

South African Reserve Bank

Financial Stability Department

**Designing a deposit insurance scheme
for South Africa - a discussion paper**

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1. Executive summary

This paper motivates the need for an explicit, privately funded deposit insurance scheme (DIS) for South Africa. It presents proposals on the key design features of such a DIS and aims to solicit views on these proposals. The paper should be read in conjunction with the discussion paper titled *Strengthening South Africa's resolution framework for financial institutions*, published by National Treasury on 13 August 2015. Together, the proposed resolution framework and the DIS are expected to form the comprehensive regulatory architecture for reducing the social and economic cost of failing financial institutions.

The proposed design features result from a comprehensive research project conducted by a team comprising senior resolution specialists and senior researchers in the SARB, National Treasury, South African academics with sound knowledge of the financial system, and international experts on resolution frameworks and DISs.¹ The policy proposals take into account country-specific characteristics as well as applicable international standards.

1.1 Policy objective

The main policy objective of a DIS for South Africa is to protect less financially sophisticated depositors in the event of a bank failure, thereby contributing to customer protection and enhancement of the stability of the South African financial system. By protecting the covered deposits in all banks, the DIS can also contribute to the development of a less concentrated banking sector and support financial inclusion and transformation of the sector.

¹ The research team comprised Dr David Hoelscher (World Bank-appointed expert involved in the compilation of the Core Principles), Mr Jan Nolte (Senior Financial Sector Specialist, World Bank), Dr Mike Lamont (Senior Lecturer: Investment Management, University of Stellenbosch), Mr Michael Kock (Head: Methodology and Special Projects Unit, SARB), Mr Roy Havemann (Chief Director: Financial Stability, National Treasury), Mr Vukile Davidson (Director: Financial Stability Directorate, National Treasury), Dr Nicola Brink (Head: Resolution Planning, SARB), Ms Sabihah Mohamed (Senior Resolution Specialist, SARB) and Mr Lourens Delport (Senior Resolution Specialist, SARB).

These objectives are consistent with National Treasury's financial sector policy priorities, as articulated in the 2011 policy document titled *A safer financial sector to serve South Africa better*. National Treasury's policy aims to promote sustained economic growth and development through a stable financial services sector that is accessible to all.

1.2 Policy rationale

The fundamental business of banks is to take deposits from depositors and allocate that money to those undertaking productive long-term investments, like building businesses or homes. The proceeds from those productive investments are in turn returned to the depositors, linking ordinary savers with the growing economy. This transformation of short-term deposits into long-term investments facilitates economic growth but requires public confidence in banks. Maintaining public confidence in the banking sector is at the heart of financial sector regulation.

However, regulation does not replace management. Despite regulators' best efforts, the key determinants of the safety and soundness of banks are management and the market forces that exercise discipline on that management. When managers and/or investors fail in their role to enforce effective risk management, failure occurs and a need arises for a safety net to minimise the negative implications.

There are currently no explicit arrangements in place to protect depositors in the event of a bank failure. In the past, government compensated depositors for their losses on a case-by-case basis, which meant that taxpayers had to bear the cost of the failure of individual commercial enterprises, albeit indirectly. As government's ability and willingness to pay for the cost of banks' failures has diminished, there is uncertainty about which depositors should be compensated in the event of a bank failure, the amount such compensation should be, and where the funding should come from.

A DIS provides a mechanism to ensure a pre-planned, orderly and efficient provision of protection rather than an unprepared scrambling for funds, haphazard policy decisions made under pressure and/or disorderly and non-transparent compensation arrangements. Just like a personal financial safety net starts with saving for a rainy day or for a significant change in circumstances (such as retirement), a DIS is part of the safety net for the financial system that should help the financial system to remain

resilient in the face of disruptive events. And just like an individual should in good times make provision for unexpected expenses or loss of income, for example through personal savings and taking out insurance, the financial system should also in good times put buffers and mechanisms in place to deal with unexpected costs, failures and disruptions.

As such, the National Treasury and the SARB took an in-principle decision in 2015 that South Africa should establish a DIS to close the existing gap in its financial safety net and to also bring South Africa in line with international best practice and other Group of Twenty (G20) countries. The proposals contained in this policy paper aim to contribute to the design of a safety net that would optimally serve the needs of the South African financial system.

1.3 Summary of proposed design features

The proposals for the various design features of a DIS include the following:

1. South Africa should implement an explicit and credible DIS, in line with the recommendations and best practice outlined in the Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes) and in the Core Principles of Effective Deposit Insurance of the International Association of Deposit Insurers (IADI) (Core Principles). The design of the DIS should not place an excessive cost on the banking system, distort the competitiveness in the banking sector, or cause moral hazard to the extent that it would become a threat to financial stability.
2. The proposed public policy objective of the DIS is to protect covered deposits (as defined in this paper) in the event of a bank failure, thereby contributing to enhanced customer protection, and the protection and enhancement of the stability of the South African financial system.
3. The DIS should have a paybox-plus mandate, which would allow for the reimbursement of the covered deposits if a bank failed and which should also support other forms of resolution, provided that it would cost the DIS less than what it would have had to pay out in the event of a liquidation of a bank.

4. The DIS should be established as a subsidiary of the SARB, making it a separate legal entity with its own legislative framework and governance requirements, but physically located in the SARB.
5. Membership of the DIS should be compulsory and in fact automatic for all registered banks, and the DIS should be consulted whenever an application for a new banking licence is received.
6. Qualifying deposits should include all the deposits held by banks, except the following categories:
 - a. deposits by banks;
 - b. deposits by the non-bank private financial sector, including money market unit trusts, non-money market unit trusts, insurers, pension funds, fund managers and other private financial corporate sector institutions;
 - c. deposits by government, including local, provincial and national government, public financial sector entities, the Public Investment Corporation, other public non-financial corporations and monetary authorities; and
 - d. bearer deposit instruments such as negotiable certificates of deposit (NCDs) and promissory notes (PNs).
7. All qualifying deposits should be covered up to R100 000 per depositor per bank.²
8. The following rules should apply with respect to deposit coverage:
 - a. Foreign nationals' deposits and foreign currency deposits held at domestic branches of South African banks will be covered.
 - b. Deposits at foreign branches and subsidiaries of South African banks abroad will not be covered.
 - c. Accrued interest will be included in the deposits covered, but the netting of account fees will not be allowed.
 - d. Deposits will be covered on a gross basis.

² Coverage is calculated based on a single customer view (SCV), meaning that a bank should be able to consolidate or aggregate a single customer's deposit balances that are held across the bank in various products into a single amount.

- e. Pooled accounts will be treated as a single account, except for pooled accounts where professional practitioners hold deposits on behalf of clients. For these pooled accounts, a 'look-through approach' should be followed to determine the deposit balance of the underlying depositors. Consultation with the banking industry will still take place to consider the feasibility of covering the individual beneficiaries of pooled accounts that meet the criteria of qualifying deposits.
 - f. Joint accounts will be split equally between the account holders or according to the specific ratios contractually laid down with the bank, provided that banks record these ratios when joint accounts are opened.
 - g. Consultation will be undertaken on the treatment of liquidity buffers held by Cooperative financial institutions (CFIs) and Cooperative banks. These are required for regulatory purposes and are typically held at a large bank.
9. South Africa should follow a partially pre-funded approach for the DIS, with the SARB providing the required liquidity in a payout and additional emergency funding in the event of shortfalls. The recommended target size for the fund is 5.0% of covered deposits, to be maintained on a continuous basis.
10. In order to alleviate the initial funding cost of the DIS, the SARB is willing to consider lowering the cash reserve requirement (CRR) from 2.5% to 2.0% of liabilities, as adjusted, which will release an amount roughly equal to the funding requirement of the DIS. Once this one-off adjustment is implemented, banks will be required to maintain a CRR of 2.0% and a separate DIS requirement of 5.0% of covered deposits. The accounting treatment and financial implications of such an option will be further explored in consultation with the banking sector.
11. For cases where the funds of the DIS are not sufficient for the payout of deposits, the SARB will maintain a committed liquidity funding line to the DIS. Recoveries will take place afterwards through a combination of a preferred claim on liquidation proceeds and a legal right to collect contributions from remaining banks.

12. In the event of a bank failing, depositors will initially be paid out within 20 working days after the closure of the bank for accounts where ownership is easily identifiable. Ultimately, payouts should be done within 7 working days, in line with international best practice.

1.4 Structure of the discussion paper

The rest of the paper is structured as follows:

Section 2 motivates the need for a DIS as part of the financial safety net and describes the role that a DIS plays in promoting financial stability.

Section 3 describes the objectives of the DIS, its mandate and the powers required to facilitate the meeting of its objectives.

Section 4 discusses the proposed governance structure of the DIS, including its ownership, location and managing Board of Directors (Board).

Section 5 describes the membership and coverage of the DIS.

Section 6 explores the possible funding arrangements for the DIS, including a target fund size, proposed funding mechanisms and emergency funding arrangements.

Section 7 goes into the relationships that the DIS will have with other stakeholders, such as the various regulators, the Resolution Authority and foreign DISs.

Section 8 discusses the role of the DIS in resolution and covers items such as the role of the DIS in contingency planning and crisis management, the reimbursement of depositors, recoveries, and dealing with parties at fault.

Section 9 focuses on a number of other factors that are important in the establishment of a DIS.

The way forward and planned timelines are set out in Section 10.

1.5 Request for comments

Comments are invited on the proposed design features of the DIS, as set out in this discussion paper. During the commenting period, National Treasury and the SARB will also arrange workshops with the banking industry to discuss the proposals in more detail. Suggestions are also invited on which elements of the design features to

concentrate on during these workshops. Any specific questions to be addressed in the workshops are welcome.

All comments should be sent to SARB-DIS@resbank.co.za for the attention of the Head: Financial Stability Department. The closing date for comments is 31 August 2017.

2. The motivation for an explicit, privately funded DIS

2.1 The role and purpose of a DIS

The financial safety net is aimed at protecting depositors and financial stability, and comprises a combination of strong regulation and supervision, crisis management tools, and an effective resolution framework. In the event of an institutional failure, it protects the most exposed or most vulnerable customers of financial institutions. The absence of an explicit and privately funded DIS in South Africa represents a gap in the design of the financial safety net that is needed to promote financial stability.

The role of a DIS is to ensure that the cost of a bank failure, in particular, does not fall disproportionately on the most vulnerable consumers or those that are least able to protect themselves through diversification, hedging, financial structuring or other sophisticated risk management measures. A DIS, in the context of this paper, refers to the complete set of legal, operational and financial arrangements that should be in place to facilitate efficient, transparent and fast protection and/or compensation of covered deposits in the event of a bank failure.

The rest of this section discusses, from various perspectives, the reasons why a decision has been taken to establish a DIS for South Africa.

2.2 Enhancing the financial safety net

A financial system functions on trust. An effective financial safety net helps to instil and maintain such trust, even in the event of a shock that puts the financial system under severe pressure.

A financial safety net typically has at least four key components, namely:

1. effective regulation and supervision which prevent failure as much as possible. In this regard, South Africa has a long-standing reputation of compliance with international standards and best practice. The country also pursues continuous improvement, for example by introducing the Financial Sector Regulation Bill (FSR Bill), which gives an explicit financial stability mandate to the SARB, among other things.

2. an effective resolution regime which ensures the orderly allocation of losses with the minimum financial stability impact and a continuation of critical financial services. The legal and regulatory framework in South Africa makes provision for dealing with failing financial institutions, and processes are underway to further strengthen the resolution framework in line with the Key Attributes.
3. general crisis management tools which support financial stability when a systemic event occurs. A typical example is the provision of emergency liquidity assistance by the central bank. In this regard, the SARB coordinates the development and testing of plans to manage systemic crises such as a liquidity or an operational crisis. Industry cooperation in this regard is essential, and the Financial Sector Contingency Forum (FSCF) plays an important supporting role.
4. some protection for the most vulnerable customers of financial institutions. This is the one element of the financial safety net where no explicit arrangements are currently in place. This gap should be addressed by the establishment of a DIS.

In the past, some of the key constraints to any form of explicit depositor protection for South Africa were the issues of affordability, the concentrated banking system dominated by a few large banks, and the risk of moral hazard. Traditional deposit insurance funds only paid out in the event of liquidation. In such a scenario, a very big fund would have to be built up to cover the deposit base of the large banks, with high costs that are likely to be passed on to depositors. Also, because of their too-big-to-fail (TBTF) status, it is unlikely that large failing banks would simply be liquidated. Therefore, in the absence of a liquidation scenario for these large banks, their contributions would contribute the most to the funding of a DIS but their depositors would be least likely to access it. A further concern was that explicit deposit protection could result in excessive risk taking by institutions and depositors (moral hazard).

However, since the 2007/08 global financial crisis, the role of depositor protection funds has evolved, in line with bank resolution frameworks. When used in combination with stabilization powers,³ a deposit protection and resolution fund could be designed in such a way that it plays a role in the protection of its depositors and in the resolution of both large and small institutions. It would also provide the SARB, as the Resolution Authority, with more options for funding a particular resolution strategy without resorting to the use of public funds. For example, instead of compensating depositors in resolution, a DIS could issue guarantees or fund a transfer of deposits to another bank, including a bridge bank.

2.3 Supporting the stability of bank funding

One of the main benefits of deposit insurance is that it minimises the risk to depositors of losing funds when a bank fails. This disincentives small depositors from causing a 'bank run' arising from asymmetric information, thereby maintaining and promoting financial stability.⁴ Deposit insurance also limits the extent to which concerns about the safety and soundness of one bank spread to other banks through contagion. It also supports financial stability by helping to reduce the probability of liquidity squeezes that could result from a reluctance to place deposits at banks or from disruptive bank runs.

The stability of insured or protected deposits is endorsed in the Basel III liquidity risk framework, in terms of which such insured deposits are assigned a lower run-off factor for calculating the net stable funding ratio (NSFR) than uninsured deposits. Thereby, a DIS can also contribute to the stability of deposit funding in South Africa and possibly play a role in assisting banks to meet their regulatory requirements for liquidity risk management.

In the event of a bank failure, a DIS enhances financial stability by providing certainty regarding depositor protection in the resolution of failed banks, which is an important element of maintaining financial stability.

³ Stabilization powers are used for open-bank resolutions, mostly in the case of systemically important banks. The stabilization powers that will be available to authorities in terms of the Special Resolution Bill (SR Bill) are described in the discussion paper *Strengthening South Africa's resolution framework for financial institutions*, published on 13 August 2015.

⁴ Hon Chu, K. 2011. *Deposit insurance and banking stability*. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2253942.

2.4 Promoting a less concentrated banking system

An explicit and privately funded deposit insurance system allows for the diversification of the financial system and the development of a less concentrated banking system over time. Currently, smaller banks suffer a competitive disadvantage because only the large banking groups may be seen as having implicit deposit guarantees and are considered safer as a result of their TBTF status. An explicit DIS could encourage the development and entry of new banks with specific target markets. Levelling the playing field between these new entrants and the more established banks potentially supports more diversification in the banking system that could improve financial inclusion and the resilience of the South African financial system.

2.5 Reducing the risk of small-bank crises

A financial crisis emerges when the failure(s) of one or more banks are serious enough to have a significant impact on the real economy. This impact is often felt through reductions in credit flows or the loss of asset values. If inappropriately addressed, a financial crisis can end with a loss of depositor confidence in the financial system as a whole, depositor runs, and runs of other creditors from even the solvent banks.

Financial crises are not normally triggered by the failure of large banks. Since the failure of a large bank can have a systemic impact, they are usually closely supervised and financial distress is addressed early in order to avoid the worsening of a bank's financial condition.

Financial crises have been more typically triggered by the failure of small, even 'insignificant', banks. Smaller banks are often less closely supervised and authorities therefore do not identify their financial difficulties in a timely manner. And once any difficulties have been identified, regulators tend to be more tolerant about the problems in small banks. If they are eventually liquidated, the liquidation costs are relatively high, resulting in low recoveries from the assets of the failed bank while both depositors (in the absence of deposit insurance) and creditors absorb a corresponding larger loss than they would have with earlier recognition of the difficulties.

In stable periods, the liquidation of smaller banks, while always difficult, does not cause contagion or financial distress in other institutions. However, during periods of uncertainty or financial instability, the failure of a small institution can have an impact that spreads throughout the financial system. Depositors in otherwise unaffected institutions can lose confidence in their own banks or even in the financial soundness of banks in general. Such a general loss of confidence can affect even the medium and larger banks. Depositor and creditor runs can become generalised.

Some previous systemic crises followed this pattern:

- Indonesia (1997): Following the closure of 16 small, deeply insolvent Indonesian banks on 1 November 1997, depositors recognised that the implicit government guarantee they expected was not in place and they began running from a large number of small and medium banks. Although the 16 banks were known to be little more than shells and insolvent, the runs spread, reflecting (i) the perception that many other weak banks remained in the system, (ii) the fact that some of the weaknesses in the small banks were unrecognised by the supervisory authorities, (iii) loss of confidence in government's overall economic management, and (iv) concerns about currency flight. Financial stability returned only after the implementation of a comprehensive reform programme that included a blanket guarantee for all depositors and creditors.
- Turkey (1999): In a precursor to the 2000/01 Turkish systemic crisis, the financial system suffered a near collapse in 1999 when a small, virtually unregulated bank (Damirbank) was found to be insolvent. The authorities' initial policy was to close the bank (as it was very small) and impose losses on depositors and creditors. Once the depositors recognised that the assumed implicit government guarantee was not invoked, runs on all banks began. The authorities stabilised the situation only through the implementation of a full, formal deposit guarantee.
- United Kingdom (UK) (2007): Northern Rock was a small mortgage bank, supervised on a three-year cycle. It was considered too small to have systemic importance. However, when its mortgage book failed, the photographs of the long queues at the bank reinforced a growing fear about the strength of many

UK banks. As runs became generalised, the authorities implemented a full guarantee of deposits above the already existing DIS whose coverage level and funding arrangements (ex post funding) were deemed insufficient to reinforce depositor confidence.

From the examples above, it is evident that although the depositors of large banks and these banks themselves may not generally be direct beneficiaries of DIS payouts, both these depositors and banks fall victim to financial crises that originate in the small-bank sector and therefore benefit indirectly from a DIS's contribution to the prevention of such crises. A DIS facilitates the orderly 'working out' of weak banks from the system, thereby contributing to a healthier financial system. Having an effective and orderly exit mechanism for weak banks, of which deposit insurance is a key component, is important.

2.6 Reducing sovereign risk, fiscal cost and uncertainty about compensation

Because South Africa does not have explicit and privately funded deposit insurance, payouts to depositors in the event of a failed bank have in the past been funded by government, on a case-by-case basis. No arrangements are in place to recover such compensation to depositors from the private sector, resulting in taxpayers ultimately funding the costs of bank failures. Implicit deposit insurance causes uncertainty among depositors as well as high fiscal costs in the event of a bank failure. Bank failures are more likely in economic downturns, when government finances are already under strain. Also, implicit insurance is often perceived to be unlimited, which increases the implicit burden on government and the taxpayer.

An explicit and privately funded scheme provides certainty about government's obligations to depositors about scope and coverage, limits discretionary decisions, promotes public confidence, helps to contain the costs of resolving failed banks, and provides countries with an orderly process for dealing with bank failures and a mechanism to fund the costs of bank failures.

Deposit insurance is often undervalued in good times but has proven invaluable during crisis times. Like any other form of insurance, it can be seen as wasteful as long as the insured event – in this instance a bank failure – does not happen. However, bank failures invariably occur, and they are always costly. By having an explicit and privately funded DIS, those who directly benefit from the insurance (i.e.

the depositors and the banks) contribute to the cost of their protection and are thus co-responsible for financial stability, not the taxpayers.

2.7 Complying with international standards

Having an explicit and privately funded DIS is an international standard that South Africa does not currently comply with. While this is not in itself a sufficient motivation to establish a DIS, it does make South Africa an outlier by suggesting that South Africa's safety net framework may be weaker than its international peers. This reinforces the other reasons why a DIS would strengthen the current financial safety net.

In response to the most recent global financial crisis, the G20 tasked the Financial Stability Board (FSB) with developing policies to address the TBTF problem. The FSB developed, among other standards, the Key Attributes, which require jurisdictions to have a privately funded depositor protection and/or resolution fund in place or, alternatively, arrangements to recover any public costs from the private sector afterwards.

In the 2007/08 global financial crisis, the critical role of explicit and privately funded deposit insurance in maintaining confidence in the financial system was once again confirmed. The IADI issued guidance on the various design features to be considered in the development and establishment of a DIS by publishing the Core Principles in 2014, which included the lessons learned from the global financial crisis, with specific reference to deposit insurance. The Core Principles represent the international standards against which the effectiveness of countries' depositor protection arrangements is measured in regular peer reviews and in the International Monetary Fund's (IMF) Financial Sector Assessment Programme (FSAP).

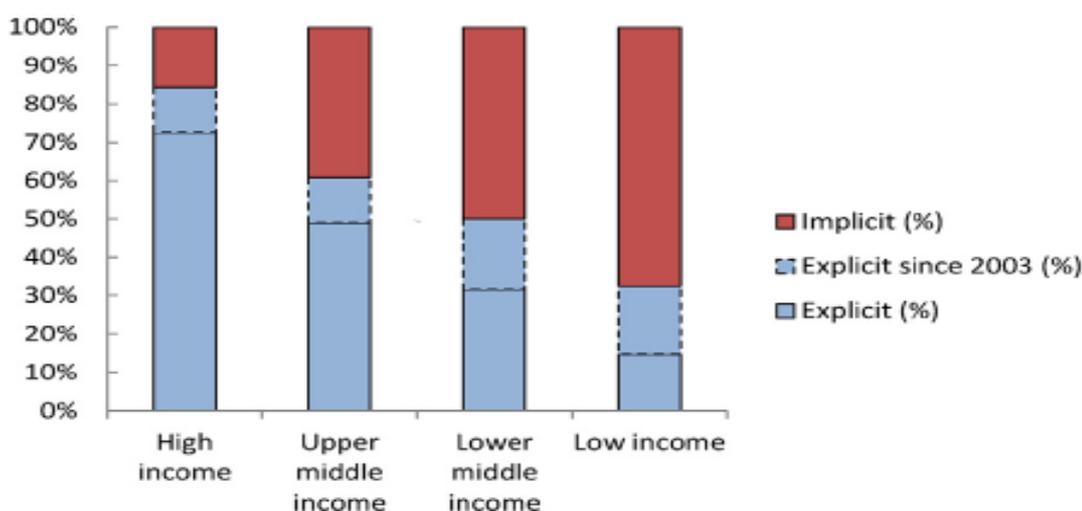
A comprehensive review of South Africa's resolution framework in 2009/10 under the auspices of the World Bank's Financial Sector Reform and Strengthening Initiative (FIRST) programme and a thematic peer review by the FSB in 2012 revealed gaps in a number of areas where South Africa's 'conventional' resolution powers did not comply with the Key Attributes. These gaps were confirmed in the findings of the IMF in its 2014 FSAP for South Africa. One of the gaps that were identified was the absence of an explicit and privately funded deposit insurance fund that could

reimburse depositors in the event of a bank failure or that could assist in funding the chosen resolution option.

Up to the beginning of 2015, South Africa was one of only three G20 countries without a DIS, the other two being China and Saudi Arabia. China implemented a DIS in May 2015⁵ while Saudi Arabia announced the implementation of a DIS from 1 January 2016.⁶ South Africa is thus currently the only G20 country that does not have explicit deposit protection in place.

However, it is not only G20 countries that consider it useful to have deposit insurance. Among a survey of 189 countries, 112 countries have an explicit DIS. As shown in Figures 1 and 2, those that do not have DISs are mostly lower-income countries and mostly in Africa.⁷ Nevertheless, 24% of countries in Africa have an established DIS and are members of the IADI despite their economies and financial systems being less developed in most cases than those of South Africa.

Figure 1: Explicit deposit insurance by income group, 2013



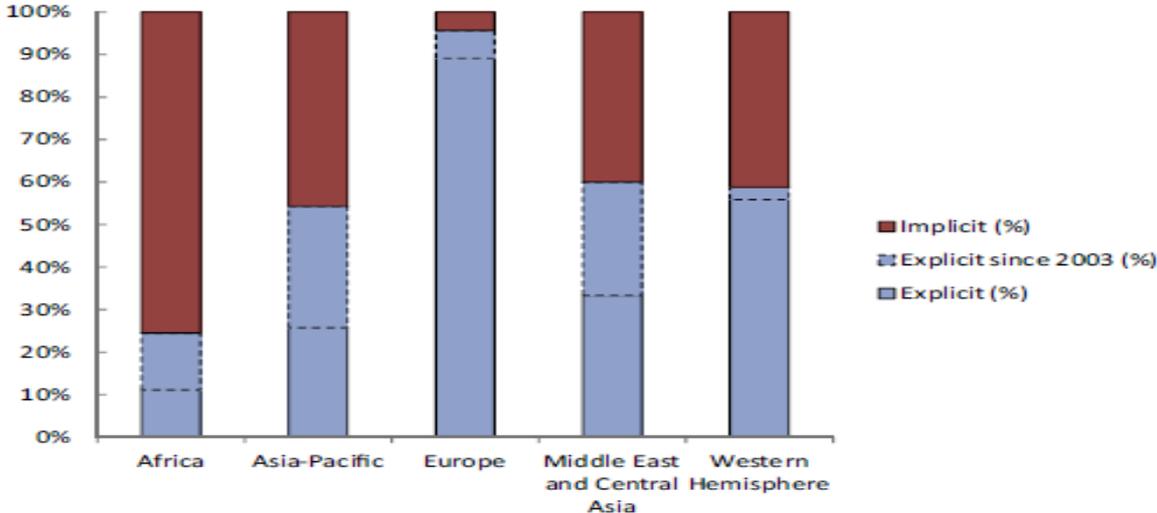
Source: Demirgüç-Kunt, Kane, Laeven. (2015)

⁵ China: deposit insurance scheme starts today.' 1 May 2015. Asia Insurance Review. Available at <http://www.asiainsurancereview.com/News/View-NewsLetter-Article?id=32657&Type=eDaily>.

⁶ Torchia, A. 12 November 2015. Saudi Arabia faces deposit insurance challenge – FSB. Available at <http://www.reuters.com/article/saudi-banking-deposits-idUSL8N1374LQ20151112#BK2GIBZspyisYkuJ.97>.

⁷ Demirgüç-Kunt, A., Kane, E. and Laeven, L. 2015. 'Deposit insurance around the world'. Journal of Financial Stability, Volume 20, Issue C, pp. 155-183.

Figure 2: Explicit deposit insurance by region, 2013



Source: Demirgüç-Kunt, Kane, Laeven. (2015)

2.8 Containing moral hazard

An argument that is often cited against a DIS is that it can contribute to moral hazard and excessive risk taking by banks and to risk indifference among depositors. However, when assessing the advantages and disadvantages of a DIS, it should be kept in mind that a DIS does not operate in isolation but as an integral part of the regulatory, supervisory and resolution framework. The various elements of the financial safety net form a holistic framework that aims to strengthen both institutional safety and financial stability in a way that balances costs, risks and benefits. The regulatory and supervisory framework has extensive measures in place to enforce effective risk management and penalise excessive risk taking by banks, among others through capital and liquidity requirements. Likewise, less risky banks are rewarded through prudential measures such as lower capital requirements.

The design of a DIS should not undermine market discipline. By limiting the amount of coverage, depositors (particularly large depositors) are still incentivised to conduct their own risk assessment of banks.

2.9 Conclusion

A DIS has various advantages for the stability of a financial system, which is why most countries in the world have such a scheme in place. Although there are disadvantages associated with establishing a DIS (mostly relating to the cost of

banking and possible moral hazard), these can be overcome through the appropriate design of the scheme. The disadvantages are generally associated with excessively large funds that are too generous in offering high coverage levels or that are administratively costly and complex.

In light of the importance of having an explicit and privately funded DIS as part of the financial safety net, it is the policy view that South Africa should implement an explicit and credible privately funded DIS, in line with the requirements of the Key Attributes and the Core Principles. The DIS should be designed in such a way that it does not place an excessive cost on the banking system, distort competitiveness in the banking sector, or cause moral hazard to the extent that it becomes a threat to financial stability. The design features proposed in the rest of the paper are intended to achieve such an outcome.

3. Objectives, mandate and powers of the DIS

The design of a DIS – including its mandate, powers as well as governance and membership arrangements – should ultimately be aligned to the overall objectives of the DIS. It is therefore useful to discuss these elements as a basis for the proposals on the design features for the DIS.

3.1 Objectives of the DIS

A DIS typically has a combination of objectives relating to financial stability and consumer protection. Provided that an appropriate balance is struck, these objectives should not be in conflict, as consumer confidence and access to finance also contribute to financial stability. It is important that the DIS's mandate and powers support the objectives of the proposed resolution framework, which are primarily aimed at preserving financial stability.

According to the Core Principles, the principal objective of a DIS is to contribute to financial stability through the protection of depositors in order to help prevent bank runs and contagion to other banks. The proposed objective of the DIS for South Africa is to protect covered deposits in the event of a bank failure, thereby contributing to customer protection, as well as the protection and enhancement of the stability of the South African financial system.

3.2 Mandate of the DIS

The safety net framework must provide for the adequate regulation and supervision of banks, the resolution of failed banks, and depositor protection. According to the Core Principles, the mandate of a DIS should be clearly and formally specified by describing which of the safety net functions are allocated to the DIS. The mandate also has to clarify the role and responsibilities of a DIS and should be aligned with the mandates of the other safety net participants. There should also be consistency between the public policy objectives and the powers and responsibilities of a DIS.

The FSB's peer review⁸ identified four different types of mandates for DISs,⁹ namely:

1. Narrow-mandate schemes or paybox schemes are only responsible for the reimbursement of insured deposits. A paybox scheme is relatively easy to implement and administer, but it has no say in the resolution strategy and has to pay out on instruction. The DIS cannot oppose a resolution strategy to protect its own financial position.
2. DISs with a paybox-plus mandate do depositor reimbursements and usually have a limited role in resolution by providing financial support in resolution. This type of scheme can support alternative resolution strategies within certain constraints or conditions, and is better suited to support the resolution of larger banks.
3. DISs with a loss minimiser mandate are actively involved in the selection, implementation and funding of resolution with the objective of achieving the resolution with the lowest overall cost. The DIS is actively involved in the choice and funding of the resolution method. This runs the risk of delays in decision making between the DIS and the Resolution Authority if they prefer different approaches.
4. DISs with a risk minimiser mandate have comprehensive risk minimisation functions that include a full suite of resolution powers as well as prudential oversight functions. This mandate ensures adequate information to the DIS and involvement in the resolution strategy, but it can duplicate the regulatory functions and also lead to conflicting interests between the DIS, the RA and the regulators.

In choosing the type of DIS to develop for South Africa, the costs and benefits of each of these types of DISs should be considered.

⁸ Financial Stability Board (FSB). 2012. *The thematic review on deposit insurance systems peer review report*. Available at http://www.financialstabilityboard.org/publications/r_120208.pdf.

⁹ This is a broad classification of the different types of mandates for deposit insurance schemes (DISs). In practice, each DIS has its own legislation and characteristics, and may not necessarily have all the characteristics of a particular type of DIS mandate.

The aim for South Africa would be to:

- Minimise the compliance costs for banks;
- Minimise the administrative costs for the DIS;
- Avoid a duplication of the functions of the prudential regulators;
- Allow the DIS some input into the choice of resolution mechanisms; and
- Ensure that the DIS's funds can be effectively safeguarded. The DIS has to be credible enough to promote confidence in its ability to achieve its objectives.

A paybox-plus mandate is recommended for South Africa to allow for the payout of depositors when a bank fails, and to allow the DIS to financially support other forms of resolution (e.g. the transfer of deposits) in order to reduce the cost of resolution to the DIS, as applicable and subject to conditions.

3.3 Powers of the DIS

In terms of the Core Principles, a DIS should have all the powers necessary to fulfil its objectives and mandate. These powers should be formally specified. All DISs require the minimum powers to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that their obligations to depositors can be met promptly.

The legislation applicable to the DIS should be part of the broader resolution framework, which should give a set of standard powers to the DIS in order to fulfil its objectives and mandate. The type of DIS influences its required powers. Table 1 lists the general legal powers that should be available to a paybox-plus DIS before, during and after a bank failure. (A loss- or risk-minimising DIS should also have these powers in place as a minimum, but would require additional powers relating to the choice of resolution strategy and supervision.)

Table 1: General legal powers that should be available to a paybox-plus DIS¹⁰

Powers before resolution: pre-positioning requirements
<ul style="list-style-type: none">• Require banks to have the ability to provide all the information that would be necessary to identify qualifying depositors, determine covered deposits, and calculate deposit balances and contributions by banks, using a single customer view basis (SCV).• Put processes in place with banks to enable the generation of payment instructions in an SCV format for depositor reimbursement, deposit accounts to be transferred to another bank, reports to be generated, and tax-related information to be provided.• Require the testing of the calculation of qualifying depositors' balances on an SCV basis and, if needed, request the regulator to do on-site reviews or to review the accuracy of information submitted by the banks.• Put processes in place to coordinate with the Prudential Authority (PA) and the Resolution Authority and to receive timely information on systemic risks, individual bank risks, and early warning indicators on failing banks.• Receive and share timely, accurate and comprehensive information with other applicable financial safety net participants, both local and international.• Compel banks to comply with the legally enforceable obligations (such as access to depositor information) to the DIS or request another financial safety net participant to do so on behalf of the DIS.• Maintain contributions by banks, as determined, and have access to backup funding and post-resolution recoveries.• Set operating budgets, policies, systems and practices.• Enter into contracts and set own regulations.• Develop own internal policies and procedures.

¹⁰ These are high-level powers that may be outlined in more detail in regulations.

Powers during resolution: power to invoke a DIS

- As the Resolution Authority, the SARB would need the power to invoke the DIS based on clearly defined triggers.

Powers after resolution: power to make payouts or fund the transfer of deposit accounts

The DIS should have the power, directly or through an administrator or liquidator, to:

- Take such steps as may be required to facilitate the calculation of covered deposit balances per qualifying depositor.
- Facilitate the preparation and transmission of payment instructions.
- Make the deposit balances of covered deposits accessible to depositors via specified channels.
- Take specified steps to communicate with depositors and other stakeholders.
- Provide funding or guarantees in support of a resolution strategy other than liquidation.
- Attend to other matters necessary for the administration of the DIS.

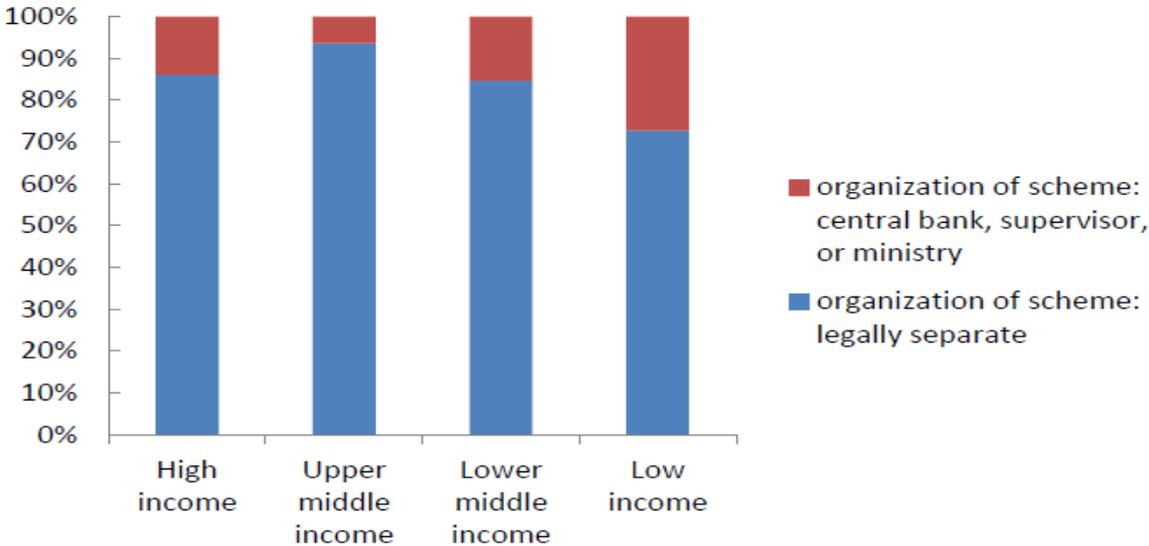
The DIS for South Africa should have the legal powers to give effect to its objectives and mandate, which should, as a minimum, include the powers associated with a paybox-plus DIS. All resolution actions supported by the DIS should cost less than the payout of the covered deposits. In addition, when the DIS supports any alternative resolution strategy financially, there should be reasonable probability of a successful resolution.

4. Governance arrangements

4.1 Ownership and location

The Core Principles recommend that a DIS be operationally independent, transparent, accountable, and insulated from undue political and industry influence. As depicted in Figure 3, the majority of DISs in the world consists of separate legal entities. An effective and independent DIS should operate within a clear and distinguishable legal framework that sets out its mandate, powers, responsibilities and accountabilities.

Figure 3: Organisation of deposit insurance globally, 2013



Source: Demirgüç-Kunt, Kane, Laeven. (2015)

The requirement for operational independence, transparency and accountability does not necessarily mean that a DIS has to be located separately. Some DISs are organised as separate legal entities but are hosted within and supported by central banks or finance ministries, as this makes them less expensive to administer.

Other DISs start off in central banks or finance ministries but grow into separate institutions at some point. Various DISs function as integral parts of resolution authorities. However, it is important to note that there should not be any conflict between the role of the DIS and that of the entity within which it is located.¹¹

The policy proposal is that the DIS in South Africa should be established as a subsidiary of the SARB, making it a separate legal entity with its own legislative framework and governance requirements, but physically located in the SARB. Locating the DIS in the SARB would reduce the start-up and operating costs of the scheme and derive benefits from administrative efficiencies by drawing on existing resources, e.g. the SARB's Human Resources Department and Business Systems and Technology Department.

Provided that operational independence is safeguarded in legislation, it can also enhance effective coordination with the resolution function within the SARB in the event of a bank failure. With the SARB to be designated as the Resolution Authority, the objectives and mandates of the DIS and the Resolution Authority should be clearly distinguished but still closely aligned. The legislation and rules of the DIS should provide for proper coordination between the DIS and the PA, the Resolution Authority and the Financial Sector Conduct Authority (FSCA) while maintaining its independence in fulfilling its mandate.

4.2 Governing Board of Directors

If the DIS is established as a subsidiary of the SARB, it should be governed in a way that ensures its independence and the availability of adequate resources to fulfil its defined duties, with its own Head and governing Board. The recommended composition of the Board includes representatives from the SARB, National Treasury, the PA, the FSCA, and the Head of the DIS. No representatives from the

¹¹ Germany has a privately organised deposit insurance scheme (DIS) that is staffed and managed by the banking sector, mainly as a result of historical reasons. Although the Core Principles are not explicitly against private DISs, such schemes pose certain practical difficulties, such as constraints on the exchange of bank-specific data and information as well as effective coordination with the supervisor and the Resolution Authority, in particular when a bank approaches resolution. A private DIS is also more inclined to save costs for the DIS itself, e.g. in the form of public awareness programme, rather than supporting a broader financial stability mandate. Conceptually, a private DIS should not be cheaper to fund and administer, unless it is underfunded and understaffed. Having to duplicate some of the systems and resources that already exist in the central bank, it is likely to be more expensive. For these reasons, a privately organised DIS is not considered to be a viable option for South Africa.

banking industry should be on the Board in order to avoid conflicts of interests and constraints on the sharing of confidential information about individual banks.

The Board should develop a governance framework for the DIS, covering the frequency of meetings, internal controls, duties and responsibilities, communication processes, transparency, disclosure arrangements and transparent processes for the appointment and removal of Board members. This governance framework should also include a regular review of whether the DIS has met its public policy objectives.

The DIS will be subject to both an internal and an external audit. The scheme will be expected to publish an annual report, which will be forwarded to the Minister of Finance for the purpose of reporting to Parliament.

The Board may establish committees, as needed, to consider policies relating to, inter alia, public awareness and information requirements from banks. The committees could consist of industry, regulatory and DIS representatives.

5. Membership and coverage

This section sets out the proposals on the membership of the DIS, the definition of deposits that potentially qualify for cover by the DIS (qualifying deposits) as well as the amount to which the qualifying deposits should be covered (covered deposits).

5.1 Membership of the DIS

To avoid adverse selection,¹² membership in the DIS should be compulsory for all the banks registered in terms of the Banks Act 94 of 1990, Mutual Banks Act 124 of 1993 and Cooperative Banks Act 40 of 2007 that are regulated by the PA as home or host supervisor. This will include all local banks, local branches of foreign banks (if agreed with the home authority's DIS), mutual banks and cooperative banks.

The final proposal will include a deposit insurance framework for cooperative financial institutions. In terms of the FSR Bill, these will also be supervised by the PA.

There are two approaches for determining the membership of a DIS: membership in the DIS could be given automatically upon registration as a bank or banks could be required to apply for membership. When banks are required to apply for membership, it allows the DIS some flexibility in controlling the risks it assumes by establishing entry and exit criteria. It is important to note that no bank will be allowed to operate as a bank without being a member of the DIS.

When membership is automatic, the prudential regulator decides on authorising the bank into the system, but arrangements can be put in place so that the DIS is consulted during the licensing process. In terms of such arrangements, the DIS can make recommendations and propose conditions for the licensing of the applicant bank, but cannot veto a decision made by the prudential regulator. The DIS may propose certain conditions for licensing a new bank when the bank does not meet the requirements of the DIS upon its entry into the system. These conditions may include a requirement for the bank to develop a credible plan to address any shortcomings or deficiencies within a prescribed time frame. The DIS can set conditions that are relevant to its the mandate, for example obligations to contribute to the fund and requirements for information technology systems that enable the bank to provide the

¹² Adverse selection is the tendency of higher-risk banks to opt for deposit insurance and of lower-risk banks to opt out of deposit insurance when membership in the deposit insurance scheme (DIS) is voluntary.

required depositor information. The DIS membership requirements have to be clear and transparent.

It is recommended that South Africa follow an approach of automatic membership for all registered banks, but with the explicit requirements that the DIS has to be consulted whenever an application for a new banking licence is received and that the DIS can set conditions (e.g. the ability to submit consolidated depositor information) for the approval of membership, which will be enforced together with any other licensing condition set by the prudential regulator.

A bank's membership of the DIS should be terminated if it is deregistered as a licensed bank, either when it returns its banking licence or when it enters resolution. In this regard, the Special Resolution Bill (SR Bill) will have to provide the legal framework to require that the DIS be informed as soon as any of the regulators consider withdrawing the bank's banking¹³ or credit-granting licence¹⁴.

For the local branches of foreign banks whose deposits are covered by their home authority's DIS, the domestic and foreign DISs will have to agree on the responsibility for the reimbursement of depositors as well as on the setting and levying of contributions from the bank. If the outcome of the discussions is that the foreign DIS will cover the deposits of the local branch of the foreign bank and this coverage offers the same protection as the South African framework, then that branch's deposits will not be covered by the South African DIS.

Newly registered banks would have to contribute to the DIS when they start submitting consolidated depositor information. These banks' deposits would be covered by the DIS and they would have to meet all the DIS's requirements and obligations from the day of registration. While the DIS will not be able to veto the approval of a new bank licence, meeting the DIS's requirements should be a condition for granting the licence.

¹³ Banking licences are granted by the Registrar of Banks in terms of the Banks Act 94 of 1990.

¹⁴ Credit-granting licensing is done by the National Credit Regulator in terms of the National Credit Act 34 of 2005.

5.2 Qualifying deposits

There are two key policy decisions on coverage that have to be made in the design of a DIS: firstly, determining which deposits qualify for coverage (referred to as 'qualifying deposits'), and secondly, determining the amount to which these deposits will be covered (referred to as 'covered deposits', including all qualifying deposits up to the cover limit).

The SARB conducted a comprehensive survey in 2013 to determine the size and distribution of retail as well as small and medium enterprise (SME) deposits in the South African banking sector. The survey was designed in consultation with the Banking Association of South Africa (BASA) to ensure that the necessary information could be requested from banks without the banks having to incur costs in this regard. In 2015, a more detailed and updated survey was conducted in which banks had to report on the size and distribution of all their deposits. This information was used to analyse the size and distribution of all depositors and deposit categories per banking institution as well as across the banking sector.

The Core Principles call on policymakers to clearly define qualifying deposits in law. The definition of 'qualifying deposits' should be aligned to the public policy objectives of the DIS. On a practical level, qualifying deposits should be quickly identifiable to enable prompt payout. The Core Principles also require that a DIS periodically review the level and scope of coverage to ensure that it continually meets its public policy objectives. The South African DIS will legally be required to review the level and scope of coverage every 5 years to ensure its public policy objectives are continuously met.

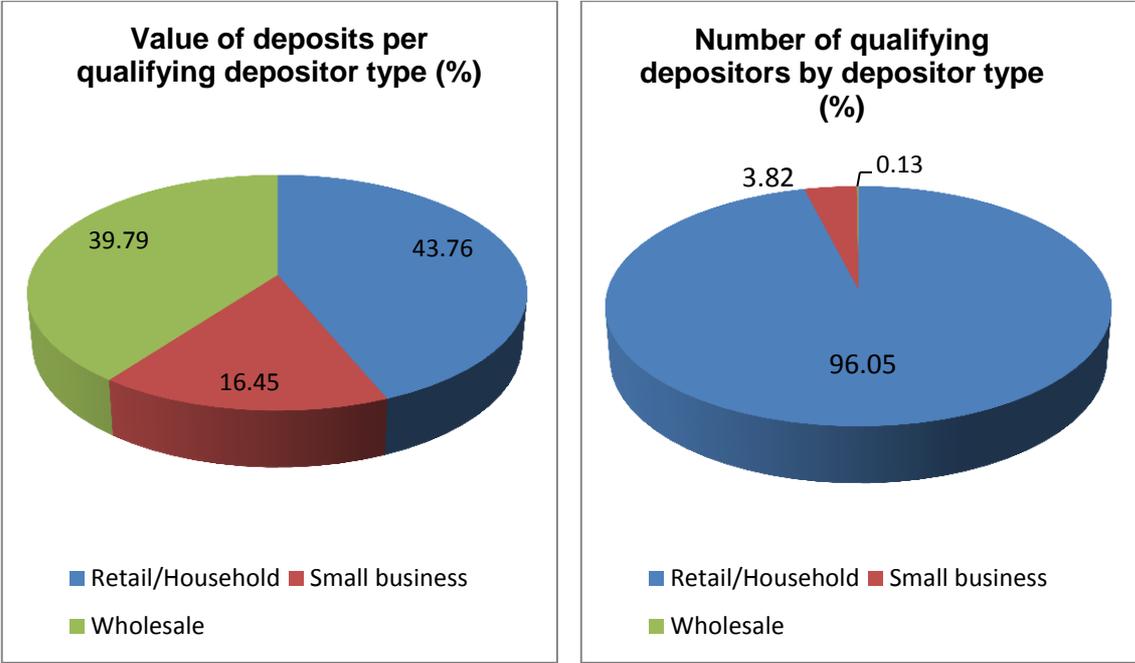
Some types of deposits are generally excluded from a DIS, provided that they are easily identifiable. The main reason for such exclusion is that these deposits are from institutions which are financially sophisticated and therefore able to make informed investment decisions. These deposits are typically large, making the coverage limit usually offered by a DIS small in comparison. In the South African context, it is proposed that certain types of deposits be excluded from cover by the DIS because they are made by informed depositors that should help to contain moral hazard and contribute to market discipline in the banking sector. The deposits that currently adhere to these criteria and which should therefore be excluded are the following:

- deposits by banks;
- deposits by the non-bank private financial sector, including money market unit trusts, non-money market unit trusts, insurers, pension funds, fund managers and other private financial corporate sector institutions;
- deposits by government, including local, provincial and national government, public financial sector entities, the Public Investment Corporation, other public non-financial corporations and monetary authorities; and
- bearer deposit instruments such as negotiable certificates of deposit (NCDs) and promissory notes (PNs).

Considering the remaining pool of potentially qualifying deposits, there is a bias towards including only retail and SME deposits in the definition of qualifying deposits. This may also be based on a concern that the cost of including wholesale deposits may be too high.

However, considering the composition of deposits in the banking sector introduces arguments for not excluding wholesale deposits. In the South African banking sector, the distribution of potentially qualifying deposits between retail and SME on the one hand and wholesale on the other is skewed towards retail and SME deposits in terms of the number of depositors but towards wholesale deposits in terms of value. As shown in Figure 4, retail and SME deposits comprise about 60% of the total value of potentially qualifying deposits in the banking sector. However, they represent almost 100% of the number of potentially qualifying depositors. Conversely, the potentially qualifying wholesale deposits (after the exclusions listed above) represent 40% of the total value of potentially qualifying deposits, but only 0.13% of the number of potentially qualifying depositors.

Figure 4: Composition of potentially qualifying deposits



Source: SARB. 2015. *Deposit Insurance Scheme Survey*. Financial Stability Department

There should be no uncertainty or ambiguity in the definition of ‘covered deposits’. The more complicated the definition of ‘covered deposits’, the more likely it becomes that banks and depositors will adapt their behaviour and classification in reaction to the legal definition, the more uncertainty is created for both the DIS and the depositors about their coverage, and the longer the DIS will take to process payouts in the event of a failure. For example, it may become difficult to decide on an ongoing basis which corporate clients are SMEs and which are not, or which retail deposits are, in fact, business accounts. Banks’ internal classification and information systems also differ, further complicating an industry-wide standard.

Given the skewed distribution of non-financial-sector deposits in South Africa, the benefits of a clear and transparent definition of ‘covered deposits’, which ensures a rapid identification in a resolution situation, exceed the additional cost of covering large deposits. It is therefore proposed that qualifying deposits comprise all deposits except the list that is specifically excluded. However, to limit the cost and to prevent moral hazard, the amount of coverage should be limited, as discussed in the following paragraphs. More extensive arguments for the definition of ‘qualifying deposits’ are outlined in Annexure A.

5.3 Covered amount

A DIS usually has limited coverage per qualifying depositor per bank.¹⁵ Unlimited coverage is expensive and more likely to cause moral hazard. The limit should be such that it provides adequate protection to the more vulnerable depositors, but it should not be too costly for the system and should still incentivise large depositors to assess and price for idiosyncratic bank risk.

According to survey data, approximately 87% of the qualifying depositors in South Africa have deposits of less than R10 000, which is less than 2.4% of the total value of qualifying deposits in the banking sector.

Because of the skewed distribution of deposits in the banking system, increasing the coverage limit adds less to the overall cost of the DIS than what it adds to the potential benefits in terms of preventing a run or maintaining financial stability. Internationally there is a trend towards higher coverage levels.

The proposal is that the DIS should be introduced with a coverage limit of R100 000 per qualifying depositor per bank. Although this amount may be small for corporate depositors, it is considered sufficient for the protection of retail and SME depositors, which is in line with the DIS's objectives. A coverage limit of R100 000 is considered to be appropriate to prevent a run by retail depositors from a bank that is perceived to be experiencing problems, but is relatively low compared to the international coverage levels.

The level of coverage influences the cost to the banking sector, alongside other variables such as the funding model, the target size of any pre-funded portion, and the period over which a pre-funded portion is built up. These aspects are discussed in detail in Section 6.

¹⁵ This observation is based on single customer view (SCV) reporting by banks.

6. Funding arrangements for the DIS

The funding considerations in the establishment of a DIS include a decision on how to balance pre- and post-funding, the funding of the start-up costs, the determination of a target fund size and how this fund size should be financed, the emergency funding arrangements that should be in place, and the mechanisms to replenish the DIS funds after a payout.

6.1 Pre- and post-funding

To ensure prompt reimbursement of insured depositor claims, a DIS should have adequate funding mechanisms in place, including supplementary backup funding for liquidity purposes. The funding of a DIS is the responsibility of the member banks since these banks and their depositors benefit directly from the DIS coverage.

Although each country can tailor its funding mechanism and contribution structure to its own circumstances, there are two generic approaches that policy makers have to choose from, namely pre-funding and post-funding.

6.1.1 Post-funding

In a purely post-funded approach, no money is held in a deposit insurance fund. In the event of a bank failure, the DIS obtains funding from the market, the government or the central bank to execute payouts, and the surviving banks then repay these funds through premiums. The main benefit of post-funding is that the opportunity cost of accumulating a fund is avoided, making it cheaper for the banking sector in the absence of a bank failure.

However, if there is a bank failure in a post-funded system, it can be more expensive and also unfair, because only the surviving banks then contribute to the cost, thus penalising the better-managed banks. A post-funded DIS is also pro-cyclical: bank failures are more likely in economic downturns, when other banks may already be under pressure and then have to be burdened with the additional contributions to be paid to refund the government or the central bank. A post-funded scheme also needs to borrow larger amounts more often from the government or the central bank if there are several bank failures, which puts a permanent contingent liability on the fiscal balance sheet. Post-funding is therefore not considered to be a best practice.

6.1.2 Pre-funding

A pre-funded scheme requires the accumulation and maintenance of a deposit insurance fund to cover deposit insurance claims and related expenses prior to a failure occurring. Most DISs are partially pre-funded. In almost all cases, a pre-funded DIS is supported by arrangements to enable borrowing from the market, the government and/or the central bank when there is a funding shortfall, and then to recover the funds after the failure through post-funding arrangements. The Core Principles consider pre-funding to be the best practice.

The main argument against pre-funding is the cost that it imposes on banks that may never be subject to liquidation, the opportunity cost of having a pool of funds available that may not be needed for several years, as well as the difficulty of having to determine an appropriate contribution system and fund size.

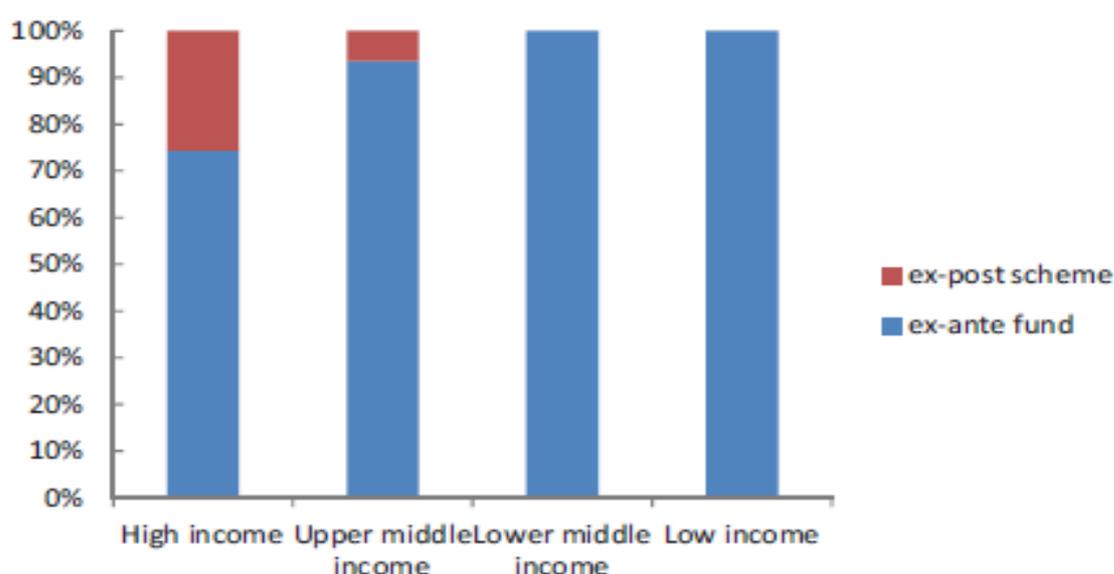
However, there are a number of benefits:

- While large banks may not necessarily use the DIS to pay out their depositors (as they may never be subject to failure), they do benefit from the enhanced financial stability provided by a robust DIS.
- The approach increases the credibility of the DIS in the eyes of the general public and ensures that the public knows that a sizeable amount of money is readily available to protect their deposits. It is less convincing to try to explain to the general public a range of complicated post-failure funding mechanisms than to simply say that 'the money is available'.
- A partially pre-funded DIS is less pro-cyclical than a fund that is entirely funded on a post-funded basis: provision is made in good times against costs that occur in bad times. Bank failures typically occur in a downward financial cycle, at which point it becomes even more difficult for surviving banks to fund the DIS.
- There is no need to use public funds, even temporarily, to resolve small banks that fail.

- Payout can be executed immediately, without parliamentary appropriation or another form of government approval.
- The failing banks have also contributed to the DIS and the burden is not only on the surviving banks.

Internationally, the majority of countries has adopted pre-funding, as shown in Figure 5. Post-funding is the exception, with no lower- to medium-income countries opting for this approach. The Core Principles promote an pre-funding approach as an international best practice.

Figure 5: DIS funding models



Source: Demirgüç-Kunt, Kane, Laeven. (2015)

It is proposed that South Africa adopt a partially pre-funded DIS, supplemented by clear and explicit emergency as well as post-funding arrangements such as extraordinary levies. The next section deals with the appropriate amount of pre-funding that should be maintained.

6.2 Target pre-funding amount

The target fund size has a direct effect on the cost of the DIS for banks. Therefore, the methodology to determine the target fund size is relevant to the assessment of the build-up mechanism. Unlike with 'normal' insurance, it is not actuarially possible to determine either the probability of failure or the exposure of the DIS in the event of

failure – variables that would be required to determine an appropriate target fund size and premiums in a scientific way. Instead, countries generally adopt a simpler target, such as a percentage of gross domestic product (GDP), total bank liabilities or total covered deposits.

The target pre-funding amount should be sufficient to reduce the probability that the DIS will run out of funds in all except the most severe bank failures or a banking crisis. Typically, the DIS should be adequately funded to compensate depositors through payouts in the event of small-bank failures, but in the event of a large-bank or systemic failure it should protect depositors by supporting another resolution strategy of the RA that involves a wider set of resolution tools. An acceptable fund for South Africa should be sufficient to cover the simultaneous failure of a number of small banks or the idiosyncratic failure of one medium-sized bank. Based on the survey analyses, it is proposed that the target size of the DIS be 5% of covered deposits. Based on the 2013 survey, this would require a fund of about R12 billion. Extrapolating the survey data to the end of 2016 indicates a target fund of approximately R17 billion.

Basing the fund size on a percentage of covered deposits rather than on a specific amount is regarded as a fairer practice in a system where some banks are proportionately more reliant on deposits that fall within the definition of ‘covered deposits’ and also record high growth in these deposits. Targeting a percentage of covered deposits prevents fast-growing retail banks from imposing a higher target amount on the whole banking system and ensures that those banks which contribute more to the exposure of the DIS also contribute more to the fund.

Internationally, the range of the target fund levels varies between 2% and 10% of covered deposits, putting the proposed 5% of South Africa in the mid-range.

6.3 Funding mechanisms

Two generic funding options are proposed in this section. Variations of these options would be discussed with the banking sector to achieve the most cost-efficient way to build up the target pre-funded amount.

6.3.1 Seed funding through a SARB loan

In terms of this funding option, the DIS will receive an interest-free loan from the SARB as seed funding, which will be repaid by levying premiums from the banks over a period of 10 years. Since the DIS funds will be held in a subsidiary within the SARB Group, there are implications for money market liquidity with regard to build-up, investment and payout decisions.

Table 2 summarises the estimated cost of pre-funding a targeted amount of R17 billion over 10 years with an interest-free loan.¹⁶

Table 2: Indicative cost of pre-funding through an interest-free loan provided by the SARB¹⁷

Amount borrowed from the SARB	R17 billion
Term of the loan	10 years
Interest rate	No interest
Fixed instalment per year	R1 700 billion
Monthly instalments	R144 million
Basis point cost per year (percentage of covered deposits)	50 basis points
Number of depositors*	44 749 million
Total covered deposits	R348 billion

* Some depositors have bank accounts at more than one bank, thereby inflating this number.

Source: SARB. 2015. *Deposit Insurance Scheme Survey*. Financial Stability Department

¹⁶ Although these calculations are based on the concept of a South African Reserve Bank (SARB) loan, they should be very similar if the deposit insurance scheme (DIS) is not funded with a SARB loan but built up over time with premiums.

¹⁷ Calculations are based on the information submitted by banks in the Deposit Insurance Scheme Survey of 2015, and then extrapolated to October 2016. These calculations do not consider deposit growth, interest earned on collected funds, or costs. The fund size in ten years was calculated as the contribution income based on the current total value of covered deposits, multiplied by ten.

There are a number of disadvantages associated with this funding model:

- This funding model is regarded as expensive. Based on informal discussions with the banking sector to date, banks seem to be more averse to funding mechanisms that will be accounted as an expense through their income statements because this has an immediate and direct impact on profitability and the future supply of regulatory capital through retained earnings.
- If the loan amount is a fixed amount to be repaid over 10 years, the fund will not grow in line with the growth in covered deposits. To allow the fund to keep up with the nominal growth in covered deposits, banks' premiums will have to increase continuously.
- This funding model presents a 'free rider' problem: once the fund is built up by existing banks, newly registered banks will share in the benefits of the fund without having made the same contributions.
- The cost of draining the money market liquidity that is created if the DIS invests funds in interest-bearing securities may be significant for the SARB. For example, at the current repo rate of 7%, it will cost the SARB about R2.6 billion to drain the additional liquidity created by a R12 billion loan amortised over 5 years and about R7.2 billion for a R17 billion loan amortised over 10 years. Charging some interest on the loan amount could alleviate the cost to the SARB to sterilise the money market impact, but it would increase the cost for banks, thus defeating the initial purpose of the loan.

For the reasons above, an alternative funding option has been developed for discussion with the banking industry.

6.3.2 Alternative funding option: reduction in the CRR

To alleviate the cost of the initial funding of the DIS, the SARB may consider allowing a one-off reduction in the statutory CRR from 2.5% to 2.0% of liabilities, as adjusted. Based on December 2016 figures, this would release an amount of approximately R18 billion, which roughly equals the required amount of 5% of covered deposits.

This amount could be transferred to the DIS as initial funding, after which banks would only have to maintain their 5% requirement as their covered deposits grow. After the one-off adjustment, banks would have to maintain a CRR of 2% of liabilities, as adjusted, as well as a separate DIS deposit of 5% of covered deposits.

The advantages of this proposal include the following:

- The DIS would be fully funded from day one – and it would be privately funded, as required in the Core Principles.
- The initial funding of the DIS will occur with minimal cash flow impact or additional opportunity costs for banks because the CRR balances are already deposited at the SARB and do not currently earn any interest. If banks' contributions remain on their balance sheets as an asset or an investment, there will be a limited impact on their profitability, except in the event of a failure.
- If banks maintain their required 5% of covered deposits at the SARB, the DIS fund will automatically grow at the same pace as banks' covered deposits, without the DIS having to invest the funds in securities. This avoids any money market liquidity impact and also makes the operations of the DIS much simpler by eliminating the need for extensive investment and risk management functions. It also significantly reduces the operational and staff costs of the DIS.
- The SARB will not have to provide a loan to the DIS, and the accounting for the DIS will be much simpler.
- This model solves the 'free rider' problem. Just like the CRR, the contribution to the DIS will be a condition for a bank licence and new banks will be required to contribute the same percentage of their covered deposits to the DIS as the other banks. New banks will therefore not receive the benefit of a reduced premium after the target fund size has been reached. If new banks take deposits away from existing banks, existing banks' required contributions will automatically decline as their covered deposit base declines.

- Reducing the CRR requirement will not have a severely detrimental impact on any individual bank's liquidity coverage ratio (LCR). Furthermore, banks may benefit from being able to classify covered deposits as stable retail deposits in the Net Stable Funding Ratio (NSFR) with a lower run-off factor.

Banks will have access to a lower level of cash reserves in the South African Multiple Option Settlement (SAMOS) system. Currently, banks have access to their cash reserves for intraday liquidity purposes in SAMOS. If they require liquidity, they can process an intra-account transfer instruction from their cash reserve account to their settlement account. They are required to transfer the funds back to their reserve account either on the same day or as soon as possible thereafter to ensure that they average their account balance over a 30-day period. If the reserve account requirement is lowered, it will result in the banks having less liquidity available to fund settlement. However, due to the binding constraint of having to average out the cash reserves over the holding period, banks tend to dip into the cash reserves in the mornings and try to replenish them by the end of the day. According to SARB's National Payment System Department, a reduction in the CRR should not have a destabilising effect on the SAMOS system. This will be confirmed in discussions with the banking sector.

On an individual-bank basis, there may be an initial misalignment between the transferred amount (which is based on liabilities, as adjusted) and the funding of the DIS (which will be based on covered deposits). Banks that have more covered deposits as a percentage of total liabilities are likely to be underfunded in the DIS, and banks whose covered deposits comprise a lower percentage of total liabilities will be overfunded. Banks that are initially underfunded will have to top up their DIS deposits to the required amounts, while banks that are overfunded will have a net reduction in their combined cash reserve and DIS requirements.

The main challenge with the CRR approach is uncertainty about whether the contributions of banks towards the DIS fund could be treated as an asset or should be accounted as an expense. Banks' CRR deposits are currently reported as assets in their balance sheets. If, for some reason, they are not allowed to treat their DIS contributions as an asset, they will have to account for them as an expense through the income statement. The SARB has engaged an auditing firm to provide an expert

accounting opinion in this regard, and will discuss the accounting treatment with the banking industry during the consultation period.

If banks' contributions to the DIS are classified as an asset, their total contributions should be refunded in the event of them voluntarily giving up their banking licence. In the event of a payout and liquidation, the claim by the DIS on the proceeds from the liquidation should be limited to the amount paid out by the DIS, minus the failing bank's share in the DIS.

Banks such as cooperative and mutual banks, as well as CFIs, do not have CRR deposits. Special arrangements will be made to allow for an appropriate contribution of their covered deposits to be made over multiple years. The proposal will take into consideration that these banks are almost wholly funded from deposits. The appropriate design should thus take into account the need to ensure that they remain competitive. Because these banks are relatively small, it should not have a material impact on the effectiveness of the DIS.

6.4 Start-up funding and cost of operations

Start-up funding refers to the initial money that should be available for the fund to become fully operational. Some of the major expenses in the establishment period relate to implementing the necessary systems, recruiting staff, ensuring that banks can provide the necessary data and information, and running a public awareness campaign. The SARB will carry its own start-up costs associated with the establishment of the fund. However, banks will be expected to have systems in place to adhere to the requirements of the DIS.

The DIS's ongoing running costs after establishment will be recovered through an annual membership fee to the DIS, which will be levied independently from the contributions to the fund, irrespective of whether banks have covered deposits or not. However, this annual membership fee is expected to be relatively small.

6.5 Emergency funding arrangements

Emergency funding is required when there is a funding shortfall during the build-up of the fund or thereafter due to one or more banks failing and requiring the use of the DIS's funds. Emergency funding arrangements for the DIS should include prearranged and guaranteed sources of liquidity funding and should be set out in law

or regulation. Sources of emergency funding may include a funding agreement with the government, the central bank and/or powers that allow the DIS to raise funds in the market.

For the South African DIS, it is proposed that the SARB should provide a committed funding line to the DIS for emergency funding purposes, which should be recovered afterwards through a combination of liquidation proceeds and contributions by surviving banks. The structure of such a loan should meet the conditions set out in the South African Reserve Bank Act 90 of 1989.

7. Coordination with other financial safety net participants

This chapter discusses the DIS relationships and coordination arrangements with other members of the financial safety net, both domestic and international.

7.1 Coordination with domestic financial safety net participants

It is important to note that a DIS should have an equal standing to other participants in the financial safety net. The SR Bill should provide the legal framework for the DIS to enter into a memorandum of understanding (MoU) and/or other arrangements with relevant financial safety net participants, such as the PA and the FSCA, for the purposes of information sharing and the coordination of activities, subject to confidentiality clauses. These MoUs and other agreements should clarify the roles and responsibilities between the different financial safety net participants.

7.2 Cross-border information sharing and coordination

According to the Core Principles, when there is a material presence of foreign banks in a jurisdiction, formal information sharing and coordination arrangements, subject to confidentiality clauses, should be in place among the deposit insurers in the relevant jurisdictions.

In the 2015 DIS survey conducted by the SARB, only one branch stated that its deposits were already covered by the home authority's deposit protection fund. Although the accuracy of this statement will have to be confirmed in the implementation of the DIS and formal agreements should be reached, it is not expected that there will be many local branches of foreign banks whose deposits will be covered by the DIS in their head office countries.

The local DIS should enter into bilateral agreements with foreign DISs, covering the deposits of the local branches of foreign banks to determine which DIS will be responsible for reimbursement, public awareness, and the determining of the levies and contributions to be made by the relevant banks. Even when the local branches of foreign banks are not covered by their head office's DIS, close relationships between the relevant DISs are essential to prepare for the impact that the resolution of head offices may have on their local operations and depositors in South Africa.

South African banks have a large presence in Africa. The resolution of a South African bank may therefore have a significant impact on its subsidiaries and branches in other African countries, which may affect financial stability in those countries if the affected bank is systemically significant and especially if the specific country has no deposit insurance in place. South Africa therefore has a key role to play in influencing the establishment of DISs in those African countries without a DIS and sharing best practices with those countries with established DISs.

The DIS will enter into bilateral arrangements with deposit insurers in countries where South African banks have a presence as well as with the host countries of the head offices of foreign banks with local branches.

7.3 Early detection and timely intervention

To comply with the Core Principles, the DIS should be part of the financial safety net framework that facilitates the early detection and timely intervention in troubled banks before they become non-viable. The DIS should have the analytical capability to develop a systemic analysis of the banking sector and develop early warning systems.¹⁸ Regular meetings between the DIS, the PA and other financial safety net participants should be held to discuss trends, identified outliers as well as the action(s) to be taken to address the concerns highlighted. A framework with clearly defined quantitative and qualitative criteria should be developed between the DIS and other financial safety net participants to trigger timely intervention and corrective action.

¹⁸ Hoelscher, D. 22-23 October 2014. *Updated core principles to strengthen the financial stability architecture*. 13th IADI Annual Conference: Port of Spain, Trinidad and Tobago. Available at dicth.org/wp-content/uploads/David-Hoelscher-Presentation.pptx.

8. The role of the DIS in resolution

This chapter describes the role of the DIS in resolution, contingency planning and crisis management.

8.1 Contingency planning and crisis management

The DIS should develop contingency plans and crisis management policies and procedures for its core functions, within the scope of its legal responsibilities, to ensure an appropriate response to bank failures and other events. Regular testing of these arrangements and the core functions of the DIS (such as the collection of data and the reimbursement of depositors) should be done through simulation exercises.

The DIS should also participate in the formulation and testing of system-wide crisis preparedness strategies and policies as well as in the development of pre- and post-crisis management communication plans with other financial safety net participants to ensure that there is consistent and comprehensive public awareness and communication.

8.2 The role of the DIS in resolution

In terms of the paybox-plus mandate recommended for the DIS, a DIS should have the power not only to directly reimburse the depositors of a failed bank (payout) but also to assist the RA through other resolution actions. Therefore, the DIS can play a variety of roles in resolution, including the following:

- Pay out to the covered depositors and take their place in the liquidation waterfall.
- Fund, partly or fully, the cost of a purchase and assumption resolution.
- Provide guarantees or loss-sharing instruments and bear costs.
- Compensate covered depositors who have been written off through bail-in.
- Provide funding for transfers to a bridge bank¹⁹ or for the sale to a private sector entity.
- Provide funds for an open bank resolution.

¹⁹ It is important to note that although the deposit insurance scheme (DIS) provides the funds for the establishment of a bridge bank, the Resolution Authority will be the owner of the bridge bank.

However, such actions should be subject to conditions to protect the fund and the interests of the member banks and depositors. The following minimum conditions should apply:

- The DIS should be informed of and involved in the resolution decision-making process.
- The use of the DIS's funds should be transparent and documented.
- The resolution of a failing institution should result in a viable, solvent and restructured bank. This should limit the DIS's exposure to further funding contributions for the same institution.
- The DIS should not contribute gross that is more than it would have paid out to covered depositors in a liquidation.
- The DIS should not take on an expected net exposure greater than the amount it would have paid out to covered depositors in a liquidation net of expected recoveries.
- The DIS should not contribute to the recapitalisation of resolved institutions without the shareholders' interests being reduced to zero and unsecured, uninsured creditors being subject to pari passu losses in line with the creditor hierarchy.
- Following a resolution using funding from the DIS, a review should take place to determine whether the resolution option had been the least-cost option and whether correct procedures were followed in the use of the DIS's funds.

To facilitate the DIS's support to the Resolution Authority, the DIS should be represented on a Resolution Committee to be established by the Resolution Authority. The DIS should be able to highlight the conditions applicable to the use of its funds, but should not have veto power with regard to resolution decisions made. The DIS should also be involved in the resolution planning process and crisis

management colleges as the resolution options may require the use of the DIS's funds.

A resolution fund is used for different resolution tools than a DIS fund and is not subject to the restrictive conditions applicable to a DIS's funds. It is an important element of a resolution framework, and the establishment of a resolution fund for South Africa will be considered in future.

8.3 Reimbursing depositors

The DIS should give depositors prompt access to the portion of their deposits that is insured. In order to facilitate prompt payout, the DIS should be informed in advance of when it would need to reimburse depositors, and it should be provided with depositor information in advance as well.

The depositors should have a legal right to reimbursement up to the cover limit and should know when and under what conditions the DIS will initiate the payment process, the time frame for payout, whether any advance or interim payments will be made, and the applicable coverage limits. In this regard, the trigger for DIS payout needs to be clearly defined as it will determine when and how the reimbursement of depositors will take place.

The DIS should develop an information strategy in advance to inform depositors of the process to be followed and the requirements to be met for the payout of deposits once a bank is placed under resolution. The DIS should make the necessary arrangements to ensure that a range of reimbursement options is available to facilitate the payout of depositors' funds. These options may include cheque payments, electronic transfers, payment agents, cash payments, and the transfer of deposits through a closed-bank purchase and acquisition transaction.

Payout should occur as soon as possible after a bank has entered resolution. The trigger for a DIS payout to depositors would be when the RA invokes the DIS, i.e. the decision resides with the RA and will depend on the resolution strategy that it adopts. Initially, the aim of the DIS will be to put systems in place to be able to pay depositors out within 20 working days after the closure of a bank for deposit accounts where ownership is easily identifiable (such as single accounts and joint accounts). The payout process for deposit accounts where ownerships is not easily identifiable (such as pooled accounts) may be longer. Over time, the DIS should reduce the payout

period for all covered deposits, ultimately aiming at payout of all covered deposits within seven working days.

Regular simulation and stress-testing exercises of the DIS's payout process will need to be undertaken and will require member banks to provide depositor information in the required format. The purpose of these exercises will be to identify any vulnerabilities that may need to be addressed and improvements to be made.

8.4 Dealing with parties at fault

Since the RA will control the resolution of a failing bank or delegate it to the PA, legal redress against parties at fault in a bank failure will be done by the RA or the PA.

8.5 Recoveries

The Core Principles recommend that a DIS share in the proceeds of the estate of a failed bank in order to replenish the funds used in the reimbursement of covered depositors. The payout to covered depositors by the DIS will result in their claims against the failed institution becoming subrogated to the DIS, meaning that the DIS will become a creditor of the estate of the failed institution for the amount that had been paid out, net of the failing bank's contributions to the DIS, to allow the DIS to recover its funds.

In countries where there is depositor preference, the DIS could, through subrogation, have preference over other creditors in recovering funds from the estate of a failed bank. The SR Bill provides for depositor preference for South Africa.

8.6 Legal protection

The SR Bill should include provisions for the protection of all current and former employees of the DIS (including contractors) against any liabilities arising from the actions, claims, lawsuits or other proceedings for their decisions, actions or omissions made in good faith during the normal course of their duties.

9. Other factors relating to the establishment of a DIS

There are a number of miscellaneous factors that are important to consider in the establishment of a DIS, which are briefly discussed in this section.

9.1 Reporting by banks to the DIS

Ideally, banks should have an SCV to determine the total value of deposits held by a single customer. This is not a new requirement; regulation 26(11) of the Regulations relating to Banks requires banks to be able to measure and manage depositor concentration. Banks should be able to use their SCVs to report consolidated depositor information in a specified format to the DIS, on a monthly basis. This information will be assessed to determine the contribution to be paid by each bank and to facilitate prompt payout. For this purpose, banks will have to be able to produce detailed SCV data in a short period similar to the time frame for the targeted payout period, when required. The DIS should, from time to time, verify banks' SCV data for accuracy and completeness through on-site inspections and off-site testing exercises. Because accurate information on covered deposits is so essential for the DIS to achieve its objectives, there should be mechanisms in place to enforce compliance, such as fines and penalties.

Based on the survey, not all banks were able to report SCV numbers. However, banks will have to develop their systems to calculate SCV balances on a daily basis once the DIS is in place. Such system developments may require an implementation period before the DIS can be fully operational.

9.2 Transition to an explicit, privately funded DIS

The transition from an implicit guarantee (which might have been perceived to be without limits) to an explicit and privately funded but limited DIS should be a managed process, taking into account the following factors:²⁰

- The public may be concerned that the level of protection of their deposits would be reduced in a limited-coverage system. The conditions of the new system,

²⁰ Bank of England. 1996. *Deposit insurance*. Available at <http://www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ccbshb09.pdf>.

and the fact that payouts would be quick and certain, should be clearly communicated.

- The DIS must be credible from the outset; the public should have confidence in the ability of the fund to make prompt payouts when required, and that it is sufficiently funded to be able to do so.
- The capacity of the banking system to fund the newly established DIS should be considered since the banks will now be required to maintain their contributions. There should also be a mechanism in place to ensure that the DIS will have access to sufficient funding during and after the period of transition.
- The speed of the transition should be determined by the country's circumstances. The transition period should be long enough for banks and depositors to prepare for and become accustomed to the new arrangements. However, during the transition period, there could be uncertainty about whether deposits are covered at all, implicitly or explicitly, and a long transition period could give rise to doubts about the authorities' commitment to the DIS.

Considering these issues, a detailed transition plan should be developed and implemented, in consultation and cooperation with the banking sector.

9.3 Public awareness

For the DIS to have credibility from the outset, its establishment should include a comprehensive and professional public awareness programme as well as an ongoing campaign to maintain public awareness of the coverage conditions of the DIS. Such a programme should inform depositors about the scope of coverage, member banks, coverage level limits and other information, such as the mandate of the DIS.

In this regard, the DIS should work closely with the FSCA, but should be in control of all public awareness material. The DIS should be responsible for the provision of brochures and other materials to member banks to distribute to their clients.

Regular public awareness surveys should be conducted to determine the effectiveness of the strategies employed to raise public awareness.

10. The way forward

The planned process and timelines going forward are as follows:

- Comments on this discussion paper should be received by 31 August 2017.
- Industry workshops will be arranged during June, July and August 2017.
- Relevant aspects of the DIS will be included in the Resolution Bill, taking into consideration the comments received.

Annexure A: Factors considered to define ‘covered deposits’

Annexure A provides further details on the factors that were considered in refining the definition of ‘covered deposits’. The arguments for and against various aspects are discussed.

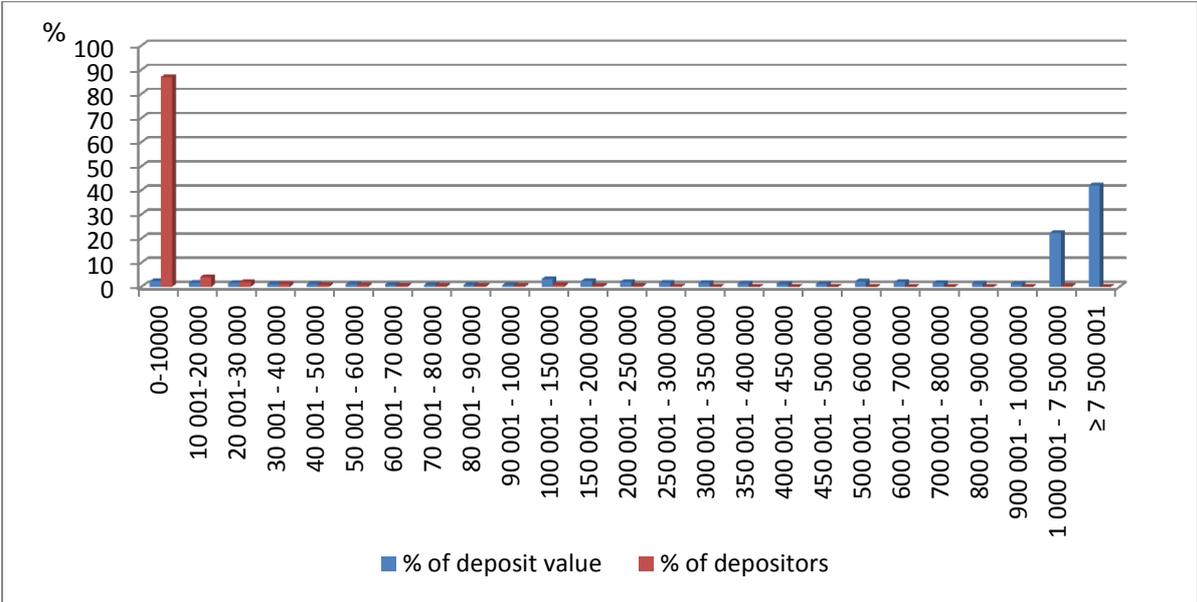
1. Retail or wholesale depositors

It is often argued that protection should focus on smaller retail deposits where the information asymmetry is the greatest, that protecting wholesale depositors increases the funding required for the deposit insurance scheme (DIS), and that deposit insurance could increase moral hazard.

However, in the South African context, the inclusion of only retail deposits does not seem to be the best policy choice, since:

- The distribution of deposits in South Africa is very skewed, as shown in Figure 1 below. Wholesale deposits are typically large in value but relatively few in numbers. Survey data indicate that potentially qualifying wholesale deposits comprise 40% of the total value of qualifying deposits in South Africa, but only 0.13% of the total number of potentially qualifying depositors. Because these deposits are large, the amount of coverage will be relatively insignificant, discrediting the moral hazard argument.

Figure 1: Number of qualifying depositors and value of deposits



Source: SARB. 2015. *Deposit Insurance Scheme Survey*. Financial Stability Department.

- If banks' contributions are based on the amount up to the limit of coverage, the cost of insuring the covered amount will be immaterial relative to the size of the deposits for potentially qualifying wholesale depositors, discrediting the cost argument.
- The excluded wholesale deposits are easily identifiable and are already reported separately on banks' regulatory returns. These deposits are usually excluded from depositor protection funds in most countries.

In summary, including both retail deposits and potentially qualifying wholesale deposits reduces uncertainty and simplifies the calculations of contributions and payout amounts without a significant impact on either the cost or the potential protection benefit for qualifying wholesale depositors and without requiring significant changes to the way in which individual banks classify their clients.

2. Covering small and medium enterprises

Small and medium enterprises (SMEs) are generally covered by depositor protection arrangements to prevent extensive failures of SMEs in the event of a bank failure. Also, SMEs are relatively more dependent on their bank deposits for operational expenses, are important employers in the economy, and generally do not have access to alternative sources of emergency funding the way large corporates may have. However, while there are good reasons why SMEs should be covered, the separation of SMEs from larger corporates creates significant definitional uncertainty and ambiguity without significant benefit.

There are practical complexities which make the singling out of SMEs problematic. Regulation 26 of the Regulations relating to Banks (Regulations) defines small businesses as those having total aggregated deposits (funding) of less than an amount specified by the Registrar of Banks, irrespective of the business type (sole proprietor, closed corporation or partnership). In terms of Directive 1 of 2016, issued in terms of section 6(6) of the Banks Act 94 1990, a small business is defined as a small business customer with total aggregate amount of funding of less than R12,5 million. This definition has been adopted for regulatory reporting purposes. However, in practice, there is not necessarily a correlation between the size of a business' bank

deposit and the size of its balance sheet, number of employees or operational costs. The way in which a business manages its accounts could also affect its classification. For example, moving funds between a direct deposit and a money market fund could affect a business' definition as an SME in terms of regulation 26 of the Regulations. Balances could also fluctuate significantly over a month or over a year, fuelling uncertainty about whether the SME is covered by the DIS at a specific payout date.

Another finding of the survey (of which more detail is provided in Chapter 5) was that banks' reporting of SME deposits in terms of this definition varied greatly. Banks do not apply a consistent classification of their SMEs and other corporate deposits. Their internal classifications differ according to their business models, their organisational and management structures, their product mixes, their client bases, and their size. According to the survey, the reported number of SMEs amounted to 4% of the total number of potentially qualifying depositors, representing 16.5% of the total value of potentially qualifying deposits.

Because of the difficulty in distinguishing between SME and non-SME businesses, the recommendation is to cover all private non-financial business entities up to the coverage limit, regardless of the size of their deposits or their legal identity.

3. Foreign depositors

In order to comply with international guidance, to contribute to financial stability by preventing a deposit run, and to avoid excessive compliance and/or administrative costs for banks, it is proposed that both South African and foreign depositors be included in qualifying deposits. The proportion of non-resident depositors is small, so the impact on the DIS should be minimal.

4. Distinguishing between deposit products

It is a policy option to distinguish between different types of deposit products in the definition of 'qualifying deposits', e.g. fixed or call deposits and short-term or long-term deposits. In the survey, all types and maturities of deposits (savings, fixed and notice deposits), all counterparties and all currencies were included. The policy view is that coverage under the DIS should cover all types of deposit products, firstly because bank products are difficult to describe in law, secondly because bank products change over time, and thirdly because any exclusions are likely to affect depositor behaviour. For example, covering only short-term maturities may

incentivise short-term deposits, with adverse implications for liquidity management and regulatory liquidity standards.

5. Deposits at foreign branches and subsidiaries of South African banks

A further consideration relates to whether deposits at foreign branches and subsidiaries of South African banking groups should be included in the definition of 'qualifying deposits'. The deposits held at foreign branches and subsidiaries currently comprise a small proportion of the South African banking groups' total deposits and therefore do not present a significant contagion or liquidity risk. However, they are expected to grow in future due to the expansion-into-Africa strategies of South Africa's largest banking groups. Since the South African resolution regime will not be applicable in those countries and since the contributions by banks cannot be levied directly on the foreign branches or subsidiaries of the local banks, these deposits should not be included as qualifying deposits by the DIS.

6. Foreign currency deposits

On considering whether only rand-based or also foreign currency-denominated deposits should be included, the survey confirmed that foreign currency-denominated deposits are relatively small, at less than 3.8% of total potentially qualifying deposits. The recommendation is therefore that foreign currency-denominated deposits be included in the definition but that the coverage limit and payout be in rand, at the official exchange rate, on the day that the deposit insurance payout is triggered.

7. Treatment of accrued interest and fees

Interest-accrual and account fees are other factors to consider when determining the definition of 'qualifying deposits'. Accrued interest is part of the contractual obligations of the bank towards the depositor. It could have cost implications for banks' systems if the daily calculation of accrued interest is not done in the normal course of business, but such instances would be exceptions as most banks should be able to calculate accrued interest on a daily basis. Account fees are a contractual obligation of the depositor to the bank, but the calculation of intra-month pro rata account fees for netting purposes is not usually done in the normal course of business. Such calculations are more likely to have administrative costs for banks, with minimal benefit. Therefore, the recommendation is for accrued interest to be

included in qualifying deposits but for the netting of account fees to be excluded. This is in line with international best practice.

8. Gross or net deposits

Coverage could be done on a gross or a net basis. Gross coverage ignores any amounts that the depositor may owe the bank, while net coverage entails deducting from the deposit the amounts borrowed from the bank. Gross deposits should be covered for administrative efficiency and also to support the financial stability objectives of the DIS. In terms of efficiency, calculating net balances would be costly for banks and would cause delays in the payout process. However, from a financial stability and depositor protection perspective, loans are typically long term while deposits are mostly held for shorter-term transactional purposes. Many depositors owe the bank more than they have in deposits, e.g. a home loan compared to a salary deposit. Netting would result in them not receiving any payout and would defeat the purpose of the DIS. With payout based on gross qualifying deposits, the value of the loans would be recovered or preserved through a liquidation or resolution process respectively. This approach is in line with international best practice.

9. Pooled and joint accounts

The proposal is for pooled accounts to be treated as a single account. It becomes administratively complex to determine with certainty who the underlying beneficiaries of a pooled account are, e.g. stokvel members or body corporate members, especially when the account holder is not a regulated legal entity. Consultation with the banking industry will take place to consider the feasibility of covering the individual beneficiaries of pooled accounts that meet the criteria of qualifying deposits.

The one exception where a look-through approach is recommended is for pooled accounts in which professional practitioners hold deposits on behalf of clients, e.g. attorneys or estate agents. The reasons for this deviation are that the underlying beneficiaries should be easily identifiable and that the temporary large-balance effect is more likely to be applicable. Funds in these accounts usually result from real-estate transactions, divorce settlements and other legal settlements that could

represent a major part of a client's wealth at a certain point in time. However, the single customer view (SCV) should still apply so that the amounts in the pooled account are combined with the deposits outside the pool when applying the coverage limit per depositor.

For a joint account, where one account is held by separately identified account holders, each account holder will be covered separately by the DIS, up to the coverage limit. The deposit balance will be split equally between the account holders, unless there is underlying account documentation specifying a different arrangement.

Consultation will be undertaken on the treatment of liquidity buffers held by Cooperative financial institutions (CFIs) and cooperative banks. These are required for regulatory purposes and are typically held at a large bank.

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List of abbreviations

BASA	Banking Association of South Africa
Board	Board of Directors
Core Principles	IADI's Core Principles of Effective Deposit Insurance Systems
CRR	cash reserve requirement
DIS	deposit insurance scheme
FIRST	Financial Sector Reform and Strengthening Initiative
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
FSR Bill	Financial Sector Regulation Bill
FSCA	Financial Sector Conduct Authority
FSCF	Financial Sector Contingency Forum
FSR Bill	Financial Sector Regulation Bill
G20	Group of Twenty
GDP	gross domestic product
IADI	International Association of Deposit Insurers
IMF	International Monetary Fund
Key Attributes	Key Attributes of Effective Resolution Regimes for Financial Institutions
LCR	liquidity coverage ratio
MoU	memorandum of understanding
NSFR	net stable funding ratio
NCD	negotiable certificate of deposit

National Treasury	National Treasury [of South Africa]
PA	Prudential Authority
PN	promissory note
SAMOS	South African Multiple Option Settlement
SARB	South African Reserve Bank
SCV	single customer view
SME	small and medium enterprise
SR Bill	Special Resolution Bill
TBTF	too big to fail
UK	United Kingdom