs is being developed. See https://www.resbank.co.za/PrudentialAuthority/Deposit-takers/Co-operativeFinancialInstitutions/Pages/default.aspx.

44 For example, the value of deposits covered in some other FSB jurisdictions are: Brazil 55%, Canada (at the federal level) 43%, Indonesia 54%, Mexico 54%, Russia 69%, Turkey 42% and the US 59%. As a ratio to per capita GDP, coverage limits are Australia 3.5, Brazil 7.9, Canada (at the federal level) 1.7, Japan 2.3, Russia 2.2, Turkey 2.6, UK 2.7 and the US 2.7.

45 The average deposit in South Africa for qualifying depositors was below R5,000 in 2014. According to the IADI Core Principles assessment methodology, "The level and scope of coverage are set so that the large

scheme for deposit insurance may over time shift depositor behaviour, particularly given the current predominance of money market funds as a means for South African households to diversify their savings. Gradual shifts in depositor behaviour and the fact that the proposed limits are based on data collected in 2014 underlines the importance of SARB monitoring and adjusting the coverage limit over time to fulfil the stated objectives of the DIS.

Funding: CoDI will have several layers to meet funding requirements (see Box 4). CoDI will have an ex ante equity tranche built from premiums collected from banks. This tranche will be supported by a liquidity tranche built from deposits of banks with CoDI. Banks will also be charged an annual membership fee (levy) based on a percentage of covered deposits of the bank to cover the operational costs of CoDI. The SARB will provide will provide emergency funding through a backup line of credit. The establishment cost of CoDI as an organisation is carried by the SARB.

The premiums for the equity tranche will be calculated monthly based on the total covered deposits of a bank, and be paid monthly. A fixed premium rate (0.20% of covered deposits per year) will be applied for all banks with the intention of moving to a risk-based differential premium system in the future.

The liquidity tranche, which represents the bulk of available funding to reimburse depositors, consists of contractual deposits placed by banks with CoDI equivalent to 3% of each bank's covered deposits. These funds represent contractually-agreed funds at CoDI's disposal.

The emergency funding will be provided by SARB for exceptional cases (i.e. amounts over and above the equity and liquidity resources of the DIS) and, consistent with SARB lending policies, a superior claim against the estate of the failed bank will serve as collateral. A formalised agreement between SARB and CoDI regarding the terms and conditions of the facility are yet to be put in place.

Box 4: CoDI's proposed funding structure

Equity tranche

The loss-absorbing equity tranche constitutes CoDI's own funds, and will be funded by annual premiums (0.20% of covered deposits) that banks expense through their income statement. Once paid, banks will have no future claim on the contributions that they made to this tranche.

Liquidity tranche

The liquidity tranche will be much larger than the equity tranche, as this will be required to fund depositor payouts. Payouts from the liquidity tranche are expected to be recovered over time from the liquidation proceeds, because CoDI will have a preferred claim in liquidation. The liquidity tranche will be funded by deposits from banks at CoDI. These deposits will be accounted for as assets by the banks and as liabilities by CoDI. The following conditions will apply:

- The terms of the deposits will be contractually agreed and not legally prescribed.
- Banks will earn a market-related interest on these deposits, even though there may be a margin in favour of CoDI through which more capital/equity is built.

majority of depositors across banks are fully protected while leaving a substantial proportion of the value of deposits unprotected".

- The deposits are deemed to be permanent as long as a bank is registered and operating, even if they may be rolled over at specified intervals. The deposits will be repaid if a bank voluntarily returns its banking license.
- The liquidity tranche will be adjusted monthly in line with the change in each bank's covered deposit balance.
- The interest earned by banks will be paid out monthly.

Because the terms are contractually agreed for a certain period (e.g. annually), CoDI has the discretion to periodically make changes to the size or terms of this tranche of funding.

Membership fee (levy)

Banks will be charged an annual membership fee (levy) based on a percentage of covered deposits of the bank to cover the operational costs of CoDI.

Back-up funding

SARB would provide the liquidity backstop for the DIS in the event of a shortfall, to be refunded from ex post bank premiums and/or liquidation proceeds, depending on the circumstances.

The various funding layers are presented below:

Funding layers	Provider	Percentage	Frequency
1. Equity tranche	Banks (premium)	0.2% of covered deposits per annum	Annual (can be paid quarterly/monthly)
2. Liquidity tranche	Banks (deposits with CoDI)	3% of covered deposits	Periodically agreed and maintained all the time
3. Levy (operational costs)	Banks (levy)	0.015% of covered deposits	Annual
4. Emergency funding	SARB	As needed	As needed

The objective of this multi-tiered approach is to provide substantive up-front industry-based funding, backstopped by SARB, and allow the DIS fund to build equity over time sufficient to absorb any unexpected shortfalls in the proceeds from the liquidation and reduce reliance on the liquidity tranche. At present, there is no publicly stated target fund size beyond the initial 3% provided through the liquidity tranche and a plan to build the ex ante equity tranche to 1% of covered deposits over the first five years.

The FSLAB provides the enabling provisions to levy banks, collect premiums from and enter into contractual loan agreements with banks. The premiums for the equity tranche and the membership levies are included separately in a Levies Bill, which are based on a formula and indicate a minimum level.

Use of funds: A payout will be funded by withdrawing/liquidating a necessary portion of CoDI's investment portfolio. At that point, the funding tranches will be utilised as follows:

a. The deposit from the failing bank to the DIS (i.e. its contribution to the liquidity tranche) would be written off so the failing bank bears the first loss;

b. The remainder of the funds required to pay out the covered deposit balances will be the deposits from the remaining banks (liquidity tranche);

c. After depleting the liquidity tranche, CoDI can use the equity tranche;

d. Should both the liquidity and equity tranches be depleted and more funds are required for payout, then additional (emergency) funding will be obtained from the SARB.

The size of a payout could result in CoDI becoming insolvent for the period until the liquidation proceeds are received. In such a case, CoDI will (once the FSLAB is promulgated) have a preferential claim on the failed bank's estate and the SARB's emergency funding will remain available. These proceeds will be used to replenish its funding tranches in the following order:

a. Repayment of any contingency facility provided by the SARB;

b. Restoring the investment portfolio of CoDI to match its loan obligations in terms of the liquidity tranche; and

c. Applying any excess to restoring CoDI's equity tranche.

SARB is of the view that this order of replenishment protects it against losses on the emergency funding that it may have provided at the point of payout. In the unlikely event that the proceeds of liquidation are insufficient to restore the solvency of CoDI, banks will have to contribute to its equity tranche with ex-post premiums.

Payout to depositors: The reimbursement to depositors is currently envisaged to take place within 20 working days, and reducing the payout period to seven working days once the DIS attains maturity.[46]

Mechanisms that have been contemplated to pay out depositors include, among others: transferring the failed bank's book to another bank where depositors can access their deposits (as was the case in the failure of VBS Mutual Bank – see Box 1 in section 2); electronic transfers to new bank accounts at a bridge bank; and cash payments at specified points. The specific payout channels will be identified during the implementation process once the FSLAB comes into force. CoDI is working with banks to develop IT systems to facilitate payouts of deposits. Regulations/by-laws will also be introduced to inform the banks of the reporting requirements, allowing them to commence work related to system changes in a timely manner. The member banks have been required to put in place mechanisms to present deposit data in an SCV[47] format, which SARB plans to use for calculating DIS premiums.

Role in resolution and recoveries: Given its mandate as a 'pay box-plus', CoDI will provide financial assistance for resolution purposes. This includes, but is not limited to, partially or fully funding a purchase-and-assumption arrangement; providing guarantees or loss-sharing instruments and bearing costs; and providing funds for a bridge bank resolution. CoDI will be a member of the RPP, which – as described in section 2 – is envisioned to serve as a forum for regulators to review early warning mechanisms and to discuss the financial position of banks, the resolution strategies for SIFIs and payout strategies for banks at risk of failure. The proposed deposit insurance and resolution framework encompasses elements such as depositor

[46] According to the IADI Core Principles, "the deposit insurer should be able to reimburse most insured depositors within seven working days. If the deposit insurer cannot currently meet this target, the deposit insurer has a credible plan in place to do so." A number of FSB jurisdictions can begin and complete the payout process in less than seven working days, e.g. Argentina, Australia, Canada, France, Germany, Italy, Korea, UK and the US. Some others (e.g. Indonesia and Mexico) begin payout in less than seven days, but allow up to 90 days to complete the process.

[47] Single customer view provides a consolidated view of all deposit accounts eligible for deposit insurance coverage for a single depositor at a given institution.

preference (which will place depositors at a senior position over unsecured creditors) and FLAC, which can encourage a high recovery rate for CoDI and potentially minimise the loss to the deposit insurance fund in a resolution scenario.

Cooperation mechanisms: As noted in section 2, the South African financial regulatory authorities involved in the safety net have entered into MoUs to improve cooperation and information sharing among them. These include MoUs between: the PA and FSCA, FSCA-SARB, PA-SARB, PA-SARB-FIC, and PA-SARB-NCR. After coming into force, the FSLAB will enable the authorities to amend the existing provisions in the FSRA to provide details on how these cooperation and information sharing activities will be carried out. Pursuant to the FSLAB, CoDI may also enter into MoUs with safety net authorities to obtain information required to perform its functions as the deposit insurer.

Public awareness: A public awareness campaign is needed to facilitate a smooth transition to an explicit DIS in South Africa. As a first step, SARB has appointed a vendor to conduct a survey of the public's current perceptions and level of understanding of deposit insurance to use as a benchmark for future assessments of the effectiveness of any public awareness initiatives. Second, a public awareness strategy for CoDI is being developed with support from SARB's Communications Department. This includes, inter alia, identifying public target audiences and defining stakeholder engagement; developing key messages; identifying the appropriate and most cost-effective channels for communication about the DIS; and monitoring campaign performance. Subject to the decision of its Board in the future, CoDI may also develop its own website, branding and full digital strategy (including social media accounts and stakeholder management tools) to communicate directly to depositors.

Conclusions and recommendations

The proposals for a DIS contained in the FSLAB demonstrate the authorities' commitment to implement the international standard for deposit insurance. SARB has adopted a number of good practices from the IADI Core Principles in the proposed CoDI framework, such as an explicit mandate of the DIS, governance arrangements and compulsory membership. Once implemented, the DIS is expected to further enhance the South African financial safety net while minimising the need for taxpayer supported rescue of retail deposits characterised by past failures. As in the case of the resolution framework, SARB followed a process of extensive consultation with market participants and studied practices in other jurisdictions.

In spite of these accomplishments, further work is needed to address potential misalignment in the proposed framework vis-à-vis the IADI Core Principles. This will further enhance the DIS credibility and thereby ensure that it meets its public policy objectives.

Implementation and public communication: SARB is working to operationalise the CoDI when the FSLAB is promulgated. Successful implementation of the new scheme needs to be supported by appropriate staffing of the CoDI with expertise in a number of technical areas in order to manage the new organisation. The current arrangement, whereby CoDI work is carried out by staff from the SARB's resolution unit, needs to be put on a more solid footing. The project plan is to develop the core functionality for CoDI by the end of 2021 and to introduce further enhancements to the system after 2021. Given the delays in the introduction of the FSLAB, a detailed implementation plan should be endorsed by the incoming CoDI Board and agreed with the SARB.

For any scheme transitioning from an implicit to an explicit deposit insurance, it is important that the objectives and main features of the scheme are clearly communicated and well understood by depositors. The DIS legislation will form part of the FSRA, whose overarching objective is to contribute to financial stability.

The FSLAB further states CoDI's primary functions are protecting qualifying depositors and raising awareness of deposit insurance. The authorities note that CoDI's objectives will be incorporated into the regulatory standards for CoDI once the FSLAB is promulgated. Embedding the public policy objectives in secondary legislation is good practice and consistent with the IADI Core Principles, which state that the public policy objectives of the DIS should be clearly and formally specified and made public through legislation or documents supporting legislation.

An extensive public awareness campaign is planned to be launched after CoDI is set up in 2021. The authorities view this campaign as a critical part of their project plan. However, it may be useful to inform depositors about the main features of the DIS at an even earlier stage, i.e. once FSLAB is promulgated and becomes available in the public domain. This involves formulating a comprehensive strategy for public awareness covering different stages (i.e. prior to the establishment of a DIS, at the launch of the DIS, and after the establishment of the DIS on a periodic basis). To this end, the authorities are encouraged to devise a plan detailing the scope of each stage to enhance the public perception and understanding of the nascent DIS.[48]

[48] See the IADI guidance paper on *Public Awareness of Deposit Insurance Systems* (November 2012).

- ***Recommendation 5*: Following swift passage of the enabling legislation, SARB should firm up the timeframe and resource plans to establish the CoDI. To ensure that the public understands the scope and functioning of the DIS in South Africa, it should also clearly state the objectives of CoDI in legislation or documents supporting legislation, and implement an extensive public awareness program over the respective implementation phases.**

Design features: Membership of the DIS will be compulsory for all banks, while CFIs will be excluded from the DIS. The authorities note that the coverage of CFIs has been identified as a possible future enhancement, but that there are a number of issues that would need to be considered on the basis of additional research, data collection and consultation. Proposals to clarify the applicability and practicality of coverage in regards to this segment should be progressed alongside enhancements in their prudential regulation and supervision, to ensure that all deposit-taking institutions are in a position to be eventually covered by the DIS as called for by the IADI Core Principles.

Coverage level is capped at R100,000 per depositor per bank. The coverage level is aimed at providing adequate protection for the large majority of retail depositors in small and medium-sized banks. Based on the authorities' 2014 survey of banks, 98% of retail depositors and 83% of small and medium-sized enterprises would have their deposits fully covered under the proposed regime. The authorities note that the chosen coverage level allows for changes in the deposit base since 2014; that it is higher than other countries in the region; and that they intend to review all aspects of the DIS every five years and make any necessary changes. Following the launch of the scheme, it is important that the authorities periodically review and reaffirm this coverage limit based on up-to-date depositor data and behaviours, as this has implications for the adequacy of coverage levels as well as appropriate target fund size going forward.

Regulations are being developed which will inform banks of the reporting requirements for depositor data. Although banks can initially report on either a granular or SCV basis, all banks will be expected to ultimately transition to SCV reporting. Banks will have to apply to CoDI to use the granular reporting method, in terms of which CoDI will do the necessary aggregation for granular data to a SCV format. The planned framework will also rely on SCV for the calculation of premiums paid by banks. The authorities note that their primary focus on SCV data is to facilitate the formulation of clear coverage rules, data specification, data integrity and effective payout processes. While the use of a SCV represents good practice and will provide more accurate information in the event of a payout, it could take time for some member institutions to generate SCV files at regular intervals and for CoDI to verify this information. In other countries, SCV has been launched typically after the DIS had developed expertise in handling regular operations. The authorities should consider interim solutions if covered institutions are unable to build the requisite systems within the timeframes specified, to avoid any delays in the collection of premiums and build-up of the ex ante fund.

- ***Recommendation 6*: The authorities should, once the DIS is established, review its design features periodically in order to: (a) ensure that all deposit taking institutions are eventually covered; (b) ensure coverage limits remain appropriate based on updated data; and (c) determine whether alternate approaches to estimate covered deposits can be used in cases where SCV systems may take longer to implement.**

Sources and uses of funds: The funding structure of the DIS – in particular the existence of a liquidity tranche built from deposits of banks with CoDI – is unusual compared to international practice. The authorities acknowledge that the funding model is different from the conventional build-up of a fund through deposit insurance premiums alone. In their view, having a liquidity tranche would facilitate timely depositor payouts while the equity layer is being built up and avoids some of the disadvantages of post-funding (pro-cyclicality and 'survivor pays'). However, it remains to be tested whether this tranche will perform as intended in the event of a bank failure.

The industry-funded liquidity tranche and ultimate backstop provided by SARB may ensure that CoDI is able to meet immediate or extraordinary payout demands. Nevertheless, the proposed funding structure has a comparatively small equity component built out of industry-funded premiums, which is projected to reach 1% of covered deposits in five years in the absence of significant pay-outs. Consistent with the IADI Core Principles, this component needs to be gradually built up in order to protect the solvency of CoDI and to provide confidence to depositors.

The authorities note that CoDI's funding structure has been calibrated based on prudent assumptions about the amount that will be required for depositor pay-out and expected liquidation proceeds of small/medium-sized banks. However, as noted in the previous section, at present there is no long-term explicit target fund size. A pre-specified target fund size would have the benefit of communicating clearly to the banking industry regarding expected contributions in the future beyond the initial establishment phase, while announcing it publicly may also enhance public confidence in the DIS.

- ***<u>Recommendation 7</u>: SARB should build up gradually the size of the equity tranche so that it represents an important component of CoDI's funding structure. It should also determine a long-term target fund size and set a reasonable timeframe to achieve it.***

Annex: South Africa's implementation of G20 financial reforms (as of September 2019)

This FSB Jurisdictional Profile presents the status of implementation of G20 financial regulatory reforms, drawing on information from various sources. The tables below distinguish between priority areas that undergo more intensive monitoring and detailed reporting via progress reports and peer reviews, and other areas of reform whose monitoring is based on annual survey responses by FSB member jurisdictions. See here for further information.

IMPLEMENTATION STATUS OF REFORMS IN PRIORITY AREAS

Reform area	Basel III						Compen-sation	Over-the-counter (OTC) derivatives				Resolution				Non-bank financial intermediation	
	Risk-based capital	Liquidity Coverage Ratio	Requirements for systemically important banks	Large exposures framework	Leverage ratio	Net Stable Funding Ratio		Trade reporting	Central clearing	Platform trading	Margin	Minimum external TLAC requirement for G-SIBs	Transfer / bail-in / temporary stay powers for banks	Recovery and resolution planning for systemic banks	Transfer / bridge / run-off powers for insurers	Money market funds	Securi-tisation
Agreed phase in (completion) date	*2013 (2019)*	*2015 (2019)*	*2016 (2019)*	*2019*	*2018*	*2018*		*end-2012*	*end-2012*	*end-2012*	*2016 (2021)*	*2019/2025 (2022/2028)*					
Status	C	C					Δ									**	

Legend	Final rule or framework implemented. Final rule published but not implemented, draft regulation published or framework being implemented. Draft regulation not published or no framework in place (dark red colour indicates that deadline has lapsed). Requirements reported as non-applicable. Basel III: C=Compliant, LC=Largely compliant, MNC=Materially non-compliant, NC=Non-compliant. △=Final rules implemented but certain elements are not finalised. OTC derivatives: R/F=Further action required to remove barriers to full trade reporting (R) or to access trade repository data by foreign authority (F). Non-bank financial intermediation: */**=Implementation is more advanced in one or more/all elements of at least one reform area (money market funds), or in one or more / all sectors of the market (securitisation). Further information on the legend.
Notes	G-SIBs=Global Systemically Important Banks. TLAC=Total Loss-Absorbing Capacity.
Source	FSB, *5th Annual Report on the Implementation and Effects of the G20 Financial Regulatory Reforms*, October 2019.

IMPLEMENTATION STATUS OF REFORMS IN OTHER AREAS

Reform area	Hedge funds			Securitisation			Supervision				Macroprudential frameworks and tools	
	Registration, appropriate disclosures and oversight of hedge funds	Establishment of international information sharing framework	Enhancing counterparty risk manage-ment	Strengthening of regulatory and capital framework for monolines	Strengthening supervisory requirements or best practices for investment in structured products	Enhanced disclosure of securitised products	Consistent, consolidated supervision and regulation of SIFIs	Establishing supervisory colleges and conducting risk assessments	Supervisory exchange of information and coordination	Strengthening resources and effective supervision	Establishing regulatory framework for macroprudential oversight	Enhancing system-wide monitoring and the use of macroprudential instruments
Status	REF*	REF	REF*	N/A*	REF	REF	REF	N/A*	REF	REF	REF	IOG

Reform area	Credit rating agencies		Accounting standards	Risk management		Deposit insurance	Integrity and efficiency of financial markets		Financial consumer protection
	Enhancing regulation and supervision of CRAs	Reducing the reliance on ratings	Consistent application of high-quality accounting standards	Enhancing guidance to strengthen banks' risk management practices	Enhanced risk disclosures by financial institutions		Enhancing market integrity and efficiency	Regulation and supervision of commodity markets	
Status	REF*	REF	REF	REF	REF	IOG	IOG	IOG	IOG

Legend	REF=Implementation reported as completed. IOG=Implementation reported as ongoing. ABN=Applicable but no action envisaged at the moment. N/A=Not applicable. *=collected in previous year(s) for all members.
Notes	The FSB has not undertaken an evaluation of survey responses to verify the status or assess the effectiveness of implementation. In a number of cases, the complexity of the reforms and the summarised nature of the responses does not allow for straightforward comparisons across jurisdictions or reform areas. In particular, reforms whose status in a particular area is reported as complete should not be interpreted to mean that no further policy steps (or follow-up supervisory work) are anticipated in that area. CRA = Credit Rating Agency, SIFI = Systemically important financial institution.
Source	FSB, *Jurisdictions' Responses to the 2019 IMN Survey*.

Other information	Latest IMF-World Bank FSAP: Dec 2014	Latest FSB Country Peer Review: 2013	Home jurisdiction of G-SIBs:	no	Signatory of IOSCO MMoU: yes	/ IAIS MMoU: yes

The following table presents the steps taken to date and actions planned by the South African authorities in core reform areas (not covered in this peer review) where implementation has not yet been completed. The actions mentioned below have not been examined as part of the peer review and are presented solely for purposes of transparency and completeness.

Reform area	***Steps taken to date and actions planned (including timeframes)***
Basel III	
Large exposures framework	The PA is in the process of drafting proposed amendments to the Regulations relating to Banks. The expected implementation date is 1 April 2020.
Over-the-counter (OTC) derivatives	
Trade reporting	The PA and FSCA issued the *Joint Standard 1 of 2018: Requirements and Additional Duties of a Trade Repository* (TR Joint Standard) on 15 August 2018 in terms of the Financial Markets Act, 2012. This standard prescribes additional criteria for the licensing of an external trade repository and additional duties of a licensed trade repository. This standard furthermore, aims to incorporate the Committee on Payments and Market Infrastructures and the Technical Committee of IOSCO's *Principles for Financial Market Infrastructures* as it relates to trade repositories, into the domestic regulatory framework in order to adopt and apply international standards to give effect to South Africa's international commitments. The Financial Sector Conduct Authority published the *Conduct Standard for Authorised OTC Derivative Providers*, which prescribes reporting obligations in respect of transactions in OTC derivatives (Reporting Obligations) on 11 October 2018. The Reporting Obligations comes into effect on a date to be determined by the FSCA. As there are currently no licensed trade repositories or recognised or exempt external trade repositories in South Africa, this has resulted in a delay in trade reporting obligations.
Platform trading	No policy decision has been made on the introduction of a regulatory framework for platform trading.
Margin requirements for non-centrally cleared OTC derivatives	On 8 April 2019, the PA and the FSCA published the revised *Joint Standard on Margin Requirements for Non-Centrally Cleared OTC Derivative Transactions* (Joint Standard on Margin Requirements), for a final round of public consultation. The Joint Standard, now in the parliamentary process for a 30-day period, is intended to incorporate the internationally agreed standard on margin requirements for non-centrally cleared OTC derivative transactions, as prepared by the BCBS and IOSCO, into the domestic regulatory landscape in order to mitigate the potential systemic risks from non-centrally cleared OTC derivative transactions and to reduce contagion and spill-over effects to the South African financial system. The PA and the FSCA intend for the Joint Standard on Margin Requirements to be implemented on 1 October 2020.

Resolution	
Transfer / bridge / run-off powers for insurers	The Insurance Act 18 of 2017 (Insurance Act) came into effect on 1 July 2018. The resolution powers for transfer of business and run-off of insurers was incorporated into the Insurance Act in sections 27 and 29. Bridge powers have not been incorporated in the Insurance Act. These bridge powers as provided for in the FSLAB will be applicable to insurers that have been declared as SIFIs in terms of the FSLAB.
Non-bank financial intermediation	
Money-market funds – measures for valuation, liquidity management and (where applicable) stable net asset value	South African money market funds (MMFs) are very liquid as only vanilla type debt instruments are permitted (or traded instruments). Very strict and comprehensive limits are prescribed to ensure diversification. Minimum 4% cash must be maintained. A risk management programme must be applied to manage interest rate risk, liquidity risk, spread risk, credit risk and any combination of these risks. The weighted average legal maturity is limited to 120 days and the weighted average duration is limited to 90 days. The quality of the issuer's financial capabilities and liquidity of instruments must be considered by the collective investment scheme (CIS) manager before investment. Some MMFs are managed by companies owned by banks - exposure to that bank would be a maximum 20% for the average bank in South Africa. Only two of South Africa's MMFs have variable net asset value (NAV), the rest is constant net asset value. Valuation of variable NAV portfolios require that market rates be applied and that it conforms to fair market price requirements of the Act. Where constant NAVs are applied, a mark-to-market value must be struck monthly to determine any variance with the constant price and the Manager must report any required adjustments to the FSCA. A more detailed standard for the valuation and pricing of all CIS funds, including MMFs, was submitted to Parliament in November 2019 for approval.
Securitisation – measures for incentive alignment and disclosure requirements	The PA, in consultation with the FSCA, intends to develop a policy framework for debt instruments, which will include debt obligations arising from securitised structures.