CoDI’s consultation on its funding model

On 1 September 2020, the South African Reserve Bank (SARB) published the paper titled *The deposit insurance funding model and the implications for banks* (the funding paper), which outlined the funding model proposed for the deposit insurance scheme (DIS) in South Africa, including details of its premiums and levies.

Background

The Financial Sector Laws Amendment Bill (FSLAB) contains amendments to the Insolvency Act 24 of 1936 (Insolvency Act), and introduces preference for covered deposits in liquidation. Clause 166AD of the FSLAB specifies that CoDI will assume the rights and remedies of a covered depositor of a bank in resolution once it has paid out funds to such a depositor. This higher ranking for CoDI in the creditor hierarchy should result in CoDI recovering most of the funds paid out to the covered depositors of a failed bank.

The policy proposals contained in the funding paper was developed subsequent to significant consultation with banks, by considering country-specific characteristics as well as applicable international standards, such as the Core Principles for Effective Deposit Insurance Systems (Core Principles) and other guidance issued by the International Association for Deposit Insurers (IADI). Consideration was also given to reduce the direct impact of CoDI’s funding on banks’ profitability by allowing a portion of the members’ funding contributions to be accounted for as an asset on members’ balance sheets, instead of being expensed through their income statements. This resulted in a tiered funding structure.

The most common practice of funding a new pre-funded DIS is to collect premiums to build a fund to a targeted overall amount over a couple of years. During the build-up period, the DIS remains underfunded. Sometimes new deposit insurance schemes receive seed capital from their government or from international organisations, which has not been the case in South Africa. The funding model proposed for South Africa is somewhat unique, designed to overcome an underfunded situation in a cost-effective manner, while still allowing CoDI to fulfil its obligations.

Funding model

The funding model for CoDI presented in the funding paper is comprised of three tiers as follows:

- a tier consisting of the DIF's own funds, built up through monthly premiums;
- a liquidity tier, which includes funds members will place with CoDI; and
- an emergency funding facility provided by the SARB.

As needed	**Emergency Tier (SARB emergency funding)** • Only needed in exceptional cases • First to be repaid by CoDI from proceeds of liquidation • If shortfall, repaid through additional contributions by banks
3% of covered deposits per year	**Liquidity Tier (Funds placed by banks with CoDI)** • Details in standard: Interest-earning asset for banks • Used for liquidity during payout – advance against liquidation proceeds • High degree of certainty of recovery from liquidation proceeds • Adjusted monthly in line with covered deposit balance
0.2% of covered deposits per year (0.2%/12 per month)	**Own Funds (Premiums by banks)** • Funded through premiums (expensed) • Flat premiums of 20 bps per year (paid monthly)
Annual levy to cover operational costs: 0.015% of covered deposits	

The deposit insurance fund (DIF) will be used to pay out the covered depositors of a failed bank or to support resolution with funds when a bank has been placed in resolution. The DIF will consist of the liquidity tier and CoDI's own funds, including the return earned by CoDI on the investment of these funds. To determine the size of these two tiers, the Resolution Planning Division within the Financial Stability Department modelled the estimated payout amounts and proceeds from liquidation of several smaller banks[1] where liquidation will be the most likely resolution strategy should these banks fail. Payout amounts were estimated from the results of previous surveys of banks' covered deposits, and liquidation values were estimated by

[1] Large banks have been declared significantly important financial institutions (SIFIs) and will, where possible, follow an open-bank resolution strategy.

assigning recovery rates to the different asset categories reported in the regulatory returns, ranging from the highest quality assets (such as high-quality liquid assets) with a 100% recovery rate, to the lowest quality unsecured but performing loans, assuming a 30% recovery rate.

CoDI's target fund size for the DIF will accordingly be 4%, consisting of 3% of the liquidity tier plus 1% in the tier with the DIF's own funds. The DIF's own funds will be built up over a period of five years. The intention is to change the composition of the DIF over time by gradually reducing the size of the liquidity tier as the DIF's own funds grow.

The analyses showed that only in the case of a number of small banks is CoDI expected to experience a shortfall in the proceeds of liquidation with which to replenish the funds paid out[2]. The shortfalls would be covered by CoDI's own funds and possible ex-post premiums.

CoDI's own funds (premiums)

The Financial Sector Levies Bill (Levies Bill) specifies that the premium will be 0.2% of all members' covered deposits per year, but payable monthly. The premium will remain at 0.2% per year until the target fund size has been achieved; CoDI has reviewed its funding needs; or a differentiated premium structure has been introduced.

Members will have to expense the premiums through their income statements and will have no future claim on the contributions once paid.

The frequency of premiums has been aligned to the frequency of the deposit insurance submissions. For banks that do not have any covered deposits, there is no premium amount payable.

Future development of the funding model may include:

- setting a range for CoDI's premiums to allow for flexibility to adjust the premium;
- the introduction of differentiated premiums for members; or

[2] There is a high degree of uncertainty in estimating liquidation values from the regulatory returns. As part of the implementation of the resolution framework, a more sophisticated model to determine more accurate estimations of liquidation values for individual banks will be developed. This information will enable a further refinement of estimated recovery rates and the calibration of the different funding tiers of the DIS will be adapted accordingly, if required.

- ex-post premium contributions.

Recoveries may take several years, which may necessitate ex-post premiums after a payout has occurred since the DIF would need to be replenished and the SARB may need to be repaid for emergency funding provided (depending on the size of the failed bank's covered deposit base). The framework for ex-post premiums still has to be developed and, if a framework is published, banks will have the opportunity to comment before the relevant legislation is amended.

Levies

Members will pay an annual levy to CoDI as an expense through their income statements. CoDI cannot use funds from the DIF to cover its operational expenses. The levy will be used to fund CoDI's operations and will include items such as staff costs, public awareness costs (there may be an additional financial impact on banks to comply with their public awareness obligations) and a fee payable to the SARB for the provision of support services to CoDI. CoDI will establish a reserve fund to provide for the maintenance, enhancements and upgrades of CoDI's systems or other potential large expenses to avoid increasing the levy percentages too often.

Currently, the Levies Bill provides for the levy percentage at 0.015% per year of a member's covered deposits, with a minimum levy amount of R1 000 per year. This percentage is based on estimations of CoDI's operational budget upon its establishment. CoDI's full operational costs will only become known once it becomes operational. One example of an expense where the costs were unknown when the initial estimates were done is the cost relating to the SARB's support services.

All annual levy payments will be based on each member's March covered deposit balance[3].

A member with no covered deposits for the March reporting period must pay a fixed levy of R1 000 to be a member of CoDI. If a member has covered deposits but the calculation results in a levy amount of less than R1 000, the minimum amount of R1 000 will be payable by the member.

[3] Aligned to CoDI's financial year end of March.

In the future, CoDI will have a range for levies to enable it to adjust the levy members have to pay periodically, based on its requirements.

The actual operational cost for CoDI will be firmed up after the establishment of CoDI and the annual levy percentage in the Levies Bill will be adjusted, when necessary, based on CoDI's requirements. For example, if system changes are required and the reserve fund built up by CoDI is insufficient, the levy will be adjusted upwards.

If the levy income in a financial year exceeded CoDI's operational expenses, the FSLAB[4] will allow for the surplus funds to be credited to the DIF.

Future revisions to the funding model

CoDI will perform analyses to review its funding needs and funding model at least every five years. Revisions to the funding model could include:

- reducing the size of the liquidity tier (based on more advanced modelling as better information from the implementation of the resolution framework becomes available);
- reducing or removing the liquidity tier when the DIF's own funds has built up sufficiently;
- adjusting the size of the premiums and levies based on CoDI's funding and operational requirements;
- aligning to new guidelines and principles published by IADI; and
- adopting differentiated funding obligations for banks with different risk profiles and/or resolution plans.

Conclusion

The funding paper contained additional information on the liquidity tier and emergency funding, discussed the financing of CoDI's governance, administration and operational costs, presented various scenarios for the calculation of members' financial obligations and treatment thereof in special situations, and considered the consequences of non-compliance with submissions and payments by banks.

[4] Clause 166AT (Surplus funds)

CoDI received a number of comments on the proposals contained in the funding paper. Most of the comments received on the funding paper's proposals pertained to the liquidity tier and CoDI's governance and not to the levies and premiums payable to CoDI. The final structure, terms and conditions of the liquidity tier will be addressed in a future discussion paper on the fund liquidity tier.

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