STRENGTHENING SOUTH AFRICA'S **RESOLUTION FRAMEWORK** FOR **FINANCIAL** INSTITUTIONS

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

South African Reserve Bank

FSB
FINANCIAL SERVICES BOARD

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CONTENTS

ABBREVIATIONS

ASISA	Association for Savings and Investment South Africa
BASA	Banking Association of South Africa
BRRD	Bank Recovery and Resolution Directive
CMG	Crisis Management Group
CPs	core principles for deposit insurers
DGS	Deposit Guarantee Scheme
DRI	designated resolution institution
D-SIB	domestic systemically important bank
EC	European Council
EEA	European Economic Area
FSCA	Financial Sector Conduct Authority
FMI	financial market infrastructure
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
FSB-SA	Financial Services Board
FSRB	Financial Sector Regulation Bill
G-20	Group of Twenty
GDP	Gross Domestic Product
GLAC	Gone-concern Loss-Absorbing Capacity
G-SIFI	Global Systemically Important Financial Institution
IADI	International Association of Deposit Insurers
IMF	International Monetary Fund
IVSC	International Valuation Standards Council

ISDA	International Swaps and Derivatives Association
KAs	Key Attributes of Effective Resolution Regimes for Financial Institutions
LAC	Loss-Absorbing Capacity
LGD	Loss Given Default
MoU	Memorandum of Understanding
MPE	multiple point of entry
NCWO	no-creditor-worse-off (than in liquidation)
NT	National Treasury [of South Africa]
PA	Prudential Authority
PONV	Point Of Non-Viability
POR	Point Of Resolution
RA	Resolution Authority
RRP	Recovery and Resolution Plan
SARB	South African Reserve Bank
SCV	Single Customer View
SIFI	Systemically Important Financial Institution
SME	Small and Medium Enterprise
SPE	Single Point of Entry
SRB	Special Resolution Bill
TBTF	too big to fail
TLAC	total loss-absorbing capacity
UK	United Kingdom
OTC	over the counter

PURPOSE

The paper sets out the motivation, principles and policy proposals for a strengthened framework for the resolution of designated financial institutions in South Africa, referred to in this paper as 'designated resolution institutions' (DRIs).

DRIs are defined as:

i. registered banks[1];
ii. non-bank financial institutions that are designated as systemically important financial institutions (SIFIs)[2] in terms of the Financial Sector Regulation Bill (FSRB);
iii. Financial market infrastructures (FMIs) that are designated as SIFIs in terms of the FSRB; and
iv. the groups within which i, ii or iii operate, from the ultimate holding company downwards, including foreign branches and subsidiaries.

The paper mostly sets out how the special resolution framework for DRIs will apply to banks, but highlights that further work will be undertaken to develop specific proposals on applying the special resolution framework to non-bank financial institutions (including insurers), FMIs and financial conglomerates.

It is a position paper that is intended to solicit public comment and to serve as a basis for further industry discussions in preparation for the drafting of a special resolution bill. The content reflects the collective views of the National Treasury (NT), the South African Reserve Bank (SARB) and the Financial Services Board (FSB-SA).

[1] Registered banks refer to any bank registered in terms of the Banks Act 94 of 1990, a cooperative bank registered in terms of the Cooperative Banks Act 40 of 2007 or a mutual bank registered in terms of the Mutual Banks Act 124 of 1993.
[2] The factors for assessing whether a financial institution is systemically important are its size, its complexity, its interconnectedness, the lack of readily available substitutes for the financial products, services or infrastructure it provides, and its global (cross-jurisdictional) activity and, in the context of resolution the likely impact of a disorderly failure of the financial institution on the financial system and the real economy.

EXECUTIVE OVERVIEW

In 2011, NT published a policy paper titled 'A safer financial sector to serve South Africa better', followed by a further paper in 2011 titled 'Implementing a twin peaks model of financial regulation in South Africa'. NT subsequently published first and second drafts of the Financial Sector Regulation Bill (FSRB) in 2013 and 2014 respectively, which set out the twin peaks framework of regulatory reform in South Africa.

The FSRB assigns an explicit responsibility to the SARB to monitor and enhance financial stability. As part of its explicit financial stability mandate, the SARB is responsible for assisting with the prevention of systemic events (Box 1) and, in the event that a systemic event occurs, contain the consequences thereof. A systemic event could include the failure of financial institutions, which will have to be managed in an orderly manner in order to protect financial stability. The paper sets out key proposals for strengthening South Africa's resolution framework for DRIs so that the failure of financial institutions can be managed in a way that will mitigate any negative impact on South Africa's financial stability and minimise macroeconomic cost.

Box 1: Systemic event

In terms of the FSRB, a systemic event means an event or circumstance where:

1. a financial institution, or a group of financial institutions, cannot provide the financial products or financial services that they have contractually undertaken to provide; or
2. there is a general failure in confidence of financial customers in the ability of one or more financial institutions to continue to provide financial products or services to an extent that may reasonably be expected to have a substantial adverse effect on the financial system and economic activity in the Republic of South Africa (the Republic), irrespective of the event or circumstance occurring or arising inside or outside the Republic.

Once finalised, the paper will form the basis from which a special resolution bill (SRB) will be drafted. Such a bill should:

- designate the SARB as the resolution authority (RA);
- specify resolution objectives;
- contain the necessary resolution powers for DRIs;
- enhance current applicable powers;
- establish appropriate safeguards in the use of resolution powers;
- provide a financial safety net for vulnerable depositors;
- reflect the unique aspects of South Africa's financial sector; and
- adhere to international best practice and comply with internationally agreed standards.

The SRB may be expanded over time as proposals are finalised on applying the special resolution framework to non-bank financial institutions (including insurers), FMIs and financial conglomerates.

The existing resolution provisions in other legislation should also be revised, where necessary, to support the resolution of a DRI in line with the objectives of the SRB. In some instances, provisions in existing legislation could be incorporated into the new bill. The paper is structured as follows:

Chapter 1 explains the rationale for an SRB for DRIs. This motivation is based on the key role that financial institutions, in particular banks, play in the financial system and the economy, and the destructive effect that their disorderly failure could have on the financial system and the real economy. South Africa's current framework for dealing with distressed financial institutions is also assessed against international best practice, with a number of gaps identified that should be addressed in the SRB.

Chapter 2 describes the key governance and administrative features of the envisaged SRB, namely its objectives, the scope (i.e. which institutions should fall in the ambit of the bill) and the role and responsibilities of the SARB as the designated RA.

Chapter 3 describes the ongoing, pre-crisis processes that should be in place, and the powers required for these processes, in order for the RA to be best prepared to execute an orderly resolution. Included among these is the function of administering a deposit guarantee scheme, which will be introduced as part of the strengthened resolution framework.

Chapter 4 deals with aspects related to the actual resolution process in terms of the envisaged SRB. It gives an indication of the criteria that would be applied to trigger entry into resolution, the powers that would be available to the RA in resolution and the safeguards that should be built into the framework.

The SRB will overlap with a number of current provisions in legislation that deal with the management and/or wind-down of failing financial institutions. **Chapter 5** highlights the main areas of alignment that will be required with existing legislation.

The paper also has three **annexures**. The annexures provide more information on specific topics and describe the reasoning behind some of the policy views as well as areas where more work is still required. These topics are the design features of a deposit guarantee scheme, bail-in as a recapitalisation tool, and the creditor hierarchy in liquidation for financial institutions.

The way forward and planned timelines are set out at the end of the paper. Comment is invited on all the proposals and issues set out in the paper and the annexures thereto.

CHAPTER 1
INTRODUCTION

A SPECIAL RESOLUTION FRAMEWORK FOR FINANCIAL INSTITUTIONS

Financial institutions perform essential intermediation functions in the economy. They allocate financial resources from savings to investments and consumption, provide vehicles for wealth accumulation, perform maturity transformation functions that facilitate the financing of long-term projects, provide liquidity, and facilitate a payment, clearing and settlement function in the economy, including cross-border payments. As these institutions grow in size and sophistication, they provide economies of scale, cost-effectiveness, efficiencies and risk-management processes that benefit their customers and the economy at large. Without a well-developed, safe and efficient financial system, growth in the real economy is constrained.

However, as financial institutions become larger and more sophisticated, they also become increasingly complex, interconnected and integrated into the fabric of the real economy. As a result, the failure of a single financial institution could result in a deadlock in critical financial markets and services, which could quickly spread through the financial system to other markets and institutions, and which could result in economic costs that vastly exceed the costs of the initial single failure. Past experience has shown that normal corporate insolvency arrangements are inadequate to deal with the potential financial system instability caused by the failure of some financial institutions.

Because of the destructive impact that the failure of some financial institutions could have on the real economy, especially if such institutions are large, complex or very interconnected, they are often regarded as being 'too big to fail' (TBTF), with a general expectation among depositors and investors that they will always be rescued if they do fail, most likely with taxpayer funds. Financial institutions that have the potential to dislocate a whole financial system and cause severe real economic costs if they fail have come to be referred to as systemically important financial institutions (SIFIs).[3]

Banks are most likely to be designated SIFIs from a resolution perspective because of their deposit-taking, maturity transformation and payment system roles. One of the key functions of banks in the economy is to facilitate the maturity transformation of money, that is, to turn short-term savings into long-term credit. Banks fund themselves mainly through deposits and deposit-like instruments with relatively short maturities. They use this short-term funding to provide longer-term credit, such as mortgages. This balance-sheet structure exposes banks to liquidity risk (i.e. the risk that short-term funding can be withdrawn instantly, while longer-term loans are only repaid over years).

Because of banks' high liquidity risk, they require a different approach to their rescue or resolution than other types of businesses. A non-bank corporate normally approaches insolvency over an extended period and the deterioration of its financials becomes apparent over time. However, even a relatively well-managed and profitable bank can experience liquidity problems, sometimes as a result of external factors. When the public or financial markets lose confidence in a bank or the banking sector, deposits are withdrawn and sources of short-term funding dry up. Even a solvent bank can fail if it cannot access funding with which to service its expenses, repay deposits and other liabilities as they become payable, and finance its longer-term loans and other assets. Resolving a bank in these circumstances requires immediate intervention, which is not provided for in the normal insolvency processes.

[3] The concept of SIFIs is used in various contexts and the designation of institutions as SIFIs or not can vary, depending on the context. For example, from a supervisory perspective, large banks can be classified as SIFIs and be subject to more intense supervision and higher regulatory requirements as a result of this designation. From a financial stability perspective, a SIFI can be any institution that poses a significant risk to stability, for example as a result of high asset growth or certain risky activities that it undertakes. From a resolution perspective, the SIFI designation indicates the likely impact of a disorderly failure on the financial system and the real economy.

Another reason why banks, in particular, require specific resolution arrangements is because they are closely interconnected with each other, the rest of the financial system and the real economy. The failure of a bank, in particular a large bank, can have catastrophic socioeconomic consequences, cause severe hardship among depositors and disrupt financial stability. Unlike other types of companies, it is not only the shareholders and creditors that bear the losses of the institution, but also the broader economy and often the taxpayer. Therefore, a special resolution framework should be in place to enable and empower the regulators and authorities to intervene in a distressed bank at an early stage, without necessarily having to wait for the initiative and approval of shareholders or the Board of Directors (Board) or for the point of balance-sheet insolvency.

Although banks are more likely to be regarded as SIFIs from a resolution perspective, large non-bank financial institutions such as insurers or asset management firms could also be classified as such, depending on their exposures to, and interlinkages with, the rest of the financial sector. Because of their cross-cutting role in the financial sector, financial market infrastructures (FMIs), which include exchanges, central counterparties and payment, and clearing and settlement systems, are also generally regarded as SIFIs and therefore special arrangements should be in place to mitigate the wider effects of their failure.

Under normal insolvency proceedings, the only options available when a SIFI fails are either an injection of public (taxpayer) funds to rescue the institution or a disorderly insolvency with high economic cost. Because of the size of large SIFIs relative to the economy, a rescue with public funds can be unaffordable or (at the very least) have long-term fiscal effects. Regardless of the affordability aspect, bail-out with public funds carries major moral hazard risks and reduces market discipline, both of which give rise to higher-risk financial systems over the longer term.

Normal insolvency processes are insufficient for the orderly resolution of a SIFI, for reasons that will become clear in the paper. A special resolution regime provides a third option to deal with the failure of an entity that may be a SIFI, thus improving efficiency by containing both fiscal costs and systemic impact.

Box 2: Systemic risk and systemic significance

The FSRB defines systemic risk as the risk that a systemic event will occur. Systemic risk can also be described as the risk of disruption to financial services that is caused by impairment to, all or parts of, the financial system and could have serious negative consequences for the real economy. Systemic risk can be caused by the failure of an individual institution or FMI.

SIFIs are financial institutions whose distress or disorderly failure would, because of their size, complexity and systemic interconnectedness, cause significant disruption to the wider financial system and economic activity. The SARB has developed a methodology for the identification of domestic systemically important banks (D-SIBS) based on the Basel Committee on Banking Supervision's recommended methodology for the identification of D-SIBs. [4]

The broad categories of indicators included in the South African D-SIB methodology are the following:

- **Size:** Size is measured in terms of on-balance-sheet assets and liabilities as well as off-balance-sheet exposures relative to the size of the banking sector and the economy. The bigger an institution, the more likely that its failure will cause systemic risk and require special resolution.
- **Global activity:** This refers to the cross-border activities of South African banks and the potential spillovers relating to these activities, especially within the African continent. Cross-border activity adds complexity to the resolution process that should be provided for in a special resolution framework.
- **Interconnectedness:** Interconnectedness refers to the extent of exposures and other financial links among financial institutions. Interconnectedness takes into account exposures to and from other financial institutions, activity in the financial markets and participation in financial market infrastructure. Such exposures and links create channels through which the failure of one institution could cause contagion to other institutions, potentially causing a domino effect of failures in the financial system. Interconnectedness in the South African banking sector is high due to the high level of concentration in the sector.
- **Substitutability:** The more substitutable a bank's activities are, the easier it becomes to sell or transfer such activities to other institutions, and therefore the less the systemic risk that is caused by its failure. However, if a bank has functions that are difficult to disentangle, segregate, transfer or replace, its failure causes more systemic risk and disruption. Such functions include, among other things, participation in payment, clearing and settlement systems, or the provision of important niche products and services.
- **Complexity:** This refers to South African banks' involvement in complex activities such as non-standardised derivatives. Such products are often difficult to value and it is also not always clear who the ultimate beneficiaries or loss-bearers will be.
- **Impact on confidence** (within the financial sector and social impact): This indicator reflects the potential impact of a bank's failure on confidence in the South African financial sector, financial inclusion and socioeconomic consequences. Should a bank fail and its customers suffer hardship in the process, it is likely to harm their confidence in the formal banking system and to have broader social consequences, especially if there are spillover effects to other banks in the sector.

The current methodology focuses on the systemic significance of banks. Similar methodologies will be developed for the identification of systemically significant insurers, asset managers and FMIs.

[4] See the document titled *A framework for dealing with domestic systemically important banks*, published in October 2012, available at http://www.bis.org/publ/bcbs233.pdf.

INTERNATIONAL STANDARDS

Legislation currently provides powers to South African authorities to address failing financial institutions and financial crisis situations in some form or another. However, lessons from the global financial crisis showed that similar powers available in other jurisdictions were inadequate to deal with the failure of SIFIs without incurring significant costs for taxpayers. Large and complex global financial institutions could not be liquidated without catastrophic consequences and, in the absence of liquidation, shareholders and creditors did not bear the cost of the failure of these institutions. Governments had to bail out these institutions and central banks had to play a significant role in stabilising markets and absorbing 'toxic' assets from financial institutions' balance sheets. Because of the size of the financial sectors relative to domestic economies, these processes lengthened the duration of the crisis and created a fiscal overhang that turned a banking crisis into a sovereign crisis in various countries.

In reaction to these events, addressing the TBTF problem became one of the Group of Twenty's (G-20) priorities. The Financial Stability Board (FSB) accordingly developed the Key Attributes of Effective Resolution Regimes for Financial Institutions (KAs). The framework recommended in the KAs does not replace existing resolution tools available to authorities, but enhances them by introducing, among other things, an additional set of powers that should make it possible for losses to be borne by shareholders and informed creditors rather than by the government. The KAs also aim to resolve a SIFI while maintaining critical functions and without incurring large costs on the rest of the financial sector and the real economy. The KAs were formally adopted by the G-20 in 2011, and will become an international standard with which member countries are expected to comply by the end of 2015.

A thematic peer review by the FSB in 2012 and a comprehensive review of South Africa's resolution framework in 2009/10 under the auspices of the World Bank's First Initiative programme revealed gaps in a number of areas in which South Africa's 'conventional' resolution powers did not comply with the KAs. These gaps were also confirmed in the findings of the International Monetary Fund (IMF) in its 2014 Financial Sector Assessment Programme (FSAP) for South Africa. Table 1 provides a summary on some of the gaps that were identified, and where South Africa will not be fully compliant when the KAs become an international standard.

Table 1: South Africa's resolution framework assessed against KAs

FSB ATTRIBUTE (ABBREVIATED EXTRACTS)	SOUTH AFRICA'S EXISTING FRAMEWORK
Objective	
To make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss.	The Insolvency Act sets out liquidation procedures for the distribution of any remaining asset value among creditors. Financial sector legislation such as the Banks Act or Insurance Act makes further provision for the protection of certain clients (such as depositors and policyholders). Current legislation does not provide for financial stability objectives such as the continuation of critical services or minimising systemic disruption.
Scope	
Any financial institution that could be systemically significant, potentially extending to holding companies, non-regulated operational entities within a financial group and branches of foreign firms.	Current insolvency proceedings such as curatorship and business rescue arrangements only apply to the failing legal entity.
Resolution authority (RA)	
Each jurisdiction should have a designated administrative authority or authorities responsible for exercising the resolution powers over firms within the scope of the resolution regime. A key function of the RA is to pursue financial stability.	Various regulators are responsible for resolution in their respective areas (banks, insurers, pension funds, etc.), according to financial sector legislation and regulation. There is no pre-identified lead authority or, alternatively, legal coordination requirements in the case of financial groups. There is no reference to an explicit financial stability mandate in the context of resolution.
Entry into resolution	
Resolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. The resolution regime should provide for early entry into resolution before a firm is balance- sheet insolvent.	Criteria for triggering liquidation or curatorship are applied on a sectoral basis (i.e. to banks, insurers or other individual financial institutions), based on criteria applicable to the type of institution. There is limited room for early intervention to prevent a severe and avoidable loss of value.
Resolution powers	
The KAs promote a broad set of powers that should make adequate provision for early corrective action and the continuation of critical services, the creation of a bridge institution and ways to recapitalise the institution or a new bridge institution.	Current resolution powers are fragmented in various acts that fall under different regulators. There are potential conflicts of interest as there is no common, shared objective. There are limited stabilisation powers (such as the ability to create and recapitalise a bridge institution), and powers require shareholder or Board approval, potentially at the expense of the public good of financial stability.

Set-off, netting, collateralisation and segregation of client assets	
The legal framework on these elements should be clear, transparent and enforceable during resolution, and should not hamper the effective implementation of resolution measures.	Limited provisions are contained in the various acts that form part of South Africa's existing resolution framework (such as sections 35A and 35B of the Insolvency Act and Protection of Funds Act).
Safeguards	
Critical safeguards to creditors include respecting the creditor hierarchy and an assurance that no creditor would be worse off in resolution than in liquidation. These safeguards should be based on ex-post reviews and remedies: creditors should not have the power to stop or reverse resolution actions.	In the Insolvency Act, all unsecured creditors rank parri passu, while some preference in creditor hierarchy may be justified on financial stability grounds. In sector prudential regulation, safeguards are not explicit and leave room for interpretation, which can create legal uncertainty.
Funding of firms in resolution	
Jurisdictions should have in place privately financed deposit insurance or resolution funds or a funding mechanism for ex-post recovery from the industry of the resolution costs resolution. Any provision by the authorities of temporary funding should be subject to strict conditions that minimise the risk of moral hazard.	South Africa does not have a privately financed deposit insurance or resolution fund. In past bank failures, retail depositors have been compensated out of public funds, without explicit arrangements to recover these funds.
Legal framework for cross-border cooperation	
The statutory mandate of a resolution authority should empower and strongly encourage the authority, wherever possible, to act to achieve a cooperative solution with foreign resolution authorities.	Financial sector legislation makes some provision for cross-border cooperation and information sharing, but is inadequate for effectively dealing with the orderly resolution of financial groups operating in numerous jurisdictions.
Crisis management groups (CMGs) and institution-specific cross-border cooperation agreements	
Home and key host authorities of G-SIFIs should maintain CMGs with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the firm. Institution-specific cooperation agreements should be in place between the home and relevant host authorities that need to be involved in the planning and crisis resolution stages.	Although South Africa does not have a G-SIFI, it would be beneficial to also establish CMGs for South African institutions operating in, for example, the rest of Africa. Currently there is no such requirement on South African regulators. Regulators generally have Memorandums of Understanding (MoUs) in place for normal supervisory functions and information sharing, but these do not include institution-specific cooperation agreements in a crisis or in a resolution.

Recovery and resolution planning	
Jurisdictions should put in place an ongoing process for recovery and resolution planning, covering domestically incorporated firms that could be systemically significant or critical if they fail.	South Africa has initiated recovery plans only for banks and still has to extend these plans to non-bank SIFIs. The criteria and minimum requirements for banks have been published as a Banks Act Circular, but are not captured in law. Comprehensive resolution plans still have to be developed.
Resolvability assessments	
Resolution authorities should regularly undertake resolvability assessments that evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm's failure on the financial system and the overall economy.	No requirements or procedures for the regular undertaking of such assessments are in place. Resolvability assessments are done on an ad hoc basis, as required, and not based on cross-industry consistent and agreed methodologies.
Access to information and information sharing	
Jurisdictions should ensure that no legal, regulatory or policy impediments exist that hinder the appropriate exchange of information, including firm-specific information, between supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes.	Home or host information-sharing agreements are generally in place, but these could be strengthened to facilitate the exchange of information relating to resolution, and to provide adequate legal protection and confidentiality clauses. The FSRB will facilitate this.

CHAPTER 2

AN ENVISAGED SPECIAL RESOLUTION BILL

In order to address the shortcomings, gaps and fragmentation of South Africa's current framework for dealing with failing financial institutions, and also to bring South Africa's legislation in line with the KAs, it is envisaged that an SRB be drafted. The SRB should draw on the experiences of other jurisdictions, but should be appropriate for the domestic financial system. South Africa's current resolution tools are likely to be inadequate in the event of a failure of a truly systemic institution, and these tools are also subject to a number of obstacles that may hinder or delay decisive action during a systemic event.

This chapter sets out the objectives, governance and administrative arrangements that should be captured in the SRB, as well as which institutions should fall within the ambit of the bill.

OBJECTIVES

The KAs state that a country's resolution framework should be able to resolve stress in financial institutions or market infrastructures without severe systemic disruption or losses to taxpayers, while maintaining vital economic functions.

The objective of the SRB is to contribute to the protection and enhancement of the stability of South Africa's financial system by improving the resolvability and, in the event of failure, facilitating the orderly resolution of financial institutions that are DRIs. In pursuit of this objective, and to assist the RA to make timely and consistent decisions in the resolution process, it is useful to identify sub-objectives in support of the objective of financial stability. However, it is possible that there may be contradictions between these sub-objectives in the resolution process, and therefore there should be some sequence of considerations on which decisions are based.

When taking any action or exercising any power, the RA must always aim to meet the objectives of the SRB as follows:

a. seek to maintain the stability of the financial system, including by:
   i. maintaining the continuity of systemically important financial services, and payment, clearing and settlement functions;
   ii. minimising the risk of contagion; and
   iii. maintaining confidence in the financial system;
b. protect depositors in a manner consistent with deposit insurance arrangements[5];
c. subject to a and b, seek to minimise or avoid:
   i. taxpayer costs;
   ii. moral hazard;
   iii. adverse impacts on the economy; and
   iv. unnecessary loss of value; and
d. subject to a, b and c, seek to minimise or avoid adverse impacts on the financial systems of other jurisdictions[6].

Due consideration should be given to these factors in the formulation and decision of a resolution strategy. The combination that best protects sustainable financial system stability and that represents the least-cost resolution strategy should be adopted.

[5] This may be expanded to include protection of policyholders should a policy decision be taken to establish a policyholder protection scheme.
[6] While South Africa is not the home supervisor of any identified G-SIFI, it is the host supervisor of subsidiaries of a number of G-SIFIs (specifically insurance G-SIIs and banking G-SIBs).

Box 3: Financial stability

Financial stability is defined as follows in section 4 of the FSRB:

"4. (1) For the purposes of this Act, there is said to be "financial stability" if–
(a) financial institutions generally provide financial products and financial services without interruption and are capable of continuing to do so; and
(b) there is general confidence in their ability to continue to do so.
(2) A reference in this Act to maintaining financial stability includes, where financial stability has been adversely affected, a reference to restoring financial stability."

SCOPE

The KAs state that a country's resolution framework should, as a minimum, cover any financial institution that could be systemically significant or critical if it fails. In order to comply with the KAs, the SRB should extend to holding companies of such institution's non-regulated operational entities within a financial group that are significant to the business of the group or conglomerate, and branches of foreign firms. In addition, FMIs and insurers should be subject to resolution regimes that apply the objectives and provisions of the KAs in a manner appropriate to FMIs and insurers, and their critical functions.[7] The choice of resolution powers should be guided by the need to maintain continuity of critical FMI functions.

The SRB will apply to all:

I. registered banks[8];
II. non-bank financial institutions that are designated as SIFIs in terms of the FSRB;
III. FMIs that are designated as SIFIs in terms of the FSRB; and
IV. the groups within which i, ii or iii operate, from the ultimate holding company downwards, including foreign branches and subsidiaries.

For ease of reference, the institutions and infrastructures listed above will be collectively referred to in this paper as 'designated resolution institutions' (DRIs). All DRIs will be resolved in terms of the powers and procedures as contained in the SRB. As soon as there is a DRI in a financial group, the whole group falls within the ambit of the SRB. The resolution of non-DRIs will be handled by the respective regulators in terms of sector legislation such as the Insurance Acts or the Financial Markets Act. However, in the resolution of a DRI, the SRB will apply.

[7] In October 2014, the FSB reissued the KAs incorporating guidance on the KAs' application to non-bank financial institutions. The annex on FMI resolution and the Recovery of Financial Market Infrastructure paper published by the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) provide a comprehensive set of guidance on recovery and resolution for systemically important FMIs. http://www.financialstabilityboard.org/wp-content/uploads/FSB-Publishes-Guidance-and-Resolution-of-Non-Bank-Financial-Institutions.pdf.
[8] Registered banks refer to any bank registered in terms of the Banks Act 94 of 1990, a cooperative bank registered in terms of the Cooperative Banks Act 40 of 2007 or a mutual bank registered in terms of the Mutual Banks Act 124 of 1993.

The SARB will develop appropriate methodologies to assess whether non-bank financial institutions and FMIs should be declared systemically significant, in line with the processes specified in the FSRB. Such processes will allow for both a pre-crisis identification of SIFIs and in-crisis identification, in which case institutions that would not normally be regarded as SIFIs could become systemically significant due to specific prevailing circumstances or contagion risks.

The SRB will not extend to broad intervention and crisis management powers that are already available to the SARB in terms of the South African Reserve Bank Act 90 of 1989 (SARB Act) or the FSRB, for example emergency liquidity assistance and intervention in financial markets. Also, it may in some instances be necessary to support a resolution strategy with taxpayer funds. In such cases, the SARB will have to collaborate with the NT and obtain specific ministerial approval.

THE RESOLUTION AUTHORITY

In terms of the KAs, each jurisdiction should have a designated administrative authority or authorities responsible for exercising resolution powers over firms within the scope of the resolution regime. The RA should:

I. pursue financial stability and ensure continuity of systemically important financial services, and payment, clearing and settlement functions;
II. protect, where applicable and in coordination with the relevant insurance schemes and arrangements, such depositors, insurance policyholders and investors as are covered by such schemes and arrangements;
III. avoid the unnecessary destruction of value and seek to minimise the overall costs of resolution in home and host jurisdictions and losses to creditors, where that is consistent with the other statutory objectives; and
IV. duly consider the potential impact of its resolution actions on financial stability in other jurisdictions.

The SARB will be the designated resolution authority in terms of the SRB and as such will be responsible to exercise the duties, functions and powers set out therein. All the resolution powers available in terms of the SRB will reside in the SARB as the RA.[9] However, the SARB has the option to delegate its resolution powers to another regulator in the resolution of specific institutions that fall within the scope of the SRB, and to give directions to the regulator on how to resolve such institutions.

GOVERNANCE AND ACCOUNTABILITY

The SARB is already governed in terms of the SARB Act. However, the SARB will be responsible for establishing appropriate governance and coordination arrangements for its resolution responsibilities, similar to those that are in place for other functions such as monetary policy, financial stability, prudential supervision or reserves management. Similar to these other functions, it will be an internal decision by the SARB on how to structure and staff the function, and how it should report to the executive management of the SARB.

[9] In the rest of the discussion paper, any reference to the SARB in the context of resolution refers to its responsibilities as RA, unless otherwise indicated. In the annexures, which provide conceptual background, reference is generally made to an RA, which in South Africa's case will be the SARB.

The structure should ensure an adequate separation of the resolution function from the other functions of the SARB, such as prudential supervision, and should promote robust governance, accountability and transparency.

However, there are a number of aspects that will have to be explicitly addressed in the SRB, such as the following:

- Decision-making processes: The SARB has to establish appropriate structures to facilitate sound decision-making and accountability. Decision-making processes should include pre-crisis decisions (such as resolution planning, and which should be done in a consultative manner), and in-crisis decisions, which will have to be made by the executive management of the SARB.
- Coordination requirements: The SARB should be required to coordinate and liaise with the Prudential Authority (PA), the Financial Services Conduct Authority (FSCA) and the Financial Stability Oversight Committee (FSOC) in its resolution-related activities.
- Accountability requirements: The SARB should be held accountable for its decisions and should put in place all mechanisms required for this purpose, such as record keeping and reviews.
- Temporary exemption from specific legal requirements that may hinder quick and effective decision-making and resolution.
- Protection of SARB staff and consultants against claims: Because of the potential financial implications of their decisions on creditors of financial institutions and other stakeholders, there should be specific protection to the staff of the SARB, as well as to consultants involved in the resolution process, against claims.

CHAPTER 3
PRE-RESOLUTION PROCESSES AND POWERS

There are certain ongoing functions that the SARB will have to perform, even in the absence of any distress or failures in the financial system, in order to be able to implement an orderly resolution of a DRI. These functions are referred to as pre-resolution processes, and encompass all processes required to ensure that the SARB will be in a position to effectively manage the failure of an institution upon entry into resolution. Pre-resolution powers enable the SARB to gather information necessary for pre-positioning and resolution planning, to require DRIs to compile recovery plans, to develop resolution plans for DRIs, and to administer a deposit guarantee scheme, or potential future policyholder protection scheme. Some of these processes may be conducted through the PA, for efficiency purposes, but the SARB retains the right to act directly, if necessary.

RECOVERY PLANS

The KAs require that all SIFIs should have recovery and resolution plans (RRPs) in place. Recovery plans are compiled by the institution itself, signed off by the Board, and set out possible strategies that the institution can implement to recover from severe stress scenarios. Recovery plans fall within the domain of the regulator, as no reliance is placed on any official assistance or intervention during periods of severe stress. The PA should ensure that the financial institutions it regulates are required to develop recovery plans and to ensure that these plans adhere to appropriate minimum standards. However, the SARB should be able to access, assess and make recommendations on the recovery plans.

Box 4: Minimum standards for recovery plans for South African banks and bank controlling companies

Directive 1/2015 was issued by the Bank Supervision Department (BSD) in January 2015, specifying the minimum requirements of a recovery plan for banks. The directive makes the requirement for a recovery plan applicable to all registered banks and controlling companies in South Africa, including locally registered branches of foreign banks. The directive also stipulates the governance requirements and the information to be provided in the recovery plan regarding the group structure and key legal entities within the banking group. Guidance is provided on the determination of triggers for recovery planning purposes and the considerations relating to stress scenarios are also covered in the proposed directive. In their recovery plans, banks also need to identify recovery options for capital, liquidity and operational stress. Guidance on the various considerations relating to these recovery options are given in the directive.

RESOLUTION PLANS AND STRATEGIES

A key pre-crisis function of the SARB is to develop institution-specific resolution plans for all DRIs. Such plans should contain all the information necessary and the various resolution strategies available to enable the SARB, in its best judgement, to determine the least-cost, most orderly resolution strategy when an institution approaches or enters resolution. The detail and comprehensiveness of resolution plans will be proportionate to the systemic significance and complexity of the DRI.

The PA will play a critical role in helping to compile resolution strategies for specific institutions. However, the SARB will be the 'owner' of the plan and will be responsible for executing the plan, or parts of it, in the event of the resolution of a DRI.

Resolution plans should be institution-specific, taking into account the specific group structures, organisational structures, ownership structures, funding structures, critical functions and linkages with the rest of the financial sector, among other things. Resolution plans should provide for both single-point-of-entry (SPE) and multiple-point-of-entry (MPE) resolution strategies. SPE refers to a strategy where the holding company is placed in resolution, resolution powers are applied at the holding-company level and operating subsidiaries remain relatively unaffected. MPE refers to a strategy where separate entities in a group are put into resolution simultaneously and resolution powers may be applied in different measures to different entities. SPE resolution may be more appropriate where intra-group linkages are high and complex. MPE resolution may be more appropriate where failure is isolated in specific, separable entities in a group. In cases where there are multiple foreign subsidiaries, either an SPE or MPE strategy could be followed, depending on the coordination arrangements with the specific host regulators and cross-border legal considerations.

The KAs require that regular assessments of the viability of resolution options should be conducted, and that obstacles or impediments to resolution should be resolved to the extent possible. Resolution powers should allow the SARB to direct such actions.

The SRB should put a legal obligation on DRIs and their regulators to have resolution plans in place according to the required standards, to provide all information required for such plans to the SARB, to participate in resolvability assessments and to implement measures, as directed by either the regulator or the SARB, to remove obstacles or impediments to resolvability. The SARB should have the ability, but not the obligation, to share resolution plans, or parts thereof, with other regulators, including host regulators.

ADMINISTERING A DEPOSIT GUARANTEE SCHEME

The KAs require jurisdictions to have a privately funded depositor protection fund[10] in place or, alternatively, arrangements to recover any public costs from the private sector ex-post the resolution. South Africa is currently one of three G-20 countries that subscribes to the KAs and that does not have explicit deposit protection in place (the other two being China[11] and Saudi Arabia). While the establishment of a privately funded resolution fund may be a longer-term objective, the authorities have in principle agreed that a deposit guarantee scheme (DGS) will be established as part of the current strengthening of the resolution framework.

The principal objective of a DGS is to contribute to financial stability through the provision of prompt access to covered deposits in order to help prevent contagion to other banks and bank runs. The DGS also assists with mitigating the cost of bank failures and protecting covered depositors from loss. In the context of the broader resolution framework, and in line with the overarching objectives of this framework, the objective of the DGS is to contribute to the protection and enhancement of the stability of the South African financial system through the protection of qualifying depositors in the event of a bank failure.

[10] The KAs also require privately-financed policyholder protection schemes or resolution funds to assist in securing continuity of insurance coverage and payments by the transfer of insurance policies to a bridge insurer or other insurer or use of any other resolution powers and compensating policyholders for their losses in the event of a wind-up or liquidation. Preliminary research has been undertaken on establishing such a scheme or fund in South Africa. A policy decision in this regard will be taken following further technical work. If such a policyholder protection scheme is established, it will form part of a second phase following the establishment of a depositor guarantee scheme.

[11] Both China and Saudi Arabia are in the process of implementing an explicit deposit insurance scheme.

The DGS will be financed by the banking industry. Membership will be compulsory for all banks that are covered by the DGS, namely banks registered in terms of the Banks Act[12], the Mutual Banks Act[13] and the Cooperative Banks Act[14], which are regulated by the BSD as home or host supervisor.[15] The DGS will be established within the SARB, thereby making the SARB the administrator of the DGS. The internal organisational arrangements should ensure operational independence, alignment with the objective of the DGS, as well as cost-effective and efficient governance and administration. For governance purposes, the DGS may be in the form of a subsidiary of the SARB that is managed in-house.[16]

The powers required for the DGS are determined by the type of DGS that is adopted. The DGS should have all the powers necessary to fulfil its mandate and these powers should be specified in the legislative framework. With the DGS administered within the SARB, and therefore closely aligned with the supervisory and SARB functions, a paybox scheme is favoured for South Africa, that is, a scheme where the DGS does not decide on the resolution strategy, but only pays out or transfers funds in resolution, provided that its own legal criteria are met. As such, the DGS will not have any supervisory or risk-minimising responsibilities. In practice, this would have the same benefits as a paybox plus or less the minimiser scheme (which also has degrees of resolution powers and prudential oversight functions), but without the potential risks relating to coordination, duplication, conflicting interests and decision- making.

The DGS should be allowed to support a variety of resolution strategies, for example by providing guarantees instead of the payout or transfer of deposits, provided that the cost of such support should not exceed the cost that would have been incurred in the event of a payout.

Any DGS has a range of design features. These are not necessarily captured in legislation, but can be part of subordinate rules or directives. Design features include the following issues:

- Coverage: Which types of depositors and deposits are covered?
- Covered amount: Up to what amount are deposits guaranteed?
- Funding mechanism: Should the fund be pre or post funded, or both?
- If there is a pre-funded portion, how large should it be and over which period should it be built up? Should there be lump sum seed capital contributions?
- What should be the premiums be, and should they be the same for all banks (flat) or risk based?
- How should the operational costs of the DGS be funded?
- What transitional arrangements should be in place to smoothly change from an implicit to an explicit DGS?
- Within which period should the DGS aim to compensate depositors? What should the recovery process be?
- How should the funds of the DGS be invested?

[12] See the Banks Act 94 of 1990.
[13] See the Mutual Banks Act 124 of 1993.
[14] See the Cooperative Banks Act 40 of 2007.
[15] A final decision on the membership of local branches and subsidiaries of foreign banks still has to be made.
[16] The exact structure of the DGS still has to be decided between the SARB and the NT.

Annexure A contains preliminary views on the possible design features of a DGS. The SARB has commissioned a comprehensive research project on the optimal design features of a South African DGS. This research will be conducted by a team that comprises senior researchers in the SARB, South African academia with financial industry expertise, and international experts on resolution and deposit guarantee schemes. This research project is expected to be finalised around the end of September 2015, and the results will be published for further discussion before final decisions on the design features of the DGS are taken.

It is most likely that the DGS will be established as a fairly simple start-up fund. However, the intention is to refine it over the medium term to best achieve its objectives. Depending on the outcome of the research project, it may not be achievable to implement all recommendations right from the start, but rather to stagger their implementation over a couple of years.

CROSS-BORDER COOPERATION

An underlying assumption of cross-border cooperation in resolution is that the overall cost of resolution should be lower if the home regulator could effect and coordinate an orderly resolution of the group, rather than having a series of disorderly and uncoordinated resolution actions of various entities in the group by host regulators. However, because multinational DRIs operate in jurisdictions with different legal systems, such a coordinated approach requires an ex-ante agreement by regulators on the preferred group-wide resolution strategy, and a commitment to support each other's resolution actions. These strategies and agreements would be formulated by the cross-border CMGs and agreed to between the SARB and the foreign authorities. However, they are generally not enforceable because of differences in the legal systems among countries. The provisions in the SRB with regard to cross-border cooperation in resolution should be enabling, rather than prescriptive.

The SRB should provide the SARB with the ability to share information with other regulators and allow the SARB to enter into cross-border agreement on a group-wide resolution strategy to minimise the cost of resolution, to support the resolution actions of home regulators and the SARB, and to solicit the support of host regulators for resolution strategies formulated and implemented by the SARB. However, the SARB should retain the right to divert from an agreed resolution strategy or to put a local entity of a foreign institution into resolution, independent from the home regulator, if necessary, for example in cases where a home authority fails to act or takes actions that are contrary to the interests of the South African financial system or economy.

PRE-RESOLUTION POWERS

In order to enable the SARB to fulfil its resolution planning responsibilities, it should have adequate access to information, the power to investigate an institution where there is a concern regarding the institution's financial position, the power to require, assess and provide recommendations on recovery plans, and the power to develop resolution plans, including powers to assess resolvability and remove obstacles to resolvability.

These powers can be exercised directly or through the PA. The SARB should always endeavour to obtain information from, and exercise any powers through and in consultation with, the PA in order to avoid duplication. Only in instances where the SARB is unable to work effectively through the PA should it be able to deal directly with the institutions involved. Table 2 lists the pre-resolution powers that should be available to the SARB.

Table 2: Pre-resolution powers

INFORMATION-GATHERING POWERS
Powers to obtain information, including in relation to: • the prudential or financial condition of the entity in question; • the management of risks in the entity; • compliance with prudential requirements; • early warning indicators; • information required for resolvability assessments (e.g. on types of business functions performed in the DRI and group, the location of functionality within each relevant legal entity, ownership and funding structures, inter-entity dependencies, and contractual documentation for essential services provided by parties outside the group); • information required for recovery and resolution planning; • information required for valuations and solvency assessments; • information required for systemic impact assessments; and • information required for assessing and/or implementing a resolution.
POWER TO INVESTIGATE
Power of the SARB or regulator to investigate or to appoint an investigator, on the basis that the person conducting the investigation has unfettered access to the premises, systems, records and staff of the entities being investigated.
POWERS RELATING TO RECOVERY PLANS
Power of the RA or regulator to require recovery plans, including powers to: • require the development and regular update of a recovery plan; • specify the required scope of, and minimum standards for, the recovery plan; • enable the SARB to review the recovery plan; • require changes be made to the recovery plan; • require the recovery plan to be audited externally or reviewed by a party approved or appointed by the regulator or SARB; • require the results of any audit or external review to be reported to the SARB; • require pre-positioning to be undertaken by the entity to enable the plan to be activated quickly and reliably (e.g. documentation for capital issues); and • require the recovery plan to be subject to regular testing by the entity under supervision by the regulator or SARB.

POWERS RELATING TO RESOLUTION PLANS
Power for the SARB to develop and implement a resolution plan for a DRI or group, including powers to: • obtain information from the bank or group for the purpose of developing a resolution plan; • obtain information from, and coordination with, the regulator with regard to the development of resolution plans; • perform resolvability assessments; • require changes to the structure of the business operations of a DRI or group, including the separation of specified types of business from other types of business; • require specified business and associated functionality to be located in specified entities; • require the location of specified business and associated functionality to be legally and operationally located within South Africa; • require the transfer of specified business and associated business functionality from an entity incorporated outside South Africa to an entity incorporated within South Africa; • require resolution plan requirements to be audited by an auditor appointed or approved by the regulator or SARB; and • require the DRI or group to undertake specified testing of matters relating to the resolution plan under the supervision of the regulator or SARB.
POWERS RELATING TO THE DGS
Power for the SARB to establish and administer a DGS including power to: • require banks to be able to provide all the information that would be necessary to determine covered deposits, identify qualifying depositors, provide a single customer view (SCV), calculate deposit balances, and premiums and aggregated deposit balances, as required; • require internal or external auditing of information provided to the SARB, including in terms of pre-positioning and banks' ability to provide information on a SCV basis; • put processes in place with banks to enable the generation of payment instructions in a specified format, deposit accounts to be transferred to another bank, reports to be generated and tax-related information to be provided; • require testing of the calculation of eligible deposit balances on an aggregated SCV basis and, if needed, request the regulator to do on-site reviews or to appoint a person to review the accuracy of information submitted by the banks; • levy premiums on banks, as determined from time to time; • borrow from the government or the SARB to fund the shortfall to be recovered from industry or failed DRI; • enter into contracts and set own regulations; and • formulate an investment policy and invest the funds of the DGS.
CROSS-BORDER COOPERATION
The SRB should provide the SARB with the power to: • share information on resolution strategies with host jurisdictions; • participate in CMGs of both home and host jurisdictions; • enter into MoUs with other jurisdictions on issues relating to cross-border resolution; • coordinate resolution actions relating to the same financial group operating in various jurisdictions; and • allow a home jurisdiction to implement a resolution strategy relating to one of its subsidiaries in South Africa, if it provides the least-cost and most orderly resolution.

CHAPTER 4
THE RESOLUTION PROCESS AND POWERS

This chapter describes the process, powers and safeguards applicable when a DRI enters resolution in terms of the SRB. The resolution process in terms of the SRB should not constitute an event of default or an insolvency process. Instead, the SRB should provide for a range of powers that are intended to stabilise a distressed DRI to ensure the continuation of its critical functions, to wind down non-critical operations and to prevent an avoidable loss of value. The use of resolution powers by the SARB will be proportionate to the nature and severity of the situation, and its interventions will depend on the reasons for distress and the characteristics and functions of the DRI.

ENTRY INTO RESOLUTION

According to the KAs, resolution should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. When an institution enters resolution, all the recovery options within the control of the institution and regulators should have been depleted or become ineffective,[17] and it should be clear at that point that the institution will not be able to survive without intervention in terms of the powers provided for in the SRB, possibly (but as a last resort) combined with some form of official support.

The current regulatory framework for banks provides for the Registrar[18] to take certain recovery actions in the context of tier 1 and 2 capital instruments when a bank becomes or is likely to become non-viable – the so-called point of non-viability (PONV). In order to make a clear distinction between the PONV in the regulatory framework and the point at which the SARB takes responsibility of the resolution process and the resolution powers of the SRB are activated, the latter will simply be referred to as the point of resolution (POR). The triggers for the POR have to be qualitative rather than quantitative, as events that trigger the failure of DRIs are often unforeseeable and should not limit the SARB's ability to act when necessary. The criteria to be used to trigger the POR include the following:

- The institution is not meeting its minimum prudential requirements and the SARB is satisfied that it is unlikely to be able to meet these requirements within a reasonable period. The SARB could override exemptions from regulatory requirements provided by the PA if it is not convinced that the institution is taking appropriate corrective action, and to avoid a prolonged period of regulatory forbearance that is not supported by appropriate recovery actions.
- In the judgment of the SARB, the institution has reached the PONV and the recovery actions available to the institution and the regulator have been implemented without the necessary success, have become depleted or are likely to be ineffective.
- No private-sector solution seems likely or feasible.

If the SARB has sufficient reason to believe, based on actions taken in terms of its pre-resolution powers, that the financial position of an institution is significantly overstated and that it is, in fact, non-viable or likely to be non-viable, it can request the PA to implement recovery actions. If such actions are unsuccessful, or likely to be ineffective or insufficient, the SARB can trigger the POR.

Once the SARB is satisfied that the criteria for triggering the POR have been met, it can make a recommendation to the Minister of Finance (the Minister) to put an institution in resolution. Once it is satisfied that an institution has become viable again, it can recommend that the Minister allow the institution to exit resolution. Once in resolution, the SARB has the full set of resolution powers in the SRB to its avail.

[17] For example, at the point of entry into resolution, the write-down or conversion of tier 1 debt capital instruments are likely to have been met, other regulatory interventions would have be made, and banks would have implemented the viable options in their own recovery options without success.
[18] The Registrar of Banks is designated in terms of the Banks Act.

The SRB should contain minimum requirements for consultation with both the PA and the FSCA, and no request for entry into or exit from resolution can be made without such consultation. However, the SARB does not need the consent of the regulators to make recommendations to the Minister.

STABILISATION POWERS

When a DRI reaches the POR, a simple wind-down or liquidation process (i.e. a closed resolution) is very unlikely, for the reasons discussed in Chapter 1. It is more likely that some form of open resolution will be followed in terms of which the institution will be stabilised before embarking on a longer-term restructuring or winding-down process. The objective of stabilisation powers is to allow critical functions to be maintained. The financial crisis, especially the failure of financial institutions such as Lehman Brothers, highlighted the inadequacy of current resolution powers to deal with large and complex financial institutions and it became evident that a new toolkit of powers is necessary.

The KAs set out three stabilisation powers that can be used in an open resolution to restore or maintain the critical functions of a DRI, namely:

i. the power to create a bridge or temporary institution for the continuation of critical functions and shared services, and for possible 'good bank, bad bank' purposes;
ii. the power to transfer some or all of the failed institution's assets and liabilities, to either a new acquiring institution or a bridge/temporary institution; and
iii. the power to assign losses of a failed institution to the shareholders and certain classes of creditors in order to recapitalise either the failed or a bridge/temporary institution. This power is referred to as 'bail-in within resolution' (bail-in) and involves that shareholders are firstly divested of their shares and that thereafter, if necessary, the institution's creditors' claims are reduced or negated to the extent necessary to restore the institution to financial viability.

These powers aim to ensure that the critical functions and essential services of the DRI in resolution can continue with minimum disruption to the remaining financial sector. The SRB should ensure that the SARB, subject to certain conditions and safeguards, is able to use these stabilisation powers as follows:

Bridge institution

The SARB should have the power to establish, manage and control a new temporary institution in order to facilitate the resolution process. The SRB must provide the SARB with the necessary power to meet regulatory requirements of the bridge institution and to obtain all the legislative approvals necessary for the establishment and control of the bridge institution.

Transfer of assets and liabilities

The SRB must provide all the necessary powers to the SARB to enable it to transfer any or all of the institution or entity's assets and liabilities to either a bridge institution or another acquiring entity without requiring the consent of the shareholders and creditors of the failed institution.

Bail-in within resolution

Bail-in refers to any process through which losses are applied to selected liability holders and shareholders in order to recapitalise an institution. The SARB should have a toolkit of appropriate mechanisms available to adequately implement a bail-in of creditors or shareholders of any DRI, regardless of its size, complexity or structure. The appropriate mechanisms will be dependent on the prevailing circumstances as well as the specific characteristics of the failing DRI's liability structure. The mechanisms available to the SARB to impose losses on the shareholders and creditors of the failed institution, and to be able to recapitalise the institution, should include the powers to:

- partially or fully divest shareholders of their shares;
- reduce or cancel the claims of the specified creditors;
- convert the claims of certain creditors to equity or another form of capital that meets loss-absorbency requirements under the relevant prudential framework (e.g. Basel III);
- issue or instruct the failed institution to issue new shares; and
- transfer certain or all of the assets and liabilities of the failed institution without shareholder or creditor consent.

More detail on bail-in as a loss-absorption and recapitalisation tool is provided in Annexure B.

CREDITOR HIERARCHY FOR FINANCIAL INSTITUTIONS IN LIQUIDATION

The creditor hierarchy in liquidation forms the core of a jurisdiction's insolvency framework. When assessing a country's insolvency framework and developing the framework for dealing with the failure of specific institutions – in this case financial institutions – it is important to consider and, where necessary, improve the insolvency creditor hierarchy for those specific institutions.

The importance of the creditor hierarchy in liquidation is confirmed in the KAs, which require member jurisdictions to adopt resolution frameworks that respect the creditor hierarchy in insolvency when resolution measures are applied, specifically those measures that affect shareholders and creditors. The no-creditor-worse-off (NCWO) rule serves as a safeguard for creditors and investors and aims to ensure that no creditor is worse off in resolution than it would be in normal liquidation. In order to adhere to the NCWO rule, the sequence in which creditors are bailed-in should respect and be in line with the hierarchy of creditor claims in liquidation.

There are various considerations in determining an appropriate creditor hierarchy. These are discussed in more detail in Annexure C, which deals exclusively with the issue of creditor hierarchy for financial institutions in liquidation. However, for financial institutions, and particularly for banks, there is a common expectation that customers will receive preferred treatment in insolvency proceedings, whether through a government bail-out or through the first payout from the proceeds of the failed institution's insolvency proceedings. In South Africa, the Insolvency Act does not give preference to depositors (or other financial institutions' customers, such as policyholders) in liquidation, but the general expectation of preference was enforced by government-funded compensation to depositors in past bank failures.

In many jurisdictions the general insolvency ranking differs from the ranking of creditors in a banking failure, mostly in respect to depositor preference. The international trends with regard to creditor hierarchy are also set out in Annexure C. South Africa's current hierarchy in liquidation of banks differs from the international trends in three respects. Firstly, South Africa does not make a distinction between junior and senior unsecured creditors. Secondly, South Africa does not make a distinction between preferred and ordinary shareholders. Thirdly, South Africa does not make a distinction between depositors and other unsecured creditors.

Based on the considerations set out in Annexure C, it is deemed necessary to afford, at least, preference to qualifying depositors and for the insolvency framework to explicitly subordinate specified instruments in order to make them loss-absorbing in resolution. These specifically identified instruments will form part of an institution's total loss-absorbing capacity (TLAC)[19], which includes both going-concern regulatory capital requirements and instruments that can become loss-absorbing in resolution (the so-called gone-concern loss-absorbing capacity, or GLAC).

The creditor hierarchy in the insolvency framework should be amended, taking into account considerations specific to financial institutions, and should provide for the following ranking of creditors:

- secured creditors: existing preference in line with Insolvency Act;
- preferred creditors: existing preference in line with Insolvency Act;
- qualifying depositors[20] (for the full amount of their deposits above the coverage limit): preference afforded to replenish the DGS and protect retail and small and medium enterprise (SME) depositors;
- unsecured creditors: all other depositors and creditors remain concurrent; and
- TLAC instruments specifically identified and disclosed as loss-absorbing.

Further work will also be undertaken relating to creditor hierarchy and implications specifically as they relate to policyholders when an insurer is in resolution.

PROPOSALS ON BAIL-IN SEQUENCE

The creditor hierarchy proposed above provides room for the SARB to apply a bail-in sequence in a way that the NCWO rule is adhered to. The creditor hierarchy should provide for a sufficient amount of available bail-in liabilities to the level necessary to recapitalise an institution, taking into consideration the funding of the financial sector.

The bail-in sequence in resolution should respect the proposed creditor hierarchy in liquidation. If the proposed creditor hierarchy is adopted, bail-in would simply apply in the reverse order of the cascade of claims in insolvency, subject to additional exclusions that may have to be applied for financial stability reasons. The SARB can allow certain motivated deviations from the *pari passu* treatment of creditors within a certain class, as long as the NCWO rule is maintained. The NCWO rule does not prevent the SARB from distinguishing between creditors in the same class and assigning greater losses to one creditor in comparison to another creditor of the same class, as long as the aforesaid creditor does not suffer a greater loss than it would have suffered in liquidation.

[19] TLAC in the context of this paper does not necessarily have the same characteristics as the proposed TLAC requirements applicable to G-SIBs.
[20] The current view is that only retail and SME depositors should qualify for deposit insurance under the DGS. This view may change subject to the results of the research project being undertaken.

The proposal on the sequence of bail-in is to set guidelines for when the SARB deviates from the *pari passu* treatment of creditors within the same class. The following sequence of loss-absorption is proposed:

i. TLAC (as identified in resolution plans):
   a. ordinary shares;
   b. preference shares; and
   c. pre-identified loss-bearing instruments[21]

ii. unsecured creditors:
   a. other marketable securities and wholesale funding; and
   b. trade creditors[22]

iii. Qualifying guaranteed depositors (for the full amount of their deposits above the coverage limit):

iv. preferred creditors; and

v. secured creditors.[23]

VALUATION

Valuation forms an integral part of the resolution process and should ensure that the SARB makes informed decisions regarding entry into resolution, the least-cost resolution strategy, the relevant actions to be taken, and other matters such as whether conditions and safeguards have been adhered to. The nature of resolution requires that valuations done for resolution be subject to different criteria than valuations done in the ordinary course of business, such as for financial reporting.

The unique characteristics and importance of valuations for resolution is recognised internationally, and in 2014 the International Valuation Standards Council (IVSC) established a working group tasked with developing a framework for valuations for resolution. Other authorities, such as the European Banking Authority (EBA), have also published proposals and considerations regarding valuations for resolution.

In line with the KAs, the SRB should include provisions:

- that give the SARB the power to appoint an independent third party to conduct valuations of assets and liabilities of an institution or entity;
- that, if due to circumstances the SARB cannot appoint an independent third party, the SARB is allowed to conduct an interim valuation; and
- that, if an interim valuation was done by the SARB, the SARB must appoint an independent third party after resolution to assess the interim valuation done by the SARB.

[21] These are pre-identified instruments, which terms must specify that they will bear losses before other creditors and which meet the necessary disclosure requirements.
[22] Trade creditors refer to suppliers of the institution who are supporting its operations.
[23] Up to the value of the security held.

The SRB should provide that these valuations be used to:

- determine whether the triggers for the POR have been breached;
- inform the SARB's decision for an appropriate strategy, action or use of a stabilisation power;
- determine whether the conditions for bail-in have been met; or
- determine whether the safeguards have been adhered to.

The decision to place an institution in resolution, as well as the resolution strategy and actions taken are final and cannot be overturned. However, the SRB should allow for a review process that provides for affected stakeholders of the institution with due process to have valuations assessed and reviewed by an independent third party to determine whether they suffered any damages, breaching any of the safeguards set out in the framework.

POWERS AVAILABLE IN RESOLUTION

The KAs list a wide range of powers that should be available to the SARB to enable it to resolve DRIs. These powers differ in their intensity, and the use of it would be proportionate to the severity of the systemic event and the characteristics of the failing institution(s). However, an underlying principle is that none of the powers available to the SARB should involve any public funding. If there is a need, or a likely need, that a specific resolution strategy may require taxpayer funds, the power to authorise such a strategy vests in the Minister.

Table 3 contains a list of the resolution powers that the SRB should provide to the SARB in respect of institutions falling within the scope of the bill. This list contains all the general resolution powers, the special powers required for open resolution or stabilisation, and powers assigned to the DGS in resolution. The SARB can decide to directly use its powers in respect of an institution in resolution or to delegate them to the PA.

Table 3: General resolution powers available to the SARB

POWERS TO ISSUE DIRECTIONS FOR THE PURPOSE OF FACILITATING RESOLUTION
The SARB should have the power to issue directions to a DRI for the purpose of facilitating resolution and to attach conditions to such directions, including the power to: • remove directors, managers and advisers; • appoint directors, managers and advisers; • recover monies from responsible persons, including claw-back of variable remuneration; • suspend any distributions to shareholders; • suspend the provision of credit to any party, other than on conditions specified by the SARB; • cease to undertake specified forms of new business without prior approval from the SARB; • comply with any requirements specified by the SARB in relation to a recovery plan or resolution plan and to undertake actions specified by the SARB for the purpose of implementing a recovery or resolution plan; • not take deposits, premiums or other customers, or undertake any other form of borrowing, other than on conditions specified by the SARB; • not repay amounts payable to a depositor, policyholder or other customer, or any other creditor, other than on conditions specified by the SARB; • not make servicing payments on any specified form of liability, other than on conditions specified by the SARB; • not provide collateral to any party, other than on conditions specified by the SARB; • not transfer assets or liabilities to, or accept the transfer of assets or liabilities from, any party, other than on conditions specified by the SARB; • continue to provide specified functions and services to other entities in the group; • make specified changes to the constitution of the entity; • issue specified forms of capital in a manner specified by the SARB; • undertake actions in accordance with contractual provisions in financial instruments to convert debt to capital or to write down debt, as specified by the SARB; and • take such other actions or refrain from taking such other actions as may be specified by the SARB.

CONSEQUENCE OF DIRECTIONS BEING GIVEN
If a direction is given to a DRI, the following provisions apply: • No party to a contract with the entity to which a direction has been given may exercise rights under contracts to deny obligations, accelerate debt, assume control of collateral, terminate a contract or seek to appoint a receiver or liquidator unless the entity to which the direction has been given has failed to honour an obligation under the contract in question. • The giving of a direction by the SARB overrides other statutes to the extent necessary to be able to implement the resolution. • The entity to which the direction has been given is empowered to take all actions required to comply with the direction, notwithstanding any provision in the law to the contrary. • The entity to which a direction has been given, and its directors, officers or agents, will not be held liable for any actions they take to comply with a direction. • A moratorium provision will apply, preventing any person from taking any actions, including the enforcement of security, exercising termination rights or other remedial actions as a result of any breach of contract by an entity resulting from the giving of directions for a period of 48 hours from the time that the direction has been issued. If, by the expiration of the 48-hour period, the entity has not resumed meeting its obligations under the contract in question, then counterparties may exercise contractual rights in relation to the breach of contractual obligations by the entity.

POWERS TO APPOINT A STATUTORY MANAGER[24] OR TO OTHERWISE ASSUME CONTROL

The SARB may appoint a statutory manager to assume control of a DRI, or the SARB may itself assume control of a DRI. The statutory manager must comply with any direction given by the SARB. On appointment of a statutory manager, the SARB will have the following powers, which can be delegated to the statutory manager:

- assume the powers of the shareholders and directors of the DRI, and the shareholders and directors cease to have the ability to exercise their respective powers;
- operate and resolve the DRI, including powers to terminate contracts, continue or assign contracts, purchase or sell assets, write down debt, and take any other action necessary to restructure or wind down the DRI's operations;
- ensure continuity of essential services and functions by requiring other companies in the same group to continue to provide essential services to the entity in resolution, any successor entity or an acquiring entity;
- ensure that the residual entity in resolution (if there is a residual entity) can temporarily provide such services to a successor or an acquiring entity;
- procure necessary services from unaffiliated third parties (at appropriate contractual or prevailing market prices);
- change the memorandum of incorporation of the DRI to facilitate resolution;
- issue capital instruments of any kind to any person for due consideration;
- override the rights of shareholders of the DRI in resolution, including requirements for approval by shareholders of particular transactions, in order to permit a merger, acquisition, sale of substantial business operations, recapitalisation or other measures to restructure and dispose of the DRI's business or its liabilities and assets;
- transfer or sell assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, to a solvent third party, notwithstanding any requirements for consent or novation that would otherwise apply;
- terminate administration or assumption of control of a DRI at any time, provided that the SARB is satisfied that the termination is consistent with the affairs of the entity being resolved in a manner consistent with the maintenance of financial stability and the protection of depositors, and any other statutory objectives applicable to the exercise of resolution powers; and
- terminate the appointment of a statutory manager and replace that person with another statutory manager at any time where it is satisfied that this is consistent with the affairs of the DRI being resolved in a manner consistent with the maintenance of financial stability and protection of depositors, and any other statutory objectives applicable to the exercise of resolution powers.

The statutory manager and the SARB are not liable for any actions they take in exercising powers available to them under the law, provided that the actions taken (or refrained from being taken) are not taken (or refrained from being taken) in bad faith.

[24] The concept of a statutory manager in this context is different from that referred to in the Financial Institutions (Protection of Funds) Act. Appropriate amendments to the latter Act will be proposed under the SR Bill to address any potential overlap.

CONSEQUENCES OF THE APPOINTMENT OF AN STATUTORY MANAGER OR ASSUMPTION OF CONTROL BY THE SARB

If a DRI has been placed in resolution, the following provisions apply:

- The mere placing of an entity into resolution in terms of the SRB is not an event of default or insolvency, and does not give rise to the rights of parties to exercise rights under contracts to deny obligations, accelerate debt, assume control of collateral, terminate a contract or seek to appoint a receiver or liquidator.
- The statutory manager is empowered to take all actions required to implement the resolution, as specified and delegated by the SARB.
- A moratorium provision will apply, preventing any person from taking any actions, including the enforcement of security, exercising termination rights or other remedial actions as a result of any breach of contract by an entity resulting from the appointment of a statutory manager for a period of [48 hours] from the time that the statutory manager assumes office. If, by the expiration of the [48-hour] period, the entity has not resumed meeting its obligations under the contract in question, then counterparties may exercise contractual rights in relation to the breach of contractual obligations by the entity.

POWER TO ESTABLISH A BRIDGE ENTITY

The SARB should have the power to establish one or more bridge institutions to take over and continue operating certain critical functions and viable operations of a failed DRI, including:

- the power to by-pass or fast-track normal company registration and licensing processes;
- the power to temporarily exempt the bridge institution from regulatory requirements within the jurisdiction of the SARB;
- the power to enter into legally enforceable agreements by which the SARB transfers, and the bridge institution receives, assets and liabilities of the failed DRI as selected by the authority;
- the power to establish the terms and conditions under which the bridge institution has the capacity to operate as a going concern, including the manner under which the bridge institution obtains capital or operational financing and other liquidity support;
- the power to determine the prudential and other regulatory requirements that apply to the operations of the bridge institution;
- the power to select management and the manner by which the corporate governance of the bridge institution may be conducted;
- the power to reverse, if necessary, asset and liability transfers to a bridge institution subject to appropriate safeguards, such as time restrictions; and
- the power to arrange the sale or wind-down of the bridge institution, or the sale of some or all of its assets and liabilities to a purchasing institution, so as best to effect the objectives of the SARB.

The law should also provide for the SARB or regulator to establish an asset management entity or other entity for resolution purposes, and to transfer business into that entity (such as impaired assets and non-systemic business).

CONSEQUENCES OF THE ESTABLISHMENT OF A BRIDGE INSTITUTION AND TRANSFER OF SOME OR ALL BUSINESS OF A BANK, HOLDING COMPANY OR SUBSIDIARY TO THE BRIDGE INSTITUTION

If a bridge institution is established and some or all business of a DRI is transferred, the following provision applies:

- no party to a contract transferred to the bridge institution may exercise rights under contracts to deny obligations, accelerate debt, assume control of collateral, terminate a contract or seek to appoint a receiver or liquidator unless the bridge institution has failed to honour an obligation under the contract.

POWER OF BAIL-IN

The SARB should have the power to:

- write-down or write-off, in a manner that respects the hierarchy of claims in liquidation, equity or other instruments of ownership of the DRI, unsecured and uninsured creditor claims to the extent necessary to absorb the losses, and to facilitate recapitalisation;
- convert into equity or other capital instruments all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation;
- convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to the exercise of resolution powers.

The law should provide for a protection to the effect that the exercise of bail-in powers may not render a person worse off than he or she would have been had the entity in question been liquidated under conventional insolvency law.

The law would provide for compensation to be paid to the persons in question to the extent that a post-resolution valuation determines that they have been rendered worse off than under conventional liquidation. To the extent that the government provides this compensation, the law would empower the government to levy the financial sector to recover the monies expended in the compensation.

The law should make it clear that the exercise of a bail-in power does not constitute grounds for the exercise of termination rights under contracts applicable to the financial instruments subject to bail-in or to any counterparties of the entity being resolved.

POWER TO CONDUCT VALUATIONS

The SRB should give the following powers to the SARB in respect of the conduct of valuations:

- to appoint an independent third party to conduct valuations of assets and liabilities of an institution or entity;
- that, if due to circumstances the SARB cannot appoint an independent third party, the SARB is allowed to conduct an interim valuation; and
- that, if an interim valuation was done by the SARB, the SARB must appoint an independent third party after resolution to assess the interim valuation done by the SARB.

POWER TO INVOKE THE DGS

The SARB should have to power to invoke the DGS deposit insurance scheme.

POWERS OF THE DGS IN RESOLUTION
The DGS should have to power to direct the statutory manager or liquidator to: • take such steps as are required to facilitate the calculation of eligible deposit balances per insured depositor; • subject to its own preconditions and criteria being met, facilitate the preparation and transmission of payment instructions; • make deposit balances of insured deposits accessible to depositors via specified channels; • take specified steps to communicate with depositors and other stakeholders; • provide funding related to guaranteed deposits on a least-cost basis in support of a resolution strategy other than liquidation; and • attend to other matters necessary for the administration of the DGS. The DGS should, in legislation, be given the right to share in the proceeds of the recoveries made from the estate of a failed bank, in the same order of preference as the covered depositors would have been in liquidation.

CHAPTER 5
ALIGNMENT WITH CURRENT LEGISLATION

The SRB will overlap with a number of current provisions in legislation that deal with the management and/or wind-down of failing financial institutions. There will be a need to either change some of the existing legislation or to incorporate whole portions into the SRB. This chapter lists the most obvious changes that should be considered, although there are likely to be more. Powers available to the relevant regulators in respect of the winding-up of financial institutions that are not DRIs will be preserved.

SOUTH AFRICAN RESERVE BANK POWERS

The SARB Act assigns various powers to the SARB to address issues in the financial sector. Although these powers are more focused on sector-wide issues, some of the powers, such as providing emergency liquidity assistance, can be used to assist specific financial institutions.

The system-wide powers include powers to address:

- system-wide shortages of rand liquidity in the domestic money market;
- foreign-exchange liquidity shortages at authorised dealer banks;
- extreme financial market illiquidity, volatility or mispricing; and
- destabilising capital inflows and outflows.

The SARB Act further provides the SARB with powers to:

- provide emergency liquidity assistance; and
- acquire shares in a limited company (S10d), but not of a bank without the Minister's approval (13b). This is a potential way to inject capital into an insolvent institution, including a bank.

The SARB can facilitate a private-sector solution through participation in negotiations. However, an assisted merger or acquisition would require coordination with NT (if guarantees or funding arrangements are involved).

These powers are assigned to the SARB as central bank and not in its capacity as the RA and should therefore not be replicated or moved within the ambit of the SRB. However, there may be a need for relatively minor amendments to align the SARB Act and the SRB, for example by referencing the SARB's responsibilities as RA and associated financial stability criteria in the SARB Act.

CURATORSHIP

Curatorship[25] is a managed insolvency tool that allows regulators of a financial institution that is likely to fail to meet its obligations, subject to the necessary approvals, to appoint a competent and qualifying person to take over the management of the institution.

[25] The concept of curatorship in this context is different from that referred to in the Financial Institutions (Protection of Funds) Act. The latter Act positions curatorship primarily as a recovery tool, which may, in the event that recovery is not possible or desirable, be used as an insolvency tool. Appropriate amendments to the latter Act will be proposed under the SR Bill to address any potential overlap.

The curatorship provisions are contained in different financial sector legislation, including:

- the Banks Act;
- the Short-term and Long-term Insurance Acts;[26]
- Financial Markets Act;[27] and
- Protection of Funds Act;[28]
- Pension Funds Act.[29]

The SARB should have the power to, where circumstances permit, appoint a curator under its control to manage the affairs of an institution under resolution, and therefore these special provisions for curatorship must be aligned to the SRB and, where necessary, incorporated into the SRB.

In the case of banks, which in terms of the scope of the resolution framework will fall within the ambit of the SRB, the intention is to remove all bank resolution provisions from the Banks Act and to incorporate them fully into the SRB in order to avoid ambiguity and overlap. In the case of other financial institutions, this will probably not be possible as some of these institutions may fall under the SRB and others not. In those cases, some alignment may be required.

LIQUIDATION

The Companies Acts[30] read with the Insolvency Act[31] sets out the process for placing a company, including a financial institution, in liquidation. These acts are supplemented by financial sector legislation, such as the Banks Act, that contain special provisions setting out additional requirements relating to the liquidation of financial institutions regulated in terms of that legislation.

The special provisions contained in the financial sector legislation regarding liquidation proceedings for financial institutions that fall within the scope of the special resolution framework, including powers relating to the treatment of creditors[32] or DRIs, should be incorporated into the SRB.

THE WAY FORWARD

The planned process and timelines going forward are as follows:

- comments to be received by the end of September 2015;
- industry workshops will be arranged during August and September 2015;
- a research paper on the design features of a DGS will be published around the end of 2015. Many of these aspects will not have to be specified in legislation, therefore commencement with the drafting of the bill is not dependent on the outcome of this research. An opportunity for comment on the paper will also be provided; and

A further phase of research will be undertaken on the application of the special resolution framework to non-bank financial institutions that are DRIs, including work on the development of a policyholder protection scheme.

[26] See the Short-term Insurance Act 53 of 1998 and Long-term Insurance Act 52 of 1998.
[27] See the Financial Markets Act 19 of 2012.
[28] See the Financial Institutions (Protection of Funds) Act 28 of 2001.
[29] See Pension Funds Act 24 of 1956
[30] See the Companies Acts 61 of 1973 and 71 of 2008 respectively.
[31] See the Insolvency Act 24 of 1936.
[32] It is however important to note that the treatment of policyholders in insolvency is not exclusive to systemic insurers, but is a matter that requires further consideration in the context of the insolvency of non-systemic insurers.

ANNEXURE A:
DESIGN FEATURES OF A DEPOSIT GUARANTEE SCHEME

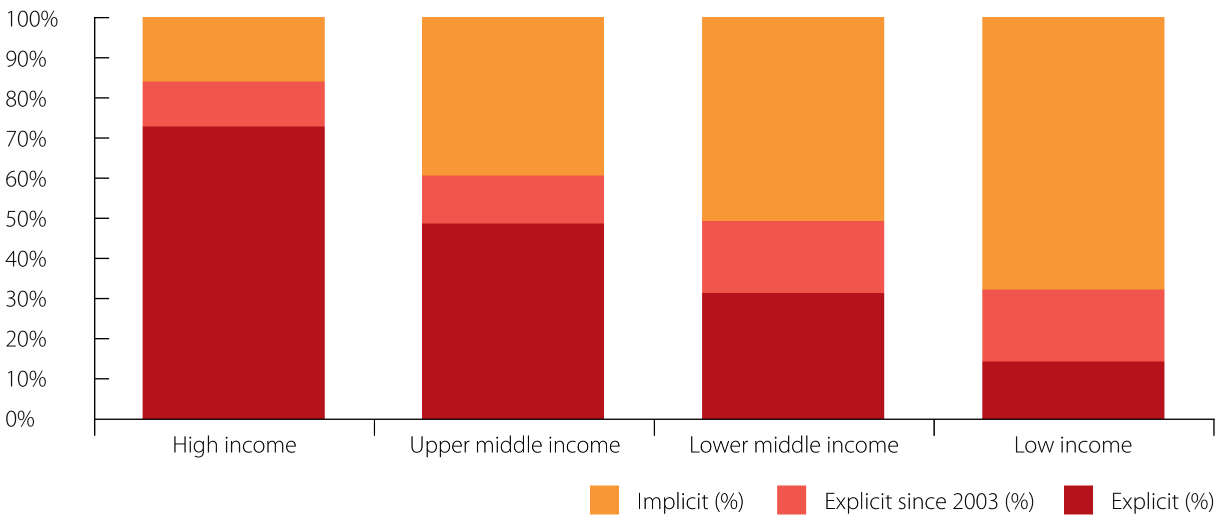
This annexure provides some further motivation for a DGS for South Africa and proposes preliminary preferences on some of the key design features. These preferences are derived from internal research, data obtained from banks in a survey done in 2013, and discussions with the banking industry.

Most of the design features of a DGS will be captured in subordinate rules and regulations, rather than in the SRB itself. The SARB has commissioned a comprehensive research project by a team that comprises senior researchers in the SARB, South African academia with sound knowledge of the financial system, and international experts on resolution and deposit guarantee schemes. This research project is expected to be finalised around the end of September 2015, and the results will be published for further comment before final decisions on the design features of the DGS are taken.

SHOULD SOUTH AFRICA IMPLEMENT AN EXPLICIT DGS?

The KAs require jurisdictions to have privately funded depositor protection and/or a resolution fund in place or, alternatively, arrangements to recover any public costs from the private sector afterwards. South Africa is currently one of three G-20 countries[33] that subscribe to the KAs and that do not have explicit deposit protection in place (the other two being China[34] and Saudi Arabia). The Legislative Affairs Office of China's State Council recently published draft regulations for a proposed deposit insurance scheme.[35] Among a survey of 189 countries, 111 have an explicit DGS. Those that do not have DGSs are mostly lower income countries, and mostly in Africa.[36]

Figure 1: Explicit deposit insurance worldwide, 2013



Source: Demirgüç-Kunt et al. (2014)

[33] Financial Stability Board, *The thematic review on deposit insurance systems peer review report*, 2012, http://www.financialstabilityboard.org/publications/r_120208.pdf.
[34] China is in the process of implementing an explicit deposit insurance scheme.
[35] The Legislative Affairs Office of China's State Council published a set of draft regulations containing 23 articles on its website on Sunday, 30/11/2014 to solicit public opinion until 30 December 2014. http://news.xinhuanet.com/english/china/2014-11/30/c_127263868.htm.
[36] A Demirgüç-Kunt, E Kane and L Laeven, 'Deposit insurance database', *IMF Working Paper WP/14/118*, Washington DC: IMF, July 2014.

Currently, South Africa has an implicit deposit insurance system that has historically been funded by the government. No arrangements are in place to recover compensation to depositors or failed banks from the private sector and taxpayers ultimately fund the costs of bank failures. Implicit deposit insurance inevitably 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 more strain. An explicit scheme provides more certainty about the government's obligations to depositors, 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 for banks to fund the cost of failures.

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 depositor 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 their customers. Also, because of their TBTF status, it is unlikely that large failing banks would simply be liquidated. Therefore, in a simple liquidation scenario, their premiums would contribute most to the fund, but their depositors would be least likely to benefit from it. There was also concern that explicit deposit protection could result in excessive risk taking by institutions and depositors.

However, after the crisis, the role of depositor protection funds has evolved, in line with resolution frameworks. When used in combination with stabilisation powers, a deposit protection or resolution fund could be designed in such a way that it plays a role in the resolution of both large and small institutions. It would also provide the SARB 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 DGS could be bailed in to recapitalise a bank, could issue guarantees or could fund a transfer of deposits to another bank, including a bridge bank. Also, a combination of pre- and post-funding arrangements could reduce the cost on the banking sector. Moral hazard could be reduced by putting a cap on covered amounts and limiting coverage to those depositors that are least able or likely to assess the riskiness of individual banks.

Table 4 sets out the key arguments against and in favour of explicit deposit insurance. Since explicit insurance also has potential disadvantages, it is important that these should be well considered. Generally, the disadvantages of explicit insurance can be overcome through the appropriate design of a scheme – disadvantages are generally associated with excessively large funds that are too generous or that are administratively costly and complex. A well-designed and efficiently administered fund could mitigate most of these disadvantages and strengthen the overall crisis management capabilities of the authorities.

Table 4: Arguments against and for explicit deposit insurance

ARGUMENTS AGAINST	ARGUMENTS IN FAVOUR OR MITIGATING FACTORS
• A DGS puts an additional cost on banks that will be passed on to customers.	• There is a direct link between the cost to depositors and the benefit they get for it. • Taxpayers have formerly absorbed the costs of bank failures. The DGS reduces this risk considerably by providing for an explicit but limited protection for depositors, which depositors pay for. • Premiums could be calibrated moderately to mitigate the cost. • Costs could be reduced by combining deposit insurance with depositor preference, in order to maximise recoveries from the liquidation process.
• Maintaining a fund is wasteful in the absence of a bank failure (opportunity costs).	• In the absence of a fund, the cost of failure is likely to be on taxpayers. Opportunity cost could be reduced by combining pre- and post-funding arrangements, thus reducing the size of a pre-funded amount. • In the event of a failure, a DGS provides the SARB with more options in a resolution strategy without having to revert to public funding.
• A DGS increases moral hazard and reduces market discipline.	• Explicit insurance may contribute to financial stability by reducing the risk of a run of insured deposits. Deposit insurance was proven helpful as a crisis management tool during the financial crisis. [37] • A limit on the insured amounts and covered deposits reduces moral hazard. Typically, those depositors and investors that are best placed to assess bank risk (i.e. providers of wholesale funding) are not covered by the DGS. Small depositors are not in a position to assess the effectiveness of a bank's risk management. • There are various prudential measures in place to address excessive risk taking by banks, such as higher capital and liquidity requirements. • Implicit insurance may create unrealistic expectations and is subject to significant political pressure and discretionary decisions. • Implicit insurance also creates moral hazard in the form of banks being regarded as 'too big to fail'.
• Explicit insurance gives the small, riskier banks a competitive advantage: they can pay higher deposit rates and provide the same safety to depositors as the large, less risky banks.	• In South Africa, the large banks rely predominantly on wholesale deposits and attract retail deposits on the basis of transactional convenience. • There are various prudential measures in place to address excessive risk taking by banks, such as higher capital and liquidity requirements. Less risky banks are rewarded through other prudential measures, such as lower capital requirements. • Explicit insurance may improve access to finance and growth in the smaller bank sector, thus reducing financial concentration over time. • In future, risk-based premiums could be considered.
• By not having a privately funded DGS, South Africa relies on public funding of bank resolution, making it non-compliant with the KAs as an international standard.	• SA has committed to implement the KAs, in line with other G-20 members.

[37] A Demirgüç-Kunt, E Kane and L Laeven, 'Deposit insurance database', *IMF Working Paper WP/14/118*, Washington DC: IMF, July 2014.

It is a policy view that South Africa should implement an explicit DGS, in line with the requirements of the KAs, but the DGS should be designed in such a way that it does not put an excessive cost on the banking system, severely distort competitiveness in the banking sector or cause moral hazard to the extent that it becomes a threat to financial stability.

COVERAGE

The core principles for deposit insurers (CPs) require policymakers to have a clear definition of a qualifying deposit in law. The level of coverage should be limited but credible and be capable of being determined quickly. It should adequately cover the majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.

When considering coverage by the DGS, the following aspects need to be considered:

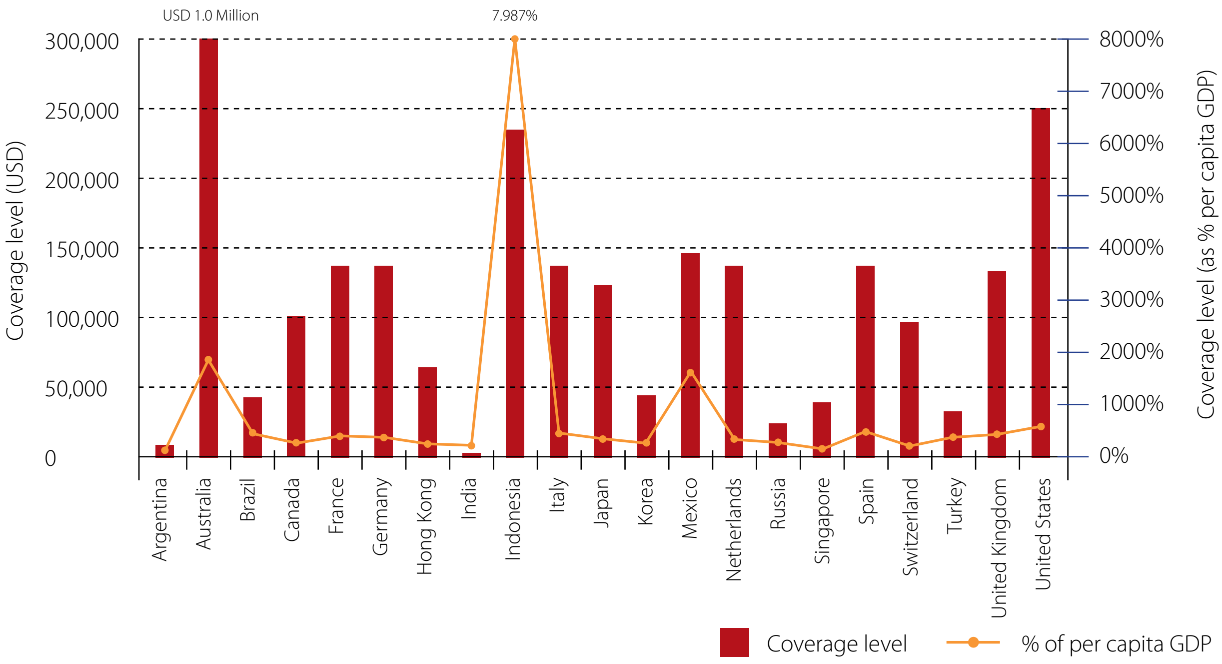
i. Beneficiaries of the DGS: A key policy question is whether all depositors or only certain classes of depositors such as retail and small business depositors should be protected. Larger depositors are considered to be financially informed and sophisticated and should be able to differentiate between different banks' riskiness. Protecting all depositors will increase the funding and premium requirements of a DGS significantly and will increase moral hazard, as there would be no incentive for larger depositors to be selective about their choice of bank. The general view is that depositor protection should focus on depositors who are most exposed to information asymmetry, and most vulnerable in the event of a bank failure. These are typically the retail and small business depositors. Protecting only these depositors will reduce the funding and premium requirements of a DGS and reduce moral hazard.
ii. Foreign depositors: An additional consideration regarding coverage is whether only permanent residents of South African or also foreign depositors should be covered by the DGS.
iii. Covered products: The types of products to be covered by the DGS should be specified.
iv. Deposits at foreign branches of South African banks: A further consideration relates to whether only deposits in South Africa should be included or whether deposits at foreign branches of South African banking groups should be covered by the DGS.
v. Foreign currency-denominated deposits: Consideration should be given to whether only rand-based deposits should be covered or if foreign currency-denominated deposits should be covered by the DGS.
vi. Interest accrual and account fees are other factors to consider when determining the coverage in a DGS. Accrued interest is part of the contractual obligation of the bank towards the depositor, but could have cost implications for banks' systems if the daily calculation of accrued interest is not currently done. In the same manner, account fees are a contractual obligation of the depositor to the bank, but calculating the netting of account fees would result in significant administrative costs for banks while the benefit thereof would be immaterial.
vii. Coverage could be done at a gross or net level. Netting would entail deducting any amounts owed by the depositor to the bank from the deposit balances held by the depositor. This would result in significant costs from the banks' perspective and could impede prompt DGS payouts. Given that many depositors may owe the bank more than they have in deposits with the bank, requiring netting to be done would result in most depositors not receiving any payouts and would defeat the purpose of the DGS of reducing financial distress in the event of a bank failure. Loans are typically long-term, while retail deposit amounts are mostly used for shorter-term transactional purposes. A netting approach will also slow down the payout process, which defeats the purpose of the scheme.
viii. The treatment and inclusion of pooled trust accounts under a DGS need to be considered. Pooled trust accounts are deposit accounts held in the name of a trustee on behalf of clients, such as a real estate agent's trust account.

COVERED AMOUNT

A DGS usually has a limit to the amount that is guaranteed, per depositor per bank. This requires the banks to have systems that would allow a SCV to be able to determine the total value of deposits held by a single customer.

In terms of the guidance provided by the International Association of Deposit Insurers (IADI),[38] two approaches are generally used to determine the cover limit, namely coverage as a percentage of the per capita gross domestic product (GDP), and the guideline of covering 80 per cent of depositors and 20 to 30 per cent of the deposit values. The international practice is to specify a limit per depositor per bank. This limit should be high enough to achieve the objectives of the DGS, but not so high that it becomes unaffordable, creates moral hazard or goes beyond the objectives of the DGS.

Figure 2: Comparison of absolute levels and percentage of per capita GDP



Source: Financial Stability Board, The thematic review on deposit insurance systems peer review report, 2012, http://www.financialstabilityboard.org/publications/r_120208.pdf.

However, cost to the banking sector is also an important consideration, in particular since South Africa does not have regular bank failures. The cost to banks is not only influenced by the covered amount, but by the funding model, the target size of any pre-funded portion, the time frame over which this target is to be reached, as well as the structure and cost of post-funding arrangements. These aspects are discussed in subsequent paragraphs.

The coverage level will not be specified in legislation, and further analyses and input will be considered before implementation of the DGS.

[38] International Association of Deposit Insurers, *Enhanced guidance for effective deposit insurance systems: deposit insurance coverage, 2013*, http://www.suerf.org/download/studies/study20095.pdf.

FUNDING MECHANISM

In order to ensure prompt reimbursement of insured depositor claims, a DGS should have adequate funding mechanisms in place, including supplementary back-up funding for liquidity purposes, when required. The primary responsibility for funding the DGS should be the banking sector since the banks and their depositors benefit directly from the DGS.

There are three funding mechanisms policymakers can choose from:

i. Pre-funding: A pre-funded scheme requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure occurring. Pre-funding is usually done through levy payments from banks. The main argument against an ex-ante fund is the cost that it incurs on banks that may never be subject to failure. However, there are a number of benefits:
    - The DGS can refrain from using public funds during a period of financial stress and crisis.
    - The DGS is able to deal immediately and effectively with the failure of small banks.
    - Failing banks also contribute to the DGS, and not only surviving banks.
    - An ex-ante funded DGS enables the use of the DGS for other resolution strategies, such as funding the transfer of selected banking business to another bank or bridge bank or to recapitalise a troubled bank.

ii. Post funding: In this mechanism depositors are reimbursed through a parliamentary appropriation or borrowing by the DGS from the government or central bank. Recoveries of the disbursements are then made from the failed bank and any shortfall in recoveries is recovered through a levy on the surviving banks. South Africa's largest banks prefer an ex-post funded DGS due to the contribution the larger banks would have to make to the DGS even though they are not necessarily the riskier banks. Post funding is obviously cheaper in the absence of a bank failure, but can be more expensive once a bank failure occurs, as only the surviving banks then contribute to the cost. Also, 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 cost of a DGS.

iii. Hybrid or combined funding: This form of funding involves elements of both ex-ante and ex-post funding, such as charging levies before a bank failure, increasing premiums, charging additional levies and receiving the proceeds of liquidations. A hybrid funding model can combine the advantages of pre- and post-funding, while reducing the disadvantages.

Irrespective of the funding mechanism, there should be clear arrangements in place for the temporary funding of a shortfall by either the government or the SARB.

Further advantages and disadvantages of pre- and post-funding mechanisms as presented by Bernet and Walter (2009: 37)[39] are set out in Table 5.

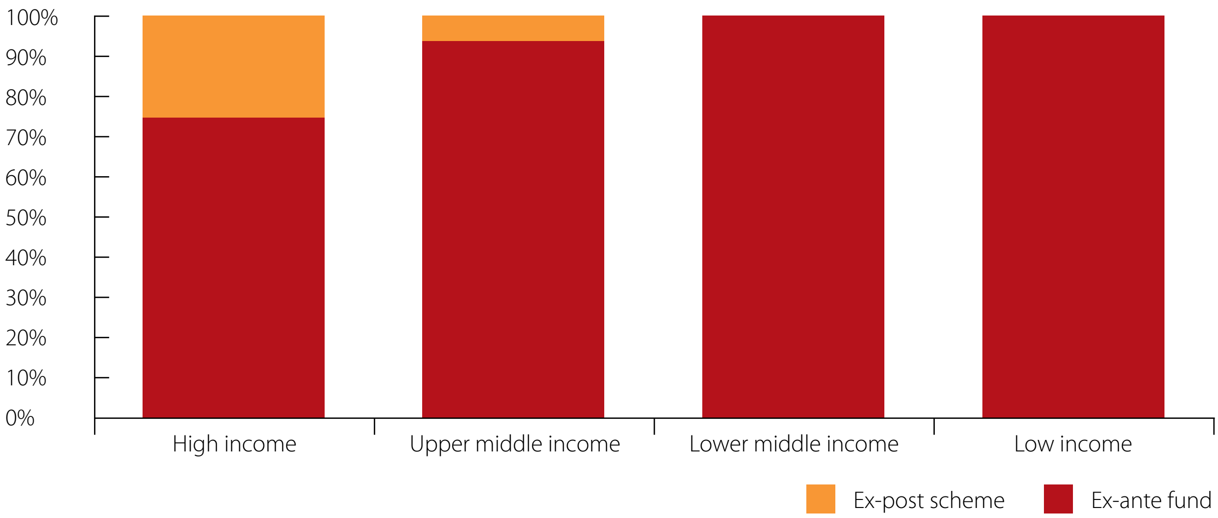
[39] B Bernet and S Walter, *The design, structure and implementation of a modern deposit insurance scheme*, published in 2009, available at http://www.suerf.org/download/studies/study20095.pdf.

Table 5: Pre- and post-funding mechanisms

	ADVANTAGES	DISADVANTAGES
Post-funding	• Market discipline: induces banks to monitor each other's activities	• Pro-cyclical effects: commitments in poor economic situations may lead to a domino effect of bank failures, a renegotiation of conditions and/or a collapse of the DIS. • Penalty on surviving banks: well- managed banks pay for the failure of poorly managed banks
Pre-funding	• Public confidence: prompt reimbursement of depositors possible • Smoothed premium payments: reduced pro-cyclical effects • Reduced moral hazard: ex-ante funding could incorporate risk-adjusted premiums • Equitable and fair: all member institutions (including prospective failed institutions) contribute	• Adequate fund size: difficult to establish a fund of sufficient size • Adequate premium calculation: difficulties in defining a 'fair' calculation method • Administrative complexity: organisational and strategic intricacy

Internationally, the majority of countries make use of an ex-ante funding approach, as shown in Figure 3.

Figure 3: DGS funding models



Source: World Bank Development Research Group[40]

[40] World Bank Development Research Group, *Deposit Insurance Database, 2014*, http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2014/06/23/000158349_20140623165947/Rendered/PDF/WPS6934.pdf.

The intended approach for South Africa is to adopt a hybrid approach to the funding of the DGS. A levy should be charged on all banks to pre-fund a DGS to the targeted level. However, in the event of a shortfall during the build-up period as well as thereafter, formal arrangements should be put in legislation for government to fund such a shortfall. This funding should be recovered afterwards through a combination of liquidation proceeds and levies on surviving banks.

SIZE OF THE PRE-FUNDED PORTION AND BUILD-UP PERIOD

The size of a DGS fund should be sufficient to reduce the probability of its insolvency to an acceptable minimum, recognising that the capacity of banks to pay a premium is limited and that the DGS fund will never be sufficient to be able to reimburse all depositors in the case of a systemic crisis.

In South Africa, bank failures historically affected only small- to medium-sized banks. The failure of a large bank is likely to be handled through a range of resolution interventions, necessitating only partial, if any, payouts or transfers. During the 2014 FSAP assessment, the recommendation from the IMF was for a fund size of 4 per cent of the insured deposits (about R8 billion at the time), and that this amount should be built up over a period of at least five years. However, the build-up period affects the premiums and should be considered in an affordability context.

If covered depositors (or the DGS in their stead) have preference in liquidation, it is likely that it will be fully compensated from liquidation proceeds. This is supported by high-level loss given default analyses conducted by BASA.

PREMIUMS

In order to fund the DGS, levies or premiums should be charged from banks. Proposals on the DGS premiums should consider both the base on which premiums should be levied, and the level of the premiums. Although the target fund size and premiums will not be specified in legislation, some policy views on, and analyses of, these aspects are necessary to estimate the likely cost of a DGS.

The wider the base on which levies are charged, the lower the premium becomes in terms of basis points. In this regard, there are several options policymakers can choose from. These include:

i. Total bank liabilities: This option results in the costs of deposit insurance shifting from depositors to larger institutions that rely less on deposits for funding. The advantages of this approach is that it is simple to apply and that it results in a more even spread of the costs of the deposit insurance between small and large banks, as large banks finds it easier to attract non-deposit funding while smaller banks are dependent on funding from deposits. On the negative side, providers of non-covered funding would subsidise covered depositors by contributing to the DGS without getting any benefit from it. Countries such as Mexico and the United States make use of a total liability proxy as a basis for assessing premiums.
ii. Total deposits (all deposits held by a bank, including retail, SMEs and wholesale deposits): Using total deposits as a base can reduce the cost of cover for individual depositors, but non-qualifying depositors (that is, the wholesale depositors) will be paying for deposit insurance without benefiting directly from it. This would in effect also mean that banks focusing on private banking clients and corporate banking would subsidise banks with many smaller depositors. Countries such as Indonesia, Kenya and Nigeria use total deposits as the basis for assessing premiums.
iii. Total qualifying deposits (total retail and SME deposits): If a levy is charged on large retail and SME deposits (including

amounts above the covered limit), banks could be tempted to structure their deposits in such a way that the lowest premiums are paid. Large retail and SME deposits could become less attractive, with possible adverse behaviour in terms of the Basel III liquidity standards. Countries such as Colombia use this as an assessment basis.

iv. Total covered deposits (retail and SME deposits capped at the covered amount): Levying a premium on total covered deposits links the cost of coverage directly with the benefit thereof since depositors only pay insurance for the amount of their deposits that are covered. This is the most equitable base for calculating premiums, as there is no subsidisation of certain classes of liability holders by others. Countries such as the United Kingdom and Switzerland use covered or insurable deposits as the basis for assessing premiums.

In order to maintain a direct link between the benefits of a DGS and the premiums, it is the preferred approach that the levies should be based on total covered amounts, up to the coverage limit.

Levies could be in the form of a flat fee (uniform percentage of covered deposits) or risk-based (also taking the riskiness of each bank into consideration). Although risk-based levies could reduce moral hazard, it is difficult to assess the risk of the bank (the probability of failure over a given period), it has higher administrative costs and it could lead to adverse signalling if the levy is disclosed publicly. In addition, prudential requirements already impose penalties on riskier banks. In the interest of simplicity, risk-based levies are not normally recommended for new funds. The advantages and disadvantages of flat and risk-based premiums are set out in Table 6.

Table 6: Comparison of flat and risk-based premiums

PREMIUM STRUCTURE	FLAT	RISK-BASED
Advantages	Easier to administer	More equitable – premium based on riskiness of bank
	Requires less resources and is less expensive to administer	Reduces moral hazard
Disadvantages	Less equitable – all banks pay the same percentage regardless of riskiness	More complex to administer
	Could increase moral hazard	More expensive since more resources are required

Source: International Association of Deposit Insurers, 2009[41]

In the 2014 FSAP, the IMF recommended that flat DGS premiums should be levied from banks, at least initially. Owing to the concentrated nature of the South African banking sector, a risk-based premium on banks will reduce the amount payable by the largest four banks, but the premium on small banks will have to be significantly higher in order to achieve a targeted fund size within a reasonable time frame. The preferred approach of the authorities is to implement the DGS in its simplest form, that is, with a flat fee structure, but to change to a risk-based fee structure once it is well established.

[41] See International Association of Deposit Insurers, *Funding of deposit insurance systems: guidance note*, published in 2009, available at http://www.iadi.org/docs/funding%20final%20guidance%20paper%206_may_2009.pdf.

TRANSITION FROM AN IMPLICIT TO AN EXPLICIT DGS

The transition from an implicit guarantee (which might have been perceived to be without limit) to an explicit but limited DGS should be a managed process, taking into account the following factors:[42]

The public may be concerned that the level of protection of their deposits would be reduced under a limited coverage system. The conditions of the new system, and the fact that payouts would be quick, should be communicated. Transitioning to a limited coverage scheme would be done quicker and easier in a time when there is financial soundness in the banking sector.

The capacity of the banking system to fund the newly established DGS should be considered since the banks will now be required to pay levies. There should also be a mechanism in place to ensure that the DGS will have access to sufficient back-up funding during and after the period of transition.

The speed of the transition should be determined by the country's circumstances. Should the implementation be done gradually, banks will have more time to get prepared and depositors will have more time to get accustomed to the new arrangements. If a gradual transition takes too long it could create doubts among banks and depositors about the commitment of government to the establishment of the new DGS. It could also lead to uncertainty about whether deposits are covered at all, albeit implicitly or explicitly.

In light of these considerations, once decisions have been taken on the outstanding issues relating to the design features of the DGS framework, a detailed transition plan should be developed and implemented, in consultation and cooperation with the banking sector.

REIMBURSING DEPOSITORS

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

The depositors should have a legal right for reimbursement up to the coverage limit and should know when and under what conditions the DGS will initiate the payment process, the time frame within which this would be done, whether any advance or interim payments will be made, as well as the applicable coverage limits. In this regard, the trigger for DGS payout needs to be defined as it will define when and how the reimbursement of depositors will be made.

The trigger for DGS payout to depositors should be when the SARB invokes the DGS, that is, the decision resides with the SARB depending on the resolution strategy that it adopts. Payout should occur as soon as possible after a bank has entered resolution. Although it may be an ambitious goal initially, the aim of the DGS should be to put systems in place to be able to pay out within seven days after the closure of a bank.

[42] See Bank of England, *Deposit insurance*, published in 1996, available at http://www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ccbshb09.pdf.

CONCLUSION

The preferences put forward in this annexure are based on preliminary research as well as input from industry, the IMF and the World Bank. A comprehensive research project is being commissioned that will either confirm these preferences or recommend different approaches. The interim comments received on this paper and its annexures will provide input into this research project. A final position paper will be published for further comment once the project has been finalised, which is intended to be towards the end of 2015.

ANNEXURE B:
BAIL-IN AS A RECAPITALISATION TOOL

INTRODUCTION

Bail-in is one of the new powers included in the KAs that attracted the most attention as countries adapted their resolution frameworks in line with these new standards. Bail-in is a valuable recapitalisation tool available to RAs, provided that is well understood, transparent and provides adequate safeguards to creditors and investors.

This annexure describes bail-in and the various types of bail-in, the mechanisms through which bail-in can be effected with their respective advantages and disadvantages, the conditions that should be in place for RAs to apply bail-in, and the safeguards that should be provided to creditors and investors.

DEFINING BAIL-IN

For the purpose of this paper, 'bail-in' is defined as any process outside of liquidation that has the effect of allocating losses to liability holders or shareholders, for the purpose of increasing the capital ratio of the institution. This is a broad, principle-based definition that does not consider the mechanism through which the purpose is achieved. There are different mechanisms and methodologies that can be applied to allocate losses and to recapitalise an institution, which are discussed below under bail-in mechanisms.

This paper treats bail-in and creditor hierarchy as two separate issues, with the latter addressed in Annexure C. Bail-in is typically applied by the RA outside liquidation (or in an attempt to avoid the liquidation of a DRI). Creditor hierarchy only applies in liquidation, but becomes relevant in the context of bail-in because of the KA safeguard that no creditor should be worse off through bail-in than it would have been in liquidation.

The KAs do not prescribe technical standards for bail-in but state the following principles:

"3.5 Powers to carry out bail-in within resolution should enable resolution authorities to:

(i) write down in a manner that respects the hierarchy of claims in liquidation (see Key Attribute 5.1) equity or other instruments of ownership of the firm, unsecured and uninsured creditor claims to the extent necessary to absorb the losses; and to

(ii) convert into equity or other instruments of ownership of the firm under resolution (or any successor in resolution or the parent company within the same jurisdiction), all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation;

(iii) upon entry into resolution, convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution and treat the resulting instruments in line with (i) or (ii).

3.6 The resolution regime should make it possible to apply bail-in within resolution in conjunction with other resolution powers (for example, removal of problem assets, replacement of senior management and adoption of a new business plan) to ensure the viability of the firm or newly established entity following the implementation of bail-in."

BENEFITS AND RISKS OF BAIL-IN POWERS

In order to comply with the KAs, South Africa's resolution framework should explicitly allow the RA to assign losses to shareholders and certain classes of creditors of a failed DRI, with or without their consent, in order to mitigate the risk of having to bail out the failed DRI.

Bail-in is essentially a loss absorption and recapitalisation tool. It provides regulators and resolution authorities with the power to recapitalise all or part of a financial institution in a transparent and legally certain way, by applying losses to shareholders and certain creditors, so that it is not necessary for the government to bail out such an institution with taxpayers' money.

The key benefits of the bail-in are that it can reduce moral hazard, the macroeconomic costs of resolution, and the need for a government to bail out a failed institution. The fact that a DRI might be seen as TBTF and that it is likely to be bailed out in the event of a failure increases the moral hazard associated with the DRI. Bail-in, as an alternative to bail-out, decreases the level of moral hazard by reducing the TBTF status of the DRI, which in turn helps to reduce risk taking and to ensure non-subsidised pricing for risk by shareholders and creditors.

However, of all the stabilisation tools, bail-in is the most controversial with the most potential negative consequences. If implemented inconsistently, it has the potential to significantly increase the DRI's cost of funding, to cause investor behaviour that does not support financial stability, and to distort the funding structure of the DRI at the expense of other risk areas, such as liquidity risk. Also, bail-in can be regarded as a form of expropriation that could be challenged legally. This risk should be addressed by clearly and explicitly defining in legislation the circumstances in which bail-in would be applied, and the conditions or safeguards that will apply in such circumstances, as discussed later in this annexure.

CONTRACTUAL AND STATUTORY BAIL-IN

Bail-in can be conducted either through a contractual agreement between the institution and the creditor or investor, or through statutory powers that do not require agreement by the creditor or investor.

i. Contractual bail-in

Contractual bail-in can be implemented in cases where the instruments contain terms that allow them to be written down or converted by the RA, regulator or even the institution itself when a defined trigger event occurs. The creditor agrees at the outset when the instrument is issued that its claim against the failed DRI, which derives from the instrument, may be reduced or negated when the trigger event, as set out in the terms, is breached. In the case of resolution, the trigger event will be when the institution is placed in resolution. This mechanism should be incorporated where the regulatory framework requires regulated institutions to hold certain instruments as a layer of loss-absorbing capacity (LAC), such as regulatory capital, gone-concern loss-absorbing capacity (GLAC) or both of the aforesaid in the form of total loss-absorbing capacity (TLAC). The Basel III framework requires that all newly issued debt instruments should contain a contractual bail-in clause in order to qualify as capital.

The resolution framework should include provisions that allow the RA or regulator to:

- identify or accept certain liabilities for purposes of GLAC or TLAC (regulatory capital plus GLAC) in line with LAC requirements; and
- instruct DRIs to include contractual terms in the instruments that allow the RA or supervisor to write down, or convert, the instrument when the institution either reaches the defined trigger or enters resolution.

ii. Statutory bail-in

In terms of statutory bail-in, the funding instruments or liabilities of DRIs do not require a contractual term that allows them to be bailed in. Instead, the resolution legislation allows the RA to exercise bail-in powers when the DRI enters resolution.

The resolution framework should specify which bail-in powers and mechanisms are available to the RA and under which circumstances certain instruments will be subject to bail-in. Statutory bail-in provisions ensure that the RA has the legislative power to implement bail-in, even if the institution does not have enough liabilities with contractual bail-in clauses. Through statutory powers, the RA can effect bail-in without the consent of shareholders or creditors. Statutory bail-in powers also make it possible to bail-in instruments in a situation where it is not possible to include contractual bail-in clauses in the agreement, such as perpetual preference shares already in issuance or deposits.

BAIL-IN MECHANISMS

i. Write-down or write-off

If the RA has the legal power to write-down or write-off, it has the power to either:

- change ownership of all or some of the shares, which will have the effect that the shares remain in existence, but that the current shareholders lose their right, title and interest in the shares; and/or
- to negate or reduce the claims of creditors. In terms hereof, certain of the failed institutions' liabilities will be reduced or completely discharged. This will increase the net asset value (i.e. the equity) of the institution.

If liabilities are written down or written off without a change in ownership of the shares, such liabilities will in effect become subordinated to equity. In order to maintain the hierarchy of claims in liquidation, shareholders will always be the first to have their shareholding written off or written down to absorb losses.

The advantages of write-down as a bail-in mechanisms are that it is relatively straightforward and quick to implement and it does not require complex additional valuations. As long as shareholders are the first to suffer losses, the hierarchy of claims can be respected. Write-down or write-off affects the ownership of shares, but not the number or value of shares in issuance, like some of the other mechanisms.

The main disadvantages of write-off or write-down include the following:

- The losses of creditors immediately become realised, which could affect the health of their own balance sheets and, in the case of institutional investors, their own prudential requirements (e.g. defined benefit pension funds that lose a significant portion of their assets).
- The realisation of losses through write-down or write-off raises the question of possible write ups once an institution recovers (i.e. returning some of the recovered value to creditors), which is a complex exercise. Most jurisdictions that apply write-down as a bail-in instrument do not write up these investments again, as the valuations in distress and subsequent recovery are highly fluid and subjective, potentially exposing the RA to years of legal challenge. Compensation could be required to reimburse creditors for excessive write-down based on ex-post valuations.
- Shareholders and creditors will be completely divested of the written down portion of their securities or liabilities and, as such, any premature or inaccurate use of the tool might severely infringe the rights of the affected shareholders and creditors and result in claims against the RA or other protracted and costly litigation processes.

ii. Conversion to regulatory capital

Conversion to share capital occurs if a claim of a liability holder is partially or fully written down (written off) and, in turn, the liability holder receives compensation in the form of shares equal to the written-down portion, or with a haircut subject to the

NCWO rule. In conversion, creditors do not lose the full value of their claims as they receive compensation in the form of shares. The converted creditors become shareholders in the recapitalised institution.

In order for the process to respect the hierarchy of claims, existing shareholders are divested of their shares and these shares are allocated to converted creditors. Alternatively, new shares could be issued and allocated to converted creditors as compensation.

The advantages of conversion to share capital are the following:

- Creditors do not have to realise their full loss. The accounting impact on creditors is smaller.
- Creditors (as the new shareholders) have an opportunity to recover their losses if the institution recovers (i.e. automatic 'write-up').
- The hierarchy of claims is respected if existing shareholders are completely written off or if liabilities are converted to shares at a more favourable price.
- If new shares are issued as compensation to creditors, it automatically dilutes the value of existing shareholders, thus maintaining the creditor hierarchy.

The disadvantages of conversion to share capital or potential problems that could be experienced are the following:

- Changing a creditor to a shareholder may result in a breach of investment limits, which may either be statutory or based on internal investment mandates. Unless specific provision is made for the temporary breach of such limits, it could result in an immediate sell-off of the newly converted securities.
- Changing creditors to shareholders also changes the ownership structure of the institution. In instances of very large exposures, this could even change the control of an institution and may require regulatory approval.
- The valuations involved in conversion are more complex than in the case of write-off. Both the liabilities and the new shares have to be valued and exchanged at an equitable conversion rate.

iii. Issuing new share capital

An institution could be recapitalised by issuing new share capital. Although this is not typically regarded as a bail-in tool, the economic effect adheres to the principle-based definition in this paper because the institution is recapitalised by forcing losses on existing shareholders, outside of liquidation. In resolution, new issuances should not require the approval of the existing shareholders, and the rules of the JSE Limited should make special provision for accelerating the issuance process.

The main benefit of issuing new shares is that it dilutes existing shares (i.e. they incur losses) without affecting any rights of liability holders. However, the main disadvantage is that it may be difficult to raise enough capital through a new issuance for a DRI that is already in resolution.

iv. Transfer

In resolution, certain assets and liabilities can be transferred from the failed institution to a new institution, while the other assets and liabilities remain in the old institution. This situation is commonly referred to as a 'good bank, bad bank' split. Although the

KAs do not specifically treat the transfer of assets and liabilities as a form of bail-in, such transfer also provides a mechanism to apply losses to shareholders and creditors and can therefore be regarded as a form of bail-in. It could involve good assets and senior debt being transferred to a bridge bank or acquiring entity, while shareholders and subordinated creditors remain in the old ('bad') entity (with the lower quality assets) which is likely to be liquidated. This will result in the situation where creditors in the liquidated entity bearing greater losses than the creditors in the new ('good') entity, and as such effectively being bailed in. The benefit of transfer is that it immediately capitalises the part of the DRI that the RA wishes to retain (e.g. the critical services or the healthy part of the business), thereby increasing the chances of recovery of the 'good bank'.

Disadvantages of this methodology usually arise where the legal framework does not sufficiently provide for it or contain obstacles that hinder the effective implementation thereof.

CONDITIONS FOR EFFECTIVE BAIL-IN

Bail-in may be seen to impact on the rights of affected shareholders and creditors. If implemented inconsistently or prematurely, it could have several negative consequences, including constitutional challenges and costly legal action against the RA. In order to mitigate possible negative consequences and inspire confidence in the financial sector that bail-in will be implemented with caution, and with respect to the rights of investors, the resolution framework should include conditions that should be met before any of the bail-in powers can be exercised by the RA.

The following conditions should apply for bail-in within resolution:

Bail-in without the consent of shareholders and creditors (i.e. pure statutory bail-in) should only be applied to DRIs where liquidation has to be avoided.[43] The regulatory and resolution framework should provide for the identification of a DRI in order for the aforesaid condition to be set. (The process for the identification of DRIs in different circumstances is set out in the draft FSRB).

The purpose of bail-in is to restore the capital adequacy of the failed DRI. However, restoring the solvency is only meaningful if there are good prospects for the DRI (or the retained part of it) to recover and become viable again. Therefore, for bail-in to be successful, it should be used in conjunction with the other resolution tools to ensure the viability of the institution, such as restructuring, change of management, selling of assets, and so forth. Bail-in restores an institution's solvency, while the supporting interventions restore the institution's viability.

SAFEGUARDS: EXCLUSIONS, CREDITOR HIERARCHY AND NCWO

After the conditions have been met for a bail-in and the form and process determined, safeguards should be present in the framework that seek to prevent the actions of the RA leading to a further loss of value, undue infringement of the rights of affected stakeholders and creditors or other avoidable negative consequences. In principle, two broad safeguarding measures are proposed, namely the explicit exclusion of certain liabilities from bail-in, and respecting the creditor hierarchy to the extent necessary to ensure that no creditors should be worse off in resolution than it would have been in liquidation. These safeguards are discussed in more detail in subsequent paragraphs.

[43] In the case of non-SIFIs, there is no need to avoid eventual liquidation, and the normal insolvency processes should be respected. It may be possible (or even likely) that a going-concern resolution for a non-SIFI will be less costly than liquidation, and that it will be beneficial to creditors to suffer a degree of bail-in rather than to enter a liquidation process. Open resolution should be an option for non-SIFIs, but this will fall outside the scope of the SRB. Also, it should be possible to obtain consent from shareholders and creditors for the open resolution of a non-SIFI, on a least-cost basis.

In order to maintain flexibility in the bail-in decision, depending on the prevailing circumstances and the characteristics of the institution to which bail-in is applied, it is not advisable to explicitly exclude in legislation large parts of liabilities from bail-in. However, there are certain liabilities for which strong arguments for exclusion can be made for reasons such as financial stability, depositor protection and the integrity of the financial system. Such exclusions could be explicit, mandatory exclusions that are set by the legislation and from which the RA cannot defer, or discretionary exclusions that allow the RA to determine at the point of failure of a DRI that certain liabilities should be excluded.

i. Mandatory exclusions

For purposes of financial stability and the uninterrupted operation of the financial system, it is necessary to exclude certain instruments or liabilities from the bail-in tool. The bail-in of certain liabilities in the payment, clearing or settlement systems may cause contagion and pose further systemic risks to the financial system.

The Insolvency Act allows for the cancellation or termination of certain agreements, namely:

- section 35A provides for certain transactions on an exchange to be cancelled or terminated upon the sequestration of the estate of the market participant, and as a result be excluded from resolution; and
- section 35B provides for the termination of certain master agreements as defined in subsection (2) upon the sequestration of the estate of the party to such master agreement, and which includes, among other things, agreements in accordance with standard terms published by the International Swaps and Derivatives Association (ISDA).

ii. Discretionary exclusions

There are also liabilities that should not be excluded in general, but particular circumstances may require the RA to exclude them from bail-in. Examples are liabilities with short maturities, liabilities that will contribute to contagion (such as interbank liabilities) or liabilities that are difficult to value (such as liabilities as a result of non-standard over-the-counter (OTC) derivatives transactions).

In line with the KAs, the bail-in tool and the sequence of bail-in must respect the hierarchy of creditor claims in insolvency between creditor classes. In order to enable bank shareholders and creditors to assess and price for the relative risk inherent in financial instruments issued by banks, and to enable banks to fund themselves appropriately, an acceptable level of transparency and predictability of the probability of bail-in should be in place.

Respecting the creditor hierarchy in bail-in does not necessarily mean that the bail-in sequence should be exactly the same as it would be in insolvency and liquidation. This safeguard should allow flexibility to depart on a case-by-case basis from the strictly *pari passu* treatment of creditors within a given creditor class, if that is necessary to maintain financial stability or maximise value for creditors as a group.

The NCWO rule is directly linked to the creditor hierarchy and ensures that a creditor does not suffer greater losses in resolution than it would have suffered in liquidation. The NCWO rule does not prevent the RA from distinguishing between creditors in the same class and assigning greater losses to one creditor in comparison to another creditor of the same class, as long as the aforesaid creditor does not suffer a greater loss than it would have suffered in liquidation. The NCWO rule is an important safeguard to investors and a necessary element in determining the loss given default (LGD) of a security as part of the pricing process.

In order to protect financial stability and to safeguard against any further systemic shocks to the financial system after the failure of a DRI, the resolution framework should allow for the exclusion, either mandatory or discretionary, of certain liabilities. The resolution framework should respect and take into account current exclusions from the insolvency framework and provide for additional exclusions that are necessary as a result of the financially interconnected nature of these institutions.

The bail-in tool in the revised resolution framework should contain the following mandatory exclusions:

i. secured creditors;
ii. qualifying deposits; and
iii. preferred creditors in the current insolvency framework.

The bail-in tool in the revised framework should also provide the RA with the discretion to exclude:

i. wholesale depositors; and
ii. trade creditors

subject to the conditions that:

a. it will not be possible to effect the resolution of the failed or failing institution without excluding the above liabilities;
b. the exclusions are necessary to sustain the critical functions and critical shared services of the failing or failed institution; and
c. the exclusions will prevent any unnecessary contagion effects.

INTERNATIONAL FRAMEWORKS

i. European Union

Section 63 of the European Council's (EC) Bank Recovery and Resolution Directive[44] (BRRD) requires member states to incorporate the bail-in within resolution tool in their local resolution frameworks in line with the requirements and principles set out in articles 43 to 52 of the BRRD. Bail-in in terms of the BRRD allows for both the write-down and conversion mechanisms. Many of the member states are in the process of adopting bail-in within resolution powers in order to comply with the timelines for 2015 given by the EC.

ii. United Kingdom (UK)

After the 2008 global financial crisis, the UK Banking Act[45] was amended to include a chapter for a new special resolution regime for banks. The Act was further amended by the Financial Services (Banking Reform) Act 2013, by conferring a further power on the Bank of England to bail-in shares and certain creditors of a failed bank. The UK is in the process of making further amendments to its framework in order to align it with the requirements set out in the BRRD.

[44] See the Directive 2014/59/EU of the European Parliament and of the Council.
[45] See the UK Banking Act 2009 of 15 May 2014.

iii. Australia

Australian legislation provides for the transfer of certain or all of the assets and liabilities of a failed institution without any creditor or shareholder approval. This allows the RA to transfer the good assets and liabilities to a new or bridge/temporary institution while leaving the shareholders and certain creditors in the old institution to bear the losses.

THE CURRENT SOUTH AFRICAN FRAMEWORK

Bail-in powers are partially provided for in the Banks Act, as set out below. However, South Africa's resolution framework does not currently have clear, transparent and explicit bail-in powers as required in the KAs, and the existing arrangements require some sort of consent from the creditors to be bailed in. It will be quite difficult under the current arrangements to apply bail-in to a DRI that is a financial conglomerate with both banking and non-banking entities, that has cross-border operations, that is very large or that has complex legal, operational and organisational structures.

i. Regulation 38 provisions

The only explicit reference to the write-down or conversion of liabilities in the South African framework is the PONV[46] write-down and conversion of additional tier 1 and tier 2 instruments as set out in regulation 38 of the Regulations relating to Banks. Regulation 38(13)(b)(i) sets out certain loss-absorbing requirements for additional tier 1 and 2 instruments, including a requirement that the instruments must contain a provision that allows such instruments to be either written down or converted at the discretion of either the bank or the Registrar of Banks. The write-down and conversion provisions contained in regulation 38 are contractual in nature and are supervisory mechanisms to enable a bank to recover from a distressed situation. These bail-in instruments form part of the recovery process, rather than being a resolution mechanism.

ii. Curatorship

The provisions of the Banks Act relating to curatorship allow a curator, subject to conditions and approvals, to transfer specific assets and liabilities. Although the conditions and approvals attempt to prevent unilaterally assigning losses to creditors within the same class, a situation resembling a 'good bank, bad bank' split may occur, with economic results similar to an explicit bail-in (refer to section 7.5).

Because bail-in is a very intrusive resolution tool that can cause market distortion even in the absence of resolution, the provisions for bail-in need to provide a greater level of clarity and transparency than the current South African framework, in particular regarding issues such as the liabilities that will be subject to bail-in, the point at which bail-in may be effected, the sequence in which liabilities may be bailed in, and the liabilities that are or may be excluded from a bail-in.

[46] Regulation 38 of the banking regulations in terms of the Banks Act 94 of 1990.

ANNEXURE C:
CREDITOR HIERARCHY FOR FINANCIAL INSTITUTIONS IN LIQUIDATION

This annexure discusses the reasons why the creditor hierarchy for financial institutions, in particular banks, may have to be different from non-financial companies. It puts forward a number of factors that should be considered in the context of creditor hierarchy for financial institutions, and compares South Africa's current arrangements in terms of the Insolvency Act with a number of other G-20 countries. Creditor hierarchy provides the basis for loss-absorbing in resolution. As such, the annexure motivates the creditor hierarchy that is proposed in the paper.

IMPORTANCE OF CREDITOR HIERARCHY

The creditor hierarchy in liquidation forms the core of a jurisdiction's insolvency framework. When assessing a country's insolvency framework and developing or improving the framework for dealing with the failure of specific institutions, it is important to consider and, where necessary, improve the insolvency creditor hierarchy for those specific institutions.

Investors in marketable securities base their pricing (or required return) on the perceived risk inherent in their investments. Risk assessments have both going-concern and gone-concern aspects. On a going-concern basis, there is a contractual waterfall of claims on income streams: senior debt receives interest before junior debt, preference shares receive dividends before ordinary shares, and so forth. This going concern waterfall enables investors to incorporate into their pricing models the probability that they will receive future cash flows.

However, investors also have to incorporate into their pricing models the estimates of the value that they expect to realise if the institution, whose securities they have invested in, should be liquidated (i.e. LGD). This gone-concern hierarchy is set out in a country's insolvency legislation and does not necessarily correspond with the contractual going-concern waterfall.

Investors require a minimum degree of certainty of their ranking in the creditor hierarchy to enable them to price their risk appropriately. In the absence of such certainty, it is likely that risk will either be overpriced or underpriced, both with financial stability risks, or that investors may avoid certain types of instruments because of excessive uncertainty, which may in turn have distorting effects on the cost and structure of bank funding and capital.

The importance of the creditor hierarchy in liquidation is confirmed in the KAs, which requires member jurisdictions to adopt resolution frameworks that respect the creditor hierarchy in insolvency when resolution measures are applied, specifically measures that affect shareholders and creditors. The NCWO rule safeguards against bail-in of creditor claims, as discussed under safeguards above, and aims to ensure that no creditor is worse of in resolution than it would be in normal liquidation. In order to adhere to the NCWO rule, the sequence in which creditors are bailed-in should respect and be in line with the hierarchy of creditor claims in liquidation.

As discussed in Chapter 5, bail-in assigns losses to investors outside of liquidation. If an appropriate hierarchy in liquidation exists, the bail-in sequence will naturally follow this sequence, although there may be some exclusions and deviation from *pari passu* within a certain creditor class, depending on circumstances and subject to the NCWO rule constraint.

GENERAL CONSIDERATIONS REGARDING CREDITOR HIERARCHY

There are various factors that should be considered in determining an appropriate creditor hierarchy, both for the purposes of bail-in within resolution and in liquidation, each of which are discussed in subsequent paragraphs.

i. Financial stability, contagion and interconnectedness

The primary objective of a strengthened resolution framework is to promote financial stability. The resolution of a DRI should aim to protect financial stability in the event of a DRI's failure and should assist with restoring financial stability. Therefore, the impact of creditor hierarchy on financial stability is a factor that must be considered.

The creditor hierarchy and subsequent bail-in sequence should support the effective resolution of a failed DRI and consider potential systemic implications. One such consideration is contagion: it will be contrary to the objectives of resolution if the bail-in hierarchy enforces the bail-in of an instrument that will have contagion effects throughout the financial sector. The interconnectedness of financial institutions is an important consideration in this regard.

Another systemic effect can arise in the situation where creditors, which are subject to bail-in, anticipate the imminent failure of an institution and, as a result of their subordinated ranking, cause a run on the bank.

The creditor hierarchy and bail-in sequence should not enforce restrictions on the RA that will prohibit it from applying bail-in on a certain DRI and as a result not be able to execute the resolution. Despite the need for transparency, the RA should retain enough flexibility in its bail-in sequence to cater for specific situations.

ii. Sophistication of creditors

The sophistication of creditors is a factor that is commonly considered in arguments regarding the protection and ranking of the specific creditors. Sophistication in this context refers to the relative ability of depositors to properly assess the riskiness of their deposits at or investments with different institutions, as well as their ability, or the lack thereof, to influence the return that they receive for the risks that they are exposed to, thereby contributing to market discipline. Generally, retail depositors are regarded a less sophisticated class of creditor than institutional and corporate (wholesale) depositors. It is generally less likely that retail creditors (depositors) will be able to assess the risk of an institution and foresee any potential failure. The ability to price for risk also depends on the size of the deposit or investment. Retail depositors in general have small deposits and are not able to influence pricing, except in the form of pooled funds.

iii. Market efficiency and transparency

Efficient financial markets are a key ingredient of financial stability. An efficient financial market corrects the prolonged mispricing of financial instruments relative to their intrinsic value that could lead to either a build-up or plummet in asset prices. Efficient pricing requires information. Financial sector participants require transparency and certainty to calculate risk accurately and price instruments accordingly. Changes to a creditor hierarchy should aim to provide this transparency and certainty to avoid disruption to the financial sector, and to allow participants to manage risk and price instruments accurately.

iv. Perceptions and expectations of market participants

Pricing can be affected by both actual and perceived risk. A perceived creditor hierarchy (for example an implicit government guarantee based on an institution regarded as a TBTF) can sometimes contradict the actual creditor hierarchy as contained in the insolvency regime, and result in an underpricing of risk. Also, going-concern waterfalls are sometimes (incorrectly) treated as liquidation hierarchy, resulting in either an under- or overpricing of risk.

It is evident from informal discussions with BASA and Association for Savings and Investment South Africa (Asisa) that there are entrenched market expectations about the sequence in which different types of equity and liabilities will be treated in resolution, irrespective of (and sometimes in contradiction to) their ranking in liquidation. Some examples of instances where market perception expectations can deviate from the insolvency legislation are the following:

- Market participants distinguish between preference and ordinary shares, and commonly expect that ordinary shareholders will bear the losses in the insolvency proceedings of a failed institution before preferred shareholders suffer any losses. The relative pricing of these instruments also reflect this expectation. However, this will only be the case if insolvency law makes the same distinction (which is not currently the case in South Africa).
- Another common expectation is that so-called 'senior' debt will bear less loss in liquidation than 'junior' debt. However, this will only be the case if insolvency law makes the same distinction (which is not currently the case in South Africa).
- There is also a common expectation that depositors, especially retail depositors, will receive preferred treatment over other creditors in liquidation, which will contribute to retail depositors' relative insensitivity to the risk profile of a bank. While a precedent of implicit guarantees of retail deposits has been established in South Africa, this hierarchy does not exist in the insolvency legislation.

v. International consistency

The focus on cross-border cooperation in resolution increased substantially after the 2008 financial crisis, especially due to the inability to deal with failing or failed G-SIFIs with operations in different jurisdictions.

The crisis highlighted the need for cross-border cooperation provisions in international resolution frameworks and a required level of consistency between these frameworks in order to deal with DRIs that have operations in multiple jurisdictions.

Alignment of jurisdictional resolution frameworks could be both beneficial and have certain negative effects. It may contribute to the effective resolution of multi-national DRIs, but it may also place additional strain on a host jurisdiction where such a DRI holds a subsidiary that is systemically important in the host financial sector.

The importance of cross-border resolution is highlighted by the KAs, which set out requirements for cross-border cooperation, CMGs and cross-border cooperation agreements. The resolution framework should, as far as possible, be consistent with international best practice, but be adapted for the South African framework.

LOSS-ABSORBING CAPACITY (LAC)

LAC is an important element of both supervision and resolution, and is required to ensure that a financial institution can absorb an adequate amount of loss and recover from severe stress without requiring government support. A comprehensive regulatory and resolution framework contains various layers of LAC that should be accessible in going-concern stressed situations, and in the event of failure and resolution.

i. Regulatory capital

The regulatory framework for financial institutions recognises the need for financial institutions to have a certain level of financial resources available to absorb shocks and losses of the financial institution during normal times (going concern) and to have funds available for distribution, should the institution fail (gone concern). These financial resources consist of equity and certain other liabilities. The Basel III Capital Framework determines the amount and composition of regulatory capital for banks, and the conditions under which these capital buffers can absorb losses. This recognised need should be incorporated into the creditor hierarchy for financial institutions to ensure that the instruments identified as regulatory capital are the first in line to suffer losses due to the failure of a financial institution.

ii. Total loss-absorbing capacity (TLAC)

The FSB acknowledged the risk that regulatory capital may be insufficient for resolution or could be almost depleted by the time a bank enters resolution. In order to ensure that there would be a sufficient amount of financial resources available in resolution to recapitalise a failed or failing institution, the FSB has issued proposals on TLAC requirements for G-SIBs. The TLAC requirement should ensure adequate availability of loss-absorbing in resolution. The aim is to establish a framework that is consistent with the Basel III Capital Framework. The TLAC of G-SIBs will provide that instruments, over and above regulatory capital requirements, are identified and available for loss absorption during resolution. Although these requirements will only be minimum standards for banks that are classified as G-SIBs, they provide useful guidance on TLAC for D-SIFIs.

The creditor hierarchy should provide for both the regulatory LAC and the identified TLAC instruments. Shareholders will always be the first to bear losses. An institution's TLAC instruments, other than shares, should rank the lowest in the insolvency creditor hierarchy. However, because losses in resolution may exceed TLAC, the FSB recommends that liabilities that are not explicitly eligible as TLAC should remain subject to potential loss absorption in resolution, in accordance with the applicable resolution law.

DEPOSITOR PREFERENCE

There is a common expectation that depositors will receive preferred treatment in insolvency proceedings, whether through a government bail-out or through first payout from the proceeds of the failed institution's insolvency proceedings. There may be no preference afforded to depositors in insolvency legislation and no formal deposit insurance or guarantee framework, but due to the implicit guarantee created by government through payout to depositors in past bank failures, this view is not unfounded.

i. KA guidance

The KAs do not set out a proposal or preference towards a specific ranking of creditors. The preamble in the KAs merely states as an objective of the resolution framework to "… protect, where applicable and in coordination with the relevant insurance schemes and arrangements such depositors, insurance policyholders and investors as covered by such schemes and arrangements, and ensure the rapid return of segregated client assets; …"

The preamble further states that the framework should have "… liquidation procedures that provide for the orderly closure and wind-down of all or parts of the firm's business in a manner that protects insured depositors, insurance policyholders and other retail customers." This requirement suggests that depositors should receive a preferred ranking in the creditor hierarchy in order to be sufficiently protected in the event of a failure of an institution.

ii. Retail and wholesale depositors

There are divergent views globally on the protection of retail depositors compared to wholesale depositors. Many countries are of the view that only retail depositors should receive preferential treatment, while other countries advocate the preferred treatment of depositors in general.

The arguments for retail depositor preference (guaranteed depositors either up to the coverage limit or for the full qualifying amount) include views based on the sophistication of these depositors and other socio-economic considerations.

Arguments for wholesale depositor protection are mainly focused on the value of these depositors and, more specifically, banks' reliance on their funding.

The arguments remain inconclusive and, as such, preference for depositors should be based on South African circumstances and be consistent with the manner in which depositors were treated in past bank failures.

iii.Depositor preference and the DGS

The DGS guarantees certain depositors that they will be paid out up to a set limit in the event of a failure of the institution where their deposit is held. The payment will be effected within a specific timeline and thus these depositors will not have to wait until the resolution process is finalised.

Depositor preference is not a guarantee to depositors that they will receive any payment from the insolvency process of the failed institution. It merely gives the assurance that, if there are funds available, they will receive payment before creditors in a lower class. The payment will also only be made when the insolvency process is finalised or during the process subject to the discretion of the administrator.

The adverse effects of moving from a limitless implicit depositor guarantee to a limited explicit depositor guarantee can be mitigated by providing a preference for depositors in the insolvency framework. This will ensure that depositors receive a limited guaranteed amount at the start of the resolution process and the assurance that they will be paid from the proceeds of the estate before the lower ranking creditors.

When guaranteed depositors are paid from the DGS, their claims against the institution are subrogated to the DGS and, as a result, the DGS becomes a creditor of the estate of the failed institution with the same ranking as the paid depositors. The subrogation will allow the DGS to replenish the funds that have been paid out. If the DGS has a preferred ranking, it can contribute to the ex-post funding portion and make the DGS less costly to the banking system.

INTERNATIONAL TRENDS

The legal frameworks for general insolvency (i.e. not for banks or other financial institutions) have similarities across jurisdictions and in broad terms apply the following ranking of creditors:

- liquidator's costs;
- creditors with special security;
- administrator's costs;
- specific employee and pension fund payments;
- creditors with general security;

- senior unsecured creditors;
- junior unsecured creditors;
- preferred shareholders; and
- ordinary shareholders.

In many jurisdictions the general insolvency ranking differs from the ranking of creditors in a banking failure, mostly in respect to depositor preference. Several of the G-20 countries have some form of depositor preference, including Australia, China, Mexico, Russia, Switzerland and the United States. The depositor preference, and exactly where depositors rank in the hierarchy, differs from jurisdiction to jurisdiction.

Table 7 gives some detail on the adoption of depositor preference in certain of the G-20 jurisdictions.

Table 7: Depositor preference in various jurisdictions[47]

COUNTRY	PREFERENCE TO BOTH RETAIL AND WHOLESALE DEPOSITS?	MONETARY LIMIT TO DEPOSIT PREFERENCE?	PREFERENCE TO DEPOSITS IN LOCAL BRANCHES OF FOREIGN BANKS?	PREFERENCE TO DEPOSITS IN FOREIGN BRANCHES OF LOCALLY INCORPORATED BANKS?
Argentina	Yes	No	Yes	No
Australia	Yes	No	No (because branches in Australia of foreign banks are not permitted to take retail deposits)	Yes, provided deposits are denominated in AUD. However, deposits legally situated in Australia have preference over assets in Australia
China	No (retail deposits only)	No	Yes	Not clear
France	No (retail deposits only)	Yes (capped at €100 000, being the deposit insurance cap)	No, unless the foreign bank has its head office in a non-European Economic Area (EEA) member state	Yes, provided the foreign branch is located in an EEA member state
India	Yes	Yes (limit set at very low level)	Yes	No
Indonesia	Yes	No	Yes	No
Russia	No (retail deposits only)	No	No	Yes
Switzerland	Yes	Yes (CHF100 000)	Yes	Yes
Turkey	No (retail deposits only)	No	Yes	No
United States	Yes	No	Yes	No, unless payable in the United States

[47] Table 7 provided by Geof Mortlock, World Bank advisor.

ANNEXURE C:
CREDITOR HIERARCHY FOR FINANCIAL INSTITUTIONS IN LIQUIDATION - continued

There is an increase in changes being made to creditor hierarchy in many jurisdictions, and in Europe this is partly due to the adoption of the BRRD. The changes being made to creditor hierarchies in these and other jurisdictions mainly involve depositor preference and alignment with the bail-in requirements.

SOUTH AFRICA'S EXISTING CREDITOR HIERARCHY IN LIQUIDATION

The South African hierarchy differs from the above international trends in three respects. Firstly, South Africa does not make a distinction between junior and senior unsecured creditors. Secondly, South Africa does not make a distinction between preferred and ordinary shareholders. Thirdly, South Africa does not make a distinction between depositors and other unsecured creditors. The insolvency provisions for financial institutions in South Africa are fragmented in various acts, but the overarching legislation for the insolvency proceedings of financial institutions is the Companies Act,[48] read with the Insolvency Act.[49]

In terms of insolvency proceedings for regulated financial institutions, the Companies Act and the Insolvency Act should be read with the special provisions set out in:

- the Banks Act;
- the Long Term Insurance Act 52 of 1998;
- the Short Term Insurance Act 53 of 1998; and
- the Financial Markets Act 19 of 2012.

None of the special provisions in the financial sector legislation listed above establishes a new or different insolvency creditor hierarchy from the one in the Insolvency Act. Therefore, the creditor hierarchy established in the Insolvency Act must be used as the relevant hierarchy. Where the above-listed legislation provides for exclusions of certain assets or liabilities in insolvency proceedings, such exclusions should be taken into account.

CREDITOR RANKING

The creditor hierarchy contained in the Insolvency Act is fairly simple and distinguishes only between limited classes of creditors, with distribution in liquidation made in the following order:

i. Secured creditors: These creditors have senior preference in terms of the security held, meaning they will be first in line to receive the proceeds from the sale of the asset held by them as security up to the value of their claim. The amount due to them is for the value of their claim and not the value of the asset. If they are unable to realise the full value of their claim from the proceeds, the shortfall will fall to unsecured claims. Therefore, if the asset (or assets) held by them as security is transferred in resolution, the asset's liquidation value will have to be established and they must be first to be compensated to that value. For the remainder of their claim, they will be *pari passu* with unsecured creditors.
ii. Liquidation costs: The cost of the liquidation, including liquidation proceedings, is paid after payment to secured creditors.
iii. Preferred creditors: Preferred creditors rank behind secured claims, meaning that they will be compensated from the estate after the secured creditors received the realised proceeds from the sale of their secured assets. These creditors are specified

[48] See the Companies Act 51 of 2008.
[49] See the Insolvency Act 24 of 1936.

by legislation, and include the employees of the insolvent company and certain tax liabilities. The Insolvency Act limits these claims, such as employee remuneration, only up to a certain prescribed amount.

iv. Security under general notarial bond: In terms of the Insolvency Act, creditors that hold a general notarial bond over movable assets are not within the secured creditor class and receive distribution only after preferred creditors.

v. Concurrent creditors: The last line of creditors is concurrent creditors, which rank *pari passu* after preferred creditors. If the estate's funds are insufficient to fully reimburse the claims of concurrent creditors, they will share in the remaining free residue pro rata to their claims, for example 50 cents in the rand.

Because the Insolvency Act does not provide for any hierarchy among concurrent creditors, there is no legal basis on which certain bank creditors (such as retail or other depositors) can be afforded preferred treatment in liquidation, unless such compensation is funded by government. The lack of hierarchy also does not provide a solid basis for a bail-in sequence, even if the RA should provide explicit bail-in powers. Therefore, the following sections make specific proposals on a minimum creditor hierarchy, which should serve as a guide to the bail-in sequence.

PROPOSED CREDITOR HIERARCHY FOR FINANCIAL INSTITUTIONS IN RESOLUTION

Input from the banking sector, through BASA, expressed a preference for a number of layers in the creditor hierarchy for banks, largely based on the current funding structure and instruments of the large banks and the relative pricing of these funding instruments. However, it is the view of the SARB and NT that the creditor hierarchy should not necessarily reflect current market practice, because funding structures and instruments change over time. Any proposed changes to the creditor hierarchy should be based on consistent arguments and on the considerations discussed in sections 13 to 16. While a multi-layered creditor hierarchy would provide a high level of certainty to the market by distinguishing among various levels of creditors, it will limit the RA's ability to deviate from the *parri passu* treatment of creditors within the same class in a specific case.

Furthermore, because the Insolvency Act is a well-established piece of legislation supported by a long history of case law, any proposed deviations from it for DRIs should be kept to those that can be specifically motivated.

Based on the considerations set out in this annexure, it is deemed necessary to afford, at least, preference to guaranteed depositors and for the insolvency framework to explicitly subordinate any TLAC instruments in order to make them loss-absorbing in resolution.

The creditor hierarchy in the insolvency framework should be amended, taking into account considerations specific to financial institutions, and should provide for the following ranking of creditors:

i. secured creditors: existing preference in line with Insolvency Act;
ii. preferred creditors: existing preference in line with Insolvency Act;
iii. qualifying depositors: preference afforded to replenish the DGS and protect retail and SME depositors;
iv. unsecured creditors: all other depositors and creditors remain concurrent; and
v. TLAC: instruments specifically identified and disclosed as loss absorbing.

If adopted in the SRB, the above creditor hierarchy will be used as the basis on which to apply the NCWO rule.
Further work will be undertaken to develop proposals on the creditor preference for policyholders when an insurer is in resolution.

NOTES

STRENGTHENING SOUTH AFRICA'S **RESOLUTION FRAMEWORK** FOR **FINANCIAL** INSTITUTIONS

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA