



SOUTH AFRICA

FINANCIAL SECTOR ASSESSMENT PROGRAM

March 2015

FINANCIAL SAFETY NET, BANK RESOLUTION, AND CRISIS MANAGEMENT FRAMEWORK—TECHNICAL NOTE

This Technical Note on Financial Safety Net, Bank Resolution, and Crisis Management Framework on South Africa was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in February 2015.

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FINANCIAL SAFETY NET, BANK RESOLUTION, AND CRISIS
MANAGEMENT FRAMEWORK

Prepared By
**Monetary and Capital Markets
Department, and Legal
Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in South Africa. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations.

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Glossary

BA	Banks Act (1990)
BSD	Banking Supervision Department (of the SARB)
CA	Companies Act
CFR	Council of Financial Regulators
CLF	Committed Liquidity Facility
CMG	Crisis Management Group
DP	Depositor Preference
DIS	Deposit Insurance Scheme
D-SIB	Domestic Systemically Important Bank
ELA	Emergency Liquidity Assistance
FMA	Financial Markets Act
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSB	Financial Services Board
FSC	Financial Stability Committee (of the SARB)
FSCF	Financial Sector Contingency Forum
FSD	Financial Stability Department of the SARB (formerly a unit)
FSOC	Financial Stability Oversight Committee
FSR Bill	Financial Sector Regulation Bill (to introduce the twin peaks model)
GFC	Global Financial Crisis
G-SIFI	Global Systemically Important Financial Institution
HQLA	High Quality Liquid Assets
IA	Insolvency Act
KAs	Key Attributes of Effective Resolution
LCR	Liquidity Coverage Ratio (under Basel III)
LTIA	Long-term Insurance Act 52 of 1998
MCA	Market Conduct Authority
MoF	Minister of Finance
MoU	Memorandum of Understanding
NBFI	Nonbank Financial Institution
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
NT	National Treasury
PA	Prudential Authority
PAJA	Promotion of Administrative Justice Act
P&A	Purchase and Assumption
RA	Resolution Authority
RB	Registrar of Banks (of the SARB)
RRP	Recovery and Resolution Plan
SADC	Southern African Development Community

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SARB	South African Reserve Bank
SCV	Single Customer View
SME	Small and Medium-sized Enterprise
STIA	Short-term Insurance Act 53 of 1998

EXECUTIVE SUMMARY

This note elaborates on the recommendations made during the Financial Sector Assessment Program (FSAP) for South Africa in the areas of contingency planning, crisis management, and bank resolution. It summarizes the findings of the FSAP mission undertaken during June 10-24, 2014, and is based upon analysis of the relevant legal and policy documents and extensive discussions with the authorities and private sector representatives.¹

The FSAP team made a number of recommendations for strengthening the crisis management and resolution regime. The FSAP team's main recommendations are summarized below:

- ***Institutional framework and coordination arrangements:*** The proposed scope of the new resolution regime (see below) and of the South African Reserve Bank's (SARB) jurisdiction as the resolution authority remains unclear. The authorities should consider, in the first instance, focusing on all deposit-taking institutions and only those other financial institutions that are currently deemed systemic. Non-deposit-taking financial institutions that are not found to be systemic should be resolved by the Prudential Authority (PA) or the Market Conduct Authority (MCA), whichever is the lead regulator.
- ***Domestic and cross-border cooperation and coordination:*** The interim Financial Stability Oversight Committee (FSOC) should be given statutory backing, as planned for under the twin peaks regulatory framework. The role of the Financial Sector Contingency Forum (FSCF) should be reviewed to remove any potential duplication with the mandates of the proposed FSOC and Council of Financial Regulators (CFR). The SARB/Financial Services Board (FSB) Memorandum of Understanding (MoU) should be expanded to cover cooperation in relation to dual regulated Financial Market Infrastructures (FMIs); e.g., payments and clearing systems. The scope of cross-border cooperation with home and host authorities should go beyond supervision to resolution and crisis management, including pre-agreed mechanisms for the exchange of information, decision-making powers and procedures, and burden-sharing arrangements to help promote orderly cross-border resolution. Supervisory colleges for the FirstRand Group and the Nedbank Group should be explored, given their significant presence in other African countries.
- ***Supervisory early intervention of problem banks:*** There is an urgent need to amend the Banks Act to strengthen the Registrar's ability to intervene early in banks, where necessary, with reasonable autonomy in the exercise of such powers and with as few constraints as feasible within constitutional boundaries. The authorities should also provide a clear statutory basis for Recovery and Resolution Plans (RRPs), and develop comprehensive guidelines on what the recovery plans should cover. The proposed PA should have explicit powers to require structural changes to group structures to enhance resolvability.

¹ This note was prepared by Elsie P. Addo Awadzi and Marc Dobler. The section on systemic liquidity benefited from contributions from K. Eckhold, D. Murphy, and D. King.

- **Emergency liquidity assistance:** A solvency test should be introduced in the framework, preferably in the SARB Act, such that any emergency liquidity assistance (ELA) to banks that may be insolvent should only take place with an indemnity from the government. The authorities should consider the potential liquidity needs of systemic nonbank financial institutions (NBFIs), such as a systemic payments or clearing system, and determine whether they may potentially need to access ELA to preserve systemic functions. Eligibility for ELA should then be explicitly defined and publically conveyed. Remaining arbitrary collateral prohibitions in the SARB Act should be removed and replaced with a requirement for the SARB to follow prudent collateral policies. If equities are retained as an eligible collateral class in the Committed Liquidity Facility (CLF), a haircut of at least 35 percent should be adopted. The SARB also should undertake its own due diligence of self-retained residential mortgage-backed securities, and of the underlying loan assets, and apply a haircut of at least 15 percent.
- **Orderly and effective resolution:** Under the current resolution regime, powers are assigned to a curator appointed by the Minister of Finance (MoF) when a bank is at the point of or close to insolvency. The Registrar may also petition the court to commence liquidation proceedings in respect of an insolvent bank. While these powers have been used in small bank failures, and have been strengthened since the last FSAP, they lack critical features necessary to deal with a systemic case and minimize taxpayer risk. While the authorities' recent intervention of African Bank (see Box 1 in the Financial System Stability Assessment) was effective in limiting contagion, it underscored the need to reform the regime so that it complies with best international practice. As a member of the Financial Stability Board, the authorities are committed to bringing the regime into compliance with the Key Attributes of Effective Resolution (KAs) by end-2015. The resolution toolkit will need to be significantly enhanced to include all the powers listed in the KAs, including bridge bank and bail-in powers. The triggers for these powers should allow for their early deployment when the firm is no longer viable or likely to be no longer viable. The FSAP team recommends that the SARB be made the resolution authority for all licensed deposit takers and for systemic NBFIs.
- **Judicial reviews and legal protection:** The MoF's power to overturn fines imposed by the Registrar of Banks (RB) or to empanel a Review Board to review and possibly reverse the RB's decisions should be removed. The RB should be empowered to take action within a shorter time frame instead of the current ex ante 30 days' notice that must be provided to affected persons in many instances. Judicial review should not prohibit the exercise of resolution powers, or suspend or reverse actions as a result of the review process. Relief available to claimants should be limited to monetary compensation where the authorities are found to have acted in bad faith, illegally, or with gross negligence, but strict proof must be provided by the claimant. The immunity from personal liability, provided to the SARB officials under the Banks Act, should be extended to non-employees of the SARB appointed to undertake or assist in resolution. Relevant officials should also be indemnified by the RB for the cost of defending legal actions.

- **Depositor protection:** International best practice aims to transfer the costs of bank resolution and depositor protection from the public to the private sector. Public funds have had to be used in past cases to stem depositor contagion in South Africa, and were deployed again in the recent resolution of African Bank. The FSAP team reiterated the recommendation from the 2008 FSAP to establish a deposit insurance scheme (DIS). It also recommended establishing an ex ante fund, sufficient to pay out a number of small and medium-sized banks. This fund should be available for use in funding resolutions as well as in liquidations, subject to strict safeguards. If the scheme is introduced, as recommended, with depositor preference² and a back-up line of credit from the National Treasury (NT) or the SARB, it could be calibrated such that long-standing industry concerns about levies in a highly concentrated banking system might be partly allayed.

² Which would minimize the potential costs of the scheme and facilitate the use of the new resolution powers.

Table 1. Main Recommendations for Crisis Management and Bank Resolution Framework

Recommendations	Priority
<i>Institutional arrangements</i>	
(i) Limit the role of the Finance Minister in a resolution to only those cases in which public funds are needed to support the resolution.	Medium
<i>Domestic and cross-border cooperation and planning arrangements</i>	
(ii) Require in statute, recovery and resolution plans to be prepared for all firms of systemic importance and provide detailed guidelines.	Immediate
(iii) Amend the legal framework to provide for an administrative process to support mutual recognition and enforcement of cross-border resolution actions.	Medium
(iv) Amend the legal framework to provide clearly for a mandate and necessary information gateways to cooperate on cross-border resolution issues.	Medium
<i>Emergency liquidity assistance and early intervention powers</i>	
(v) Clarify the ELA policy framework, including with regard to solvency and eligibility requirements preferably through an amendment to the SARB Act.	Medium
(vi) Remove the remaining prohibitions on collateral classes and amend CLF collateral policies to protect the SARB balance sheet.	Immediate
(vii) Remove constraints to early intervention powers and improve legal protection for resolution officials.	Immediate
<i>Resolution tools</i>	
(viii) Introduce a resolution regime compliant with the Key Attributes for, and make the SARB the resolution authority of, all banks and SIFIs.	Medium
(ix) Ensure that the regime triggers allow for the full range of KA resolution powers to be deployed at an early juncture when the institution is no longer viable or likely to be no longer viable, including when liquidity requirements are seriously breached.	Medium
<i>Depositor protection</i>	
(x) Introduce a DIS with ex ante funding that could be used to fund a payout or a resolution, subject to a least cost test set out in legislation.	Medium
(xi) Levy the industry to build up a deposit insurance fund sufficient to make payouts in case of the failure of a number of medium-sized banks, and provide a back-up line of credit from the National Treasury.	Medium
(xii) Adopt depositor preference in the legislation.	Medium

INTRODUCTION

1. No public support was extended to banks during the global financial crisis (GFC) and the recession it triggered in South Africa. Banks remained sound and profitable during the crisis with the return on equity staying close to 20 percent. While nonperforming loans (NPLs) jumped from 2 percent of total loans at the onset of the crisis to 6 percent in late 2009, the average NPL ratio has declined since to 3.6 percent in 2013. The regulatory tier one ratio of 13.5 percent in 2013 compares favorably with banks in other countries, and the SARB applies a 1 percent systemic risk surcharge to the large banks. However, after six years of fiscal accommodation and easy liquidity conditions, public and private balance sheets are more leveraged and exposed to changes in domestic and external conditions. A combination of slow growth, high unemployment, low savings, and relatively high household debt present clear risks to banks' balance sheets.

2. The high dependence on domestic short-term wholesale funding and the risk of asset quality deterioration present clear risks. Bank credit is funded largely by local deposits, with institutional deposits from insurance companies, pension funds, and other financial institutions representing 29 percent of total deposits. The average funding maturity of South African banks has shortened, while the liquid asset to short-term liabilities ratio of around 35 percent is low among peer countries and considerably lower than in advanced economies. The average loan-to-deposit ratio is 113 percent, and bank lending is concentrated in the household sector (representing 60 percent of loans in 2012), with mortgages accounting for 37 percent of bank credit. NPLs will likely reverse recent declines in the face of rising interest rates and subdued growth, and bank provisions will rise accordingly.³ These vulnerabilities were highlighted in August 2014, when African Bank (accounting for 1.5 percent of banking system assets) was placed under curatorship after record losses on unsecured lending to low-income households. Its problems demonstrated how asset quality can quickly deteriorate in a weak economy, and how systemic risk may arise, even from the failure of a relatively small bank, due to the high level of interconnections in the South African financial system.

3. The highly concentrated structure of the banking system creates the perception that several groups are too big to fail. South Africa's financial system is composed of a few large financial conglomerates with subsidiaries in the banking, insurance, pension broker/dealer, and other financial sectors. The banking system is concentrated, with the largest 5 out of 29 operating

³ The current provisioning coverage ratio (specific loan loss provisions as a percentage of impaired loans) is relatively low at approximately 45 percent.

banks holding about 90 percent of system assets and deposits.⁴ Subsidiaries of foreign banks represent about one-third of total banking sector assets.⁵

4. The rapid expansion of banks into other sub-Saharan African countries entails coordination challenges. While starting from a low level, the claims of South African banks on other African countries, mostly in Sub-Saharan Africa, have more than tripled over the last five years. The expansion reflects greater economic integration of countries in southern Africa, and South African banks have taken advantage of the increased business opportunities associated with the integration. While the expansion may reflect the competitiveness of South African banks, the development of effective collaboration with the host supervisory authorities with respect to resolution has lagged behind.

5. Wide-ranging reforms of the supervisory framework are currently under way. The current structure of supervision is complex and multi-layered, which makes it challenging to conduct supervision at the consolidated or conglomerate level. The authorities are introducing a “twin peaks” model that will reduce the number of agencies involved in supervision to a “prudential” and a “conduct” regulator and take a more holistic approach. The draft 2013 Financial Sector Regulation Bill (FSR Bill), expected to be passed into law later this year, will provide the legal underpinnings for the reforms. A resolution bill currently being drafted will assign resolution authority and new resolution powers to the SARB.

6. “Best practice” resolution and financial safety net arrangements have advanced significantly since the GFC. Best practice arrangements for dealing with failing financial institutions include the planning and cooperation architecture, and a broad set of powers for early intervention, official liquidity, and solvency support, as well as a suite of resolution powers available at an early juncture. In the case of South Africa, several elements of best practice are missing or have some weaknesses. More specifically:

- the SARB’s current powers for early intervention in ailing financial institutions require strengthening to address the significant limitations to its authority to suspend a bank’s license, restrict a bank’s activities, or remove a director or officer of a bank;
- the current curatorship powers require the approval of the minister, are not available at a suitably early juncture, and lack the full range of resolution tools recommended in the Financial Stability Board’s Key Attributes of Effective Resolution (2010); and
- no mechanism exists for industry funding of depositor protection and resolution costs.⁶

⁴ The top four banks—ABSA Bank, FirstRand Bank, Nedbank, and Standard Bank—account for almost 85 percent of total assets, and, exceed 90 percent with the fifth largest bank (Investec Bank).

⁵ In that regard, Moody’s removal of the systemic support uplift factored into its South African bank ratings, following the 10 percent haircut announced on African Bank’s wholesale creditors, was a positive development.

⁶ Jurisdictions should have in place privately financed deposit insurance or resolution funds, or a funding mechanism for

7. Bringing the financial safety net arrangements up-to-date with international best practice would mitigate the risks and better distribute the costs associated with financial instability. Strengthening the financial safety net would provide better incentives for financial institutions to manage risk, while protecting the less financially sophisticated participants (depositors) and reducing the contingent public risks associated with preserving financial stability.

INSTITUTIONAL FRAMEWORK, DOMESTIC AND CROSS-BORDER COORDINATION

A. Institutional Framework

8. The institutional framework should facilitate the effective use of financial safety net and crisis management tools. Clear allocation of roles and responsibilities, sound legal underpinnings for mandates, and effective mechanisms for domestic and cross-border cooperation and coordination are some of the key prerequisites for effective crisis management.

9. The existing legal framework does not provide explicitly for a financial stability objective. The SARB's "primary objective" under the 1994 Constitution and the SARB Act, is to protect the value of the currency "in the interest of balanced and sustainable growth in the Republic". No secondary objective is explicitly provided for in law. While government policy since 2010 reflects a financial stability and macro prudential responsibility for the SARB, amendments to the SARB Act are required to provide legal underpinnings for such a mandate. These amendments should not only reflect a clear financial stability objective, but also provide for the SARB's functions and powers to enable it to realize that objective.

10. Responsibility for the regulation and supervision of the financial sector is allocated among a number of independent agencies and self-regulatory organizations. See Box 4 in the Financial System Stability Assessment Report, which summarizes the roles of the key institutions.

B. Domestic Cooperation and Coordination

11. The legal framework expressly provides for cooperation amongst the supervisory agencies.

- a. **SARB:** Section 4 (3) of the Banks Act empowers the Registrar of Banks to enter into written cooperation arrangements such as MoUs with any supervisor or other person or institution as the Registrar may deem fit, although the permitted scope of such agreements appears limited to supervisory matters. Section 89 of the Banks Act permits the sharing of information by the Registrar of Banks with fellow regulators, provided that the Registrar is

⁶ (Continued) "ex post recovery from the industry of the costs of providing temporary financing to facilitate the resolution of the firm" (KA 6.3).

satisfied that the information is essential for the proper performance of a function under any law by the fellow regulator. The SARB (Bank Supervision Department) and the South African FSB have an existing MOU signed in December 1998 for coordination and cooperation, and meet regularly to discuss systemic issues. The MOU provides, among other things, for mutual assistance in supervision, exchange of information, and guidelines for cooperative supervision of financial conglomerates involving banks, mutual banks, and financial institutions under the FSB's jurisdiction.

- b. **FSB:** The FSB Act and, more recently, the Financial Markets Act of 2012 (FMA) provide for strong cooperation and coordination mechanisms:
- i. The FSB Act empowers the FSB to (i) liaise with any regulatory authority on matters of common interest; (ii) participate in the proceedings of any regulatory authority; and (iii) advise or receive advice from any regulatory authority. Under the same Act, the FSB is required to notify (before or after) other relevant regulatory authorities of any pending regulatory action it intends to take against a regulated interest in which such other regulators have an interest. It also has the power to negotiate and enter into bilateral or multilateral cooperation agreements with supervisory authorities (including foreign supervisors) to coordinate and harmonize reporting and other obligations of financial institutions, coordinate supervisory activities, and share information subject to adequate safeguards. By virtue of a 2013 amendment to the FSB Act, the FSB may share information in the public interest; or with a regulatory authority (including an organ of state) for the purpose of ensuring the safety and soundness of financial institutions, for ensuring financial stability, or for coordinating the supervision of financial institutions with other regulatory authorities.
 - ii. Under the FMA, the Registrar of Securities Services within the FSB is required to make adequate arrangements for effective cooperation with the SARB governor in respect of the monitoring and mitigation of systemic risks. The Registrar is also required under the FMA to inform the minister and the governor of any matter that, in his/her opinion, may pose systemic risks to the financial markets.
- c. **National Treasury:** The minister's role under the existing legal framework relates to making regulations under the various sectoral legislation, approving certain supervisory actions (e.g., cancellation or suspension of a foreign bank branch's authorization under the Banking Act), and the appointment of a curator under the Banks Act. Section 224 (2) of the Constitution requires the SARB, while maintaining its independence in pursuit of its primary objective, to regularly consult with the minister. In terms of public financing for crisis management, the minister's approval is required under section 13 (b) of the SARB Act in the event that acquisition of a bank's shares by the SARB is contemplated. Also, under section 66 of the Public Finance Management Act of 1999, the minister has the exclusive mandate to borrow on behalf of the government and to approve any government guarantees if needed for a public purpose.

- d. **National Credit Regulator (NCR):** The NCR regulates consumer credit and registers credit providers,⁷ in addition to their sectoral registration by their lead regulators, and has powers to impose conditions on their lending activities or cancel their authorization to provide credit under the National Credit Act of 2005 (NCA). The NCA empowers the NCR to cooperate with any regulatory authority on matters of common interest, and, under sections 17 and 57, requires the NCR to enter into agreements with relevant financial sector regulators, and to cooperate and coordinate with them before taking action against a registered credit provider.

C. Coordinating Bodies

12. While there is no formal legal framework for financial stability oversight and crisis management, a number of practical arrangements exist to promote coordination.

- a. **FSCF:** The Financial Sector Contingency Forum (FSCF) was created in 2003 to coordinate plans, mechanisms, and structures for managing financial crises. It operates as a voluntary coordinating body for the financial sector and ordinarily meets twice a year. Chaired by the deputy governor of the SARB, its membership is drawn from the NT, SARB, FSB, Bank Association of South Africa, South African Insurance Association, Johannesburg Stock Exchange, Payments Association of South Africa, SA Bankers Services Company, South Africa's Central Securities Depository (Strate Limited), and the Association for Savings and Investment South Africa. An MoU defines the respective obligations and expectations of the member organizations and members of the FSCF to ensure a common understanding and commitment to promote the optimum efficiency of the FSCF.⁸ Its work is organized around two sub-committees; the one on operational risk includes private-sector participants and focuses on infrastructure failures and operational risks. The other sub-committee includes the SARB and the NT representatives and is responsible for contingency planning for financial crises, and the identification of the systemic risks and possible mitigating actions. The forum has led crisis exercises, including one held in March 2014, formed a small incident-management team, and prepared a manual for managing a broad spectrum of crises with particular emphasis on liquidity issues.
- b. **Interim FSOC:** The interim FSOC was informally established to coordinate financial stability matters between the SARB, other regulatory agencies, and the NT. It is currently co-chaired by the minister and the governor. It is assisted in its work by the internal Financial Stability Committee (FSC) within the SARB, which is chaired by the governor. The recently established

⁷ The NCR currently shares concurrent jurisdiction over consumer credit regulation with various provincial government credit regulators who are required to share information on their registrations and supervisory activities with the NCR (Sections 37 and 38 of NCA).

⁸ Under the Multilateral MOU for the FSCF, members have agreed in principle to cooperate in the processes, initiatives, strategies and activities of the FSCF and its constituents and to exchange information and execute agreed-upon actions in the broad interest of the financial system as a whole.

Financial Stability Department (FSD) also helps to identify and evaluate systemic risks and make recommendations and policy proposals to the governor to mitigate systemic risks.

13. Proposed reforms will vest financial stability oversight and resolution authority in the SARB. The Draft Financial Sector Regulation Bill was approved by the cabinet and published in December 2013 by the NT for public consultation and is currently being revised to reflect the comments received from the public and international experts. When enacted and effective, it will introduce a “twin peaks” regulatory and supervisory model for the financial sector, and provide a statutory mandate for financial stability and macroprudential oversight as well as for improved cooperation and coordination among various domestic stakeholders.

14. In particular, the Draft Financial Sector Regulation Bill 2013 will:

- reallocate regulatory and supervisory responsibilities in the financial sector to a Prudential Authority (PA) within the SARB, and a Market Conduct Authority (MCA);
- provide explicitly for financial stability oversight and resolution by the SARB, although the SARB’s financial stability objective is still unclear, as is the scope of its proposed resolution authority; and
- improve cooperation and coordinating mechanisms through the FSOC as well as with the Council of Financial Regulators (CFR),⁹ which will both have statutory mandates. The CFR will help to coordinate financial sector regulators in areas of common interest, including rule making, inspections, and enforcement. These statutory mechanisms are expected to coexist with the existing FSCF, whose membership includes industry representatives. The existing technical advisory mechanisms within the SARB (the FSC and the FSD) are expected to remain and support the work of the FSOC.

15. The proposed role of the minister under the proposed twin peaks model will be prominent. Among other things, the minister will have sole responsibility for:

- taking decisions relating to crisis management, which may have an actual or potential impact on public finances. As contemplated in the draft FSR Bill, this will include any likelihood of an increase in public expenditure, an increase, or risk of an increase, in actual or contingent liabilities assumed by the government, or anything that may affect the price at which the government is able to raise money in the debt markets;
- designating a financial institution as systemically important (on the recommendations of the FSOC); and

⁹ The proposed CFR will be made up of financial sector regulatory agencies and will act as a consultative and coordinating forum for matters of common interest, including joint enforcement, legislation and standard-setting, and the analysis of financial sector outcomes.

- making emergency regulations necessary to facilitate the management of a financial crisis.

16. While the proposed twin peaks reforms will help strengthen institutional arrangements for cooperation and coordination, the current proposals could benefit from further strengthening. To this end,

- The proposed financial stability responsibilities of the SARB under the draft FSR Bill is a step in the right direction, although more clarity is required in terms of its purported effect. The draft FSR Bill provides that “The Reserve Bank has primary responsibility for promoting financial stability in terms of section 3 of the Reserve Bank Act.” Given that section 3 provides for a price stability objective, the language of the draft legislation suggests that the financial stability responsibility would have to be carried out in furtherance of, and only to the extent that it contributes to achieving, price stability. In particular, financial stability cannot be pursued as an end in itself or in a manner that undermines price stability. Ideally, the draft Bill should specifically amend the SARB Act to include an explicit financial stability objective¹⁰ and provide for the SARB’s functions and powers to give effect to that objective. This would ensure that there is legal and operational separation between the price stability and financial stability objectives, in particular given that under the draft FSR Bill, the latter is to be pursued within a policy framework agreed with the minister;
- The minister’s role in designating institutions as systemic should be reconsidered in light of the proposed financial stability mandate of the SARB;
- The scope of circumstances that determine the minister’s power to exclusively take decisions relating to crisis management should be more circumscribed. In a crisis, many measures may affect the price at which the government borrows and the too widely drafted proposal could well give the minister exclusive authority to make all the decisions relating to crisis management, to the exclusion of the SARB (which will have the mandate for financial stability and resolution), and the supervisory authorities (PA, MCA, NCR). As a general matter, the responsibility for taking crisis management-related decisions should be shared by the NT, the SARB, and all supervisory authorities. The minister’s exclusive authority should be limited to circumstances where public funding/guarantees will be required; and
- The draft FSR Bill should, in the first instance, focus the SARB’s resolution authority on all deposit-taking institutions, and only on those other financial institutions that are deemed systemic. This decision would need to take into account the wider financial and economic circumstances at that point in time. Non-deposit-taking financial institutions that are not found to be systemic should be resolved by the PA or MCA, whichever is the lead regulator.

¹⁰ Section 224 (1) of the Constitution and section 3 of the South African Reserve Bank (SARB) Act assign price stability as the SARB’s primary objective.

17. Lastly, the authorities should review existing cooperation and coordinating mechanisms to ensure that they are aligned with the proposed twin peaks architecture. In particular:

- The FSCF will need to be reconstituted to reflect the new mandates of the PA and the MCA. The authorities should also determine whether the existing MoU and Terms of Reference for the FSCF will require revisions in the light of proposed institutional arrangements and coordinating mechanisms under the draft twin peaks legislation. It will be important, at a minimum, to clarify the differences between its role and that of the FSOC.
- The existing MoU between the BSD and the FSB will have to be replaced by a new MoU between the PA and the MCA.

D. Cross-Border Cooperation and Coordination

18. Experience during the GFC highlighted anew that crisis management and resolution are rendered more complex in a cross-border context. As such, the framework for early intervention and resolution should reflect the fact that banks are increasingly part of larger international groups. In times of crisis, the coordination between home and host presents considerable challenges. Diverging incentives often stand in the way of finding a cooperative solution that is in the collective interest of both home and host authorities. To address these challenges, the Key Attributes of Effective Resolution (KAs) provide that the statutory mandate of resolution authorities should empower and strongly encourage them, wherever possible, to act to achieve a cooperative solution with foreign resolution authorities.

19. The existing legal framework is broadly supportive of cross-border cooperation. The Registrar of Banks' power under section 4(3) of the Banks Act to enter into written cooperation arrangements covers arrangements with host or home supervisors or any other person or institution as the Registrar may deem fit. The scope of such agreements, as set out in the Banks Act, covers supervisory matters.¹¹ The FSB's power to cooperate and share information also extends to cooperation with foreign regulatory authorities. Its powers more explicitly cover cooperation and information sharing relating to not only supervisory matters but also for the purpose of ensuring the safety and soundness of financial institutions, or for ensuring financial stability.¹²

20. Current arrangements in place for cross-border cooperation include:

¹¹ For example, arrangements for on-site supervision, acceptance of approval and supervisory methods/processes and information sharing between the Registrar and a host supervisor relating to the financial condition performance of, adverse assessments, and significant problems experienced by a bank or its foreign branch, subsidiary, holding company, or other affiliates.

¹² Section 22 (2) (dd) (ee) (B), (C), (D).

- **MoUs:** The SARB's operational policies for foreign banks require the establishment of an MOU with the foreign supervisor as part of the authorization or registration process.¹³ A number of MOUs have been entered into between the SARB and other regulatory authorities in jurisdictions where South African banks operate or from which banking institutions operating in South Africa originate. The number of MOUs with foreign supervisors increased from 10 in 2008 to 25 in 2012, with another 12 currently being negotiated. Furthermore, in the context of the Protocol on Finance and Investment signed by the 14 heads of state or government of the Southern African Development Community (SADC), a framework for cooperation and coordination in banking regulatory and supervisory matters in SADC countries exists.
- **Supervisory colleges:** Supervisory colleges are mainly used as a platform by home country supervisors to share information with BSD in its capacity as host country supervisor. As home supervisor, the BSD has in recent years organized supervisory colleges for the Standard Bank Group, which has operations in 17 other African countries. A supervisory college is also planned for Barclays Africa Group Limited during November 2014, given its presence in eight other African countries. No plans currently exist for the hosting of supervisory colleges for the FirstRand Group and the Nedbank Group, which have eight and five subsidiaries, respectively in Africa. The BSD also participates in supervisory colleges of foreign banks as a host supervisor, and holds ad hoc meetings with supervisors from other jurisdictions, particularly the Prudential Regulation Authority in the United Kingdom.
- **Crisis management groups:** South Africa participates in two Crisis Management Groups for G-SIFIs, namely that of Barclays (for ABSA Bank), and of Old Mutual (for Nedbank).

21. The authorities' framework for home-host cooperation in the context of crisis management could be further strengthened. The effectiveness of the existing framework is untested, given that there has not been any failure of a multi-jurisdictional institution of which South Africa was the home or host jurisdiction, which involved significant cross-border issues. That said, the authorities should take urgent action to close key gaps in the framework to help promote crisis preparedness. In particular:

- Existing cooperation arrangements and MOUs with foreign authorities deal with supervisory issues only and, as yet, not with resolution and crisis management related issues.
- The existing statutory framework in South Africa, which provides for the enforcement of foreign judicial actions by domestic courts under certain conditions,¹⁴ may not support enforcement of administrative resolution actions, such as bail-in by a foreign resolution

¹³ Authorization for branches of foreign banks seeking to operate in South Africa, and registration for subsidiaries of foreign banks and other domestic banks.

¹⁴ That is, the foreign court had jurisdiction over the defendant; that the foreign judgment is final and conclusive; does not involve the enforcement of a penal or revenue law of a foreign country; or is not contrary to public policy.

authority of a foreign bank with operations in South Africa. Under the Enforcement of Foreign Judgments Act, South African courts may recognize and give effect to foreign judgments, but it appears not to provide specifically for the recognition and enforcement of foreign administrative resolution actions that may affect a branch or subsidiary in South Africa. Furthermore, there appears to be no flexibility for the recognition and enforcement of such decisions through administrative action by the resolution authorities. The KAs contemplate that procedures for the recognition or support of foreign measures should be transparent and expedited, provisional on the equitable treatment of creditors in the foreign resolution proceeding. Where courts are involved in giving effect to resolution actions, the process should not impede prompt resolution.¹⁵

22. Advance planning can help align incentives such that home and host authorities consider international spillovers. As an illustration, Australia and New Zealand have statutory arrangements in place for the prudential regulators to support each other in meeting prudential regulation and financial stability responsibilities and to consult, where practicable, before taking action that might have a detrimental effect on financial system stability in the other country.

23. To enhance cross-border coordination and information sharing, particularly for resolution purposes, the FSAP team recommends that:

- The scope of cross-border cooperation should be expanded under the legal framework to explicitly cover cooperation and coordination in respect of cross-border resolution and crisis management arrangements generally, and in respect of specific institutions/groups with cross-border operations. These should cover pre-agreed arrangements for the exchange of information, decision-making powers and procedures to promote orderly resolution. The legal framework should also provide clearly for the mandate to cooperate not only with foreign supervisory agencies, but also with all foreign resolution, fiscal authorities, deposit insurance schemes, and others that share responsibility for crisis management and burden-sharing arrangements.¹⁶ With a financial stability objective and designated resolution authority under the proposed twin peaks legislation, and with the support of the NT, the SARB should be in a strong position to take the lead in initiating a dialogue with foreign authorities.
- The authorities should explore the feasibility of hosting supervisory colleges for the FirstRand Group and the Nedbank Group, given their substantial presence in other African countries. Furthermore, in the context of all supervisory colleges, the authorities should spearhead the establishment of Crisis Management Groups for the various banking groups

¹⁵ The KAs (7.5) require jurisdictions to provide for transparent and expedited processes to give effect to foreign resolution measures. Also see KA 2.1 and 5.4.

¹⁶ See for example, the Nordic-Baltic Stability Group MoU which allocates public costs on the basis of the share of the bank's asset in each country and supervisory responsibility and recognizes other factors—such as the share of problem assets, excessive fiscal consequences and proven early action—that may be taken into account.

to ensure that relevant information is shared and that recovery and resolution plans are prepared and updated on a group-wide basis.

- The legal framework should support mutual recognition and enforcement of resolution actions (preferably through administrative measures) between the South African authorities and their foreign counterparts, subject to the principle of non-discriminatory treatment of foreign creditors in the context of cross-border resolution and crisis management. This could involve an amendment to the Enforcement of Foreign Judgments Act to provide that decisions of foreign resolution authorities made out-of-court be considered as foreign judgments that are subject to recognition and enforcement through the streamlined procedures already in place. Furthermore, the resolution legal framework should empower the resolution authority to recognize foreign resolution actions and to take measures under the domestic resolution regime that support and are consistent with the resolution measures taken by the foreign home resolution authority. The authorities could also explore with their foreign counterparts, the extent to which contractual solutions could help support the cross-border enforceability of resolution actions such as bail-in affecting cross-border banks.¹⁷ The authorities' cooperation agreements with foreign counterparts should also cover cooperation for mutual recognition and enforcement (through administrative processes) of resolution actions, including through the use of contractual approaches (voluntary and through regulatory requirements), where feasible, in addition to the applicable statutory framework.¹⁸ As home jurisdiction for a number of South African banks operating in Sub-Saharan Africa and host jurisdiction to foreign bank branches and subsidiaries, it is imperative for the South African authorities to engage proactively with its counterparts in home and host jurisdictions to ensure that appropriate statutory, contractual, and cooperative mechanisms are in place to facilitate enforcement of resolution actions that have cross-border implications.

E. Resolution and Recovery Planning

24. The existing legal framework does not require mandatory recovery plans to be prepared by banks. The SARB currently relies on its general powers under the Banks Act to request recovery plans from banks. The Registrar of Banks published a number of Guidance Notes in 2012¹⁹ announcing the introduction of recovery and resolution planning in a phased-in approach, with recovery plans expected to ultimately become a key element of the BSD's supervisory process. Under these Guidance Notes, banks were expected to develop recovery plans over a two- to three-year period with guidance from the BSD.

¹⁷ Some jurisdictions already require, or are in the process of adopting measures to require, firms to include contractual provisions in instruments governed by a foreign law to facilitate the cross-border enforceability of bail-in.

¹⁸ These will likely involve amendments to legislation and/or changes to existing contractual provisions.

¹⁹ Under section 6 (5) of the Banks Act, the Registrar may issue a Guidance Note from time to time furnishing regulated entities with information in respect of market practices or market/industry developments within or outside the republic. These are unlike directives (section 6 (6)) which have the force of binding rules.

25. Recovery plans have been prepared and initially discussed with the SARB for the systemically important banks, while resolution plans are on hold until new resolution powers are introduced. While the sequencing is logical, it would nevertheless be helpful to (i) set out a clear regulatory basis for recovery and resolution plans (RRPs); and (ii) provide the PA with the powers (in consultation with the Resolution Authority) to direct a bank/group to make structural changes to promote resolvability. The lack of a legal basis for RRP could create difficulties in obtaining relevant information from overseas entities or authorities, as has been the case in other countries. The authorities should therefore provide a clear statutory basis for RRP, and develop comprehensive guidelines on what the recovery plans should cover.

SUPERVISORY EARLY INTERVENTION IN BANKS

26. The existing legal framework provides the Registrar of Banks (RB) with a range of early intervention powers, but these are constrained in key respects.²⁰ Under the Banks Act, the Registrar may apply the powers set out in Appendix 1. These are, however, saddled with significant restraints that have far-reaching implications for early intervention. Among other things, the RB lacks the operational autonomy to cancel or revoke a banking license, approve a merger or acquisition, remove a director or officer of a bank, or impose a fine. For instance:

- The RB is required to obtain prior consent from the minister for cancellation or suspension of the authorization of a branch of a foreign bank;²¹ and to consult with the minister in the case of a bank that has ceased to conduct the business of a bank or is no longer in operation.²²
- The minister's approval is required for bank mergers and the acquisition of more than 25 percent of the assets, liabilities or assets and liabilities of a bank (except under an approved securitization scheme);²³
- The RB is required to obtain a court order for the cancellation or suspension of a banking license, including for unsatisfactory conduct of business, undesirable business practices, or non-compliance under the Banks Act. Recourse to the courts for cancellation or suspension of a bank's registration on grounds including non-compliance under the Banks Act would seem an unnecessary fetter on the early intervention powers of the RB. The court has the power under section 25 to grant or refuse the RB's application;
- The RB is required to seek approval from an arbitrator in order to remove a director or officer of a bank where the affected person makes representations to the RB challenging the

²⁰ The Registrar of Banks is mandated to regulate and supervise banks under sections 3 and 6 of the Banks Act 1990 amended as of 2013.

²¹ Section 18B of the Banks Act.

²² Section 23 (3) of the Banks Act.

²³ Section 54 (1); (1A) of the Banks Act.

intended action, or fails to make any representations.²⁴ Like the court, the arbitrator has discretion under section 60 (6) to make a determination that the RB's proposal lacks merit and, in such cases, the director or officer cannot be removed.

27. The RB's powers are also subject to significant due process requirements under the existing legal framework, which could impede early intervention. Prior notice and a waiting period of 30 days is required to allow an affected bank to make representations to the RB as to why he/she should not cancel/suspend a bank's registration, restrict its activities, or impose a fine for non-compliance under the Act.²⁵ There is no power given to the RB to reduce this timeframe or waive it, if necessary, to protect the interests of depositors, the bank, or the financial sector, except in the case of administrative fines for a breach of regulatory requirements, where the RB is allowed under the Act to waive notice requirements if it deems it fit to do so in the circumstances. This could lead to, in some cases, a further deterioration in the financial condition of a bank with likely contagion effects on financial stability.

28. In addition to the constraints outlined above, a number of other gaps exist.

- The triggers (quantitative and qualitative) for graduation from minor to more intrusive intervention are somewhat unclear. Currently, the RB's powers include simple fines at one end of the spectrum to curatorship in the event of insolvency at the other end. While flexibility in the use of tools is desirable, a careful balance must be struck with the need for transparency and proportionality by clarifying what powers may be exercised when. A practical example reflects the RB's power under section 74(4) to impose a fine on a bank when it suffers a shortfall in minimum capital, unimpaired reserves, or minimum liquidity requirements. The RB is empowered by law to "condone the failure or inability" and allow the institution an opportunity to make up the shortfall. This provides the RB with a lot of discretion for forbearance, and it is unclear when he/she is required to take corrective action to help restore a bank to sound financial health. Also, in relation to the breach of prudential requirements, he/she is empowered to impose a fine for every day the breach is not rectified. It is unclear from the legal framework when more intrusive corrective powers are triggered to help save the bank before it reaches insolvency.
- The RB is allowed to impose fines on a bank, but there is no power to impose fines on persons associated with banks (including shareholders, directors, and management).
- The RB can remove but not replace directors and/or officers of a bank.

29. Overall, the existing legal framework for early intervention requires urgent reforms to align it more closely with good practices and to make it an effective tool for promoting early

²⁴ Under the auspices of the Arbitration Foundation of South Africa or other body designated by the Registrar.

²⁵ Sections 23 (2); 24; 91A. In the case of action to remove a director or officer, the notice and waiting period is reduced to 14 days, although the Registrar must therefore submit the matter to arbitration if, within the 14-day period, the affected person makes representations against the intended action or makes no representations at all.

corrective action in troubled banks. The FSAP team recognizes that the existing constraints under the legal framework reflect an attempt to build in checks and balances against arbitrary administrative power and to ensure that substantive and procedural rights under the Constitution are respected.²⁶ Due-process requirements serve the useful purpose of keeping the exercise of supervisory powers in check. In the context of early intervention and resolution, however, the legal framework should provide a special dispensation to ensure that such requirements do not result in inordinate delays and hurdles for effective and swift intervention in problem banks.²⁷ In this regard, there is the need to amend the Banks Act in various parts to strengthen the RB's ability to intervene early in banks where necessary, with reasonable autonomy in the exercise of such powers and as few constraints as are feasible within constitutional boundaries. In particular:

- The right to a fair hearing by the RB could be respected in a manner that does not unduly constrain the RB at crucial times. The authorities should consider legislative amendments to the Banks Act to (i) reduce the ex ante 30-day and 14-day notice and hearing requirements to a much shorter period (24 hours, if possible); and/or (ii) empower the RB, on a case-by-case basis, to waive ex ante notice and hearing requirements on the basis of necessity; or (iii) remove the requirement for ex ante notice and provide an ex post mechanism for notifying the person affected and providing the right to redress if the action of the RB is found to have no merit. Section 3(4) and (5) of the Promotion of Administrative Justice Act (PAJA) would seem to support such changes, as it permits an agency to depart from the strict requirements of the PAJA if empowered by other legislation in that regard. We urge the authorities to seek local expert legal advice to ensure that the above recommendations can be implemented within the boundaries of constitutional jurisprudence.
- Section 54 of the Banks Act should be amended to dispense with the minister's power to approve mergers and acquisitions of the assets and liabilities of a bank.
- The authorities should amend the Banks Act to dispense with the requirement for the RB to (i) seek a court order for the cancellation or suspension of a banking license (section 23 (3) and section 25); and (ii) obtain approval from an arbitrator in order to remove a director or officer of a bank (section 60 (6)).

30. Amendments to the Banks Act or secondary legislation would be required to clarify triggers (quantitative and qualitative) for the exercise of more intrusive intervention powers.

²⁶ Section 33 (1) and (2) of the Constitution provides that every person has a right to administrative action that is lawful, reasonable, and procedurally fair and that every person whose rights have been adversely affected by administrative action has the right to be given written reasons. More specifically, section 3 of the Promotion of Administrative Justice Act of 2000 requires, among other things, that an administrative agency provide adequate prior notice of the nature and purpose of an administrative action that could materially and adversely affect the legitimate rights or legitimate expectations of any person, and a reasonable opportunity to make representations.

²⁷ Key Attribute 5.4 provides that the resolution authority should have the capacity to exercise the resolution powers with the necessary speed and flexibility, subject to constitutionally protected legal remedies and due process.

Such triggers should reflect a graduated regime of simple enforcement actions to more intrusive corrective powers that help restore an institution's safety and soundness before insolvency. The legal framework should also clarify triggers for the point of non-viability, where an institution is moved out of the early intervention regime to the resolution regime to help ensure that banks do not remain in early intervention for an indefinite period. This would provide for a transparent basis for the exercise of intervention powers and reduce potential legal risks for supervisors.

31. Lastly, early intervention and resolution powers under the existing legal framework should be re-aligned with the proposed changes to the institutional framework. As part of the implementation of the twin peaks approach, amendments to existing sectoral legislation for banking, insurance, securities, and financial market infrastructures (FMIs) are expected to align such legislation with the new regulatory architecture. In that context, the authorities should streamline early intervention powers under such legislation in line with the proposed institutional arrangements under the twin peaks model.

CRISIS MANAGEMENT TOOLS

A. Framework for Systemic Liquidity Provision

32. The SARB uses a range of instruments to keep money market rates close to the monetary policy rate. To ensure that its repo rate remains the anchor to overnight interest rates, the SARB aims to compel the banks to borrow from the SARB. The SARB transacts regularly to drain liquidity from the money market. In addition to levying a structural cash reserve requirement on banks (2.5 percent on certain bank liabilities), the central bank uses various open-market instruments, such as SARB debentures, reverse repos, foreign-exchange swaps, and movement of government funds between the SARB and the market, to create a liquidity shortage (the money market shortage is also called the "liquidity requirement").²⁸ The resulting short-term liquidity needs of banks are met through refinancing operations with the SARB. It offers fixed-rate repurchase (repo) auctions with one-week maturities at the repo rate set by the Monetary Policy Committee. The SARB's standing facility is available to banks on an automated basis in the form of overnight repo or reverse repos. The interest rate on the standing facility is set at a spread of 100 basis points above and below the prevailing repo rate. The SARB may offer supplementary "square-off auctions" to the clearing banks (22 banks have settlement accounts with the SARB) "if some unexpected developments cause a large shift in liquidity conditions in the market."²⁹ The SARB also uses (tom-next)³⁰ foreign exchange swaps for domestic liquidity management purposes.

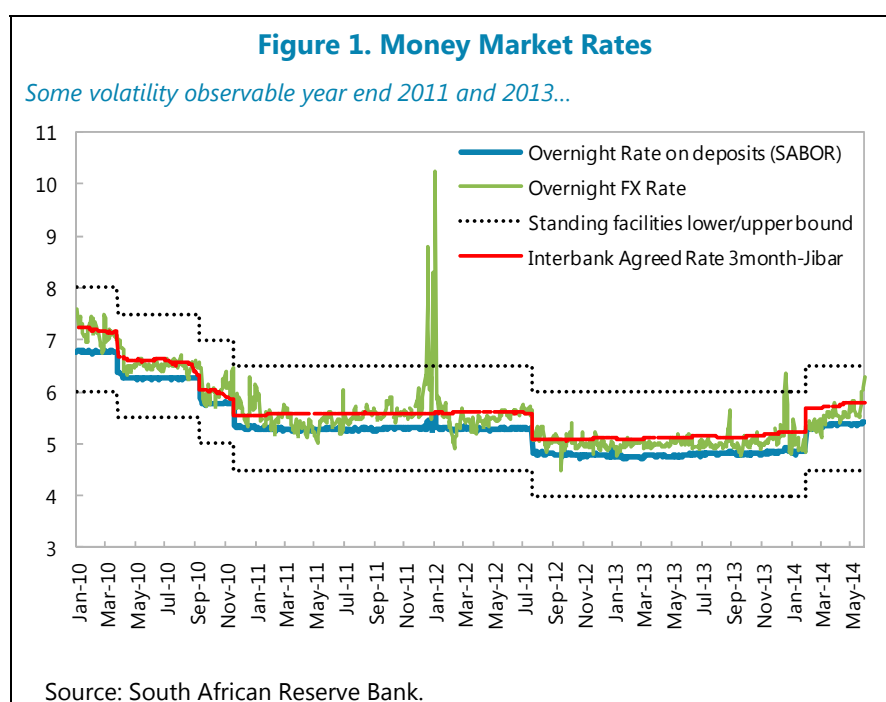
33. Since introducing the repurchase system in 1998, the SARB has made a number of refinements to its open market operations (OMOs). In 2007, the range of collateral eligible at the SARB's refinancing facilities was widened to include non-government bonds issued by state-owned

²⁸ This is distinct from the 2.5 percent reserve requirement and the 5 percent liquid asset requirement set by the RB.

²⁹ SARB, Operational Notice, Financial Markets Department, Money Market Operations, February 2012.

³⁰ FX swaps in which the spot leg settles tomorrow and the forward leg settles the day after.

enterprises. The SARB then reverted in 2011 to rand-denominated government bonds and treasury bills, SARB-issued debentures, and Land Bank bills. In February 2012, following year-end rate volatility (see Figure 1),³¹ the SARB announced further changes. These included increasing the range of maturities of its instruments and allocating excess orders on a pro rata basis. A SARB announcement in August 2013, that it would gradually increase the money market shortage over time, caused short-term volatility in money market rates. Some year-end volatility was also observable in 2013, and the SARB injected rand liquidity via FX swaps in response. While the SARB pays lower interest on some of its liabilities (e.g., SARB debentures rates pay less than the repo rate, and bank reserves pay no interest), the cost to the SARB of manipulating bank reserves can be significant due to the relative volumes. The FSAP team recommends that the authorities request technical assistance from the Fund's Monetary and Capital Markets Department to review the current framework and its cost.



34. The SARB is committed to implementing the Basel III liquidity standards and will offer a committed liquidity facility (CLF) from 2015 to enable banks to meet the Liquidity Coverage Ratio (LCR). As with several other Basel Committee member countries, certain aspects of the financial market (e.g., a limited supply of government bonds, an illiquid and small corporate debt market) make the implementation of LCR and Net Stable Funding Ratio (NSFR) standards difficult.³² As a result, the authorities will adopt one of the alternative liquidity approaches defined in the Basel text. The LCR will be phased in, starting at 60 percent of banks' net cash flow over a 30-day period from 2015, and then rise 10 percent annually to reach 100 percent in 2019. The SARB will accept

³¹ The SARB is discussing with market participants options for a new overnight interest rate benchmark.

³² A higher run-off rate also applies to retail deposits as they are not covered by deposit insurance in South Africa.

significantly wider collateral classes in the CLF than at its open market and standing facilities (Box 1). South African banks will also face challenges in meeting the NSFR standard, although implementation will not be until 2018, and the details are yet to be finalized. Banks should be encouraged to improve the structure of their balance sheets through adherence to the LCR and NSFR regulations and by adjusting the CLF fee structure (see below).

Box 1. Committed Liquidity Facility (CLF) of the South African Reserve Bank

In 2012, the SARB announced that it would open a committed liquidity facility (CLF) to assist banks to meet the phased-in Liquidity Coverage Ratio (LCR) requirements under Basel III, using one of alternative liquidity approaches allowed for in the revised Basel text. Directive 2/2013 (March 2013) advised banks of the SARB's intention to incorporate all the changes made to the Basel text in January 2013, including the new 15 percent allowance for lower quality (level 2B) liquid assets, such as equities.¹ Guidance Note 6/2013 (August 2013) detailed the terms and conditions for banks' access to the CLF at the SARB.

Access conditions: The CLF will be available to all banks that apply at the discretion of the SARB, but will be capped at a maximum of 40 percent of a bank's total HQLA requirement. Banks are required to meet the requirements for level 1 assets without assistance. The SARB will review the 40 percent cap on an annual basis, and may reduce it if the supply of HQLA in the market increases. The SARB estimated in August 2013, that the shortfall for South African banks in meeting the 100 percent LCR requirement was approximately R140 billion (SARB Guidance Note 6/2013, Aug, 2013).

Fees and maturity: Banks using the facility will be charged a scaled commitment fee (between 10 and 45 basis points) based upon each bank's usage of the facility. Drawdowns will incur an interest rate of the SARB repo rate plus 100 basis points (as per standing facilities) and have a maturity of 31 days.

Eligible collateral	Haircuts
Listed debt South African securities (sovereign and parastatal issues) with a minimum domestic credit rating of A- (equivalent to BBB- on an international scale)	Varying, by rating and maturity, from 0.5 percentage points (ppt) to 6 ppt for sovereign, and 1 to 12 ppt for other issuers
Self-securitized rand-denominated residential mortgage-backed securities (RMBS). No credit rating required if the issue complies with SARB guidelines, including a loan to value (LTV) cap of 80 percent; and concentration, arrears, and seasoning requirements	No haircut if the issue complies with SARB's guidelines
Self-securitized rand-denominated commercial mortgage-backed securities (CMBS) may be accepted on a case-by-case basis	On a case-by-case basis
Securitized notes, of on- or off-balance sheet retail loans, e.g., vehicle or asset finance. Banks using the internal-ratings-based approach can self-rate; banks on standardized approach need an external rating	On a case-by-case basis
Equities listed on the Johannesburg Stock Exchange main exchange and included in South Africa's Top 40 index	15 percent

¹ High quality liquid assets (HQLA) are divided into three types: level 1 assets that are the most liquid (such as government debt, central bank reserves) and level 2 assets that are less liquid and subject to haircuts and a cap to be counted as HQLA. The latter is further divided into level 2A and 2B assets based on their liquidity, with level 2B assets subject to more stringent capping (15 percent) and haircuts.

35. The CLF does not prevent the SARB from providing ELA on wider terms, but this lacks a formal framework. The SARB retains discretion to provide liquidity to banks on different terms than the CLF; for example, against other collateral such as individual loans and on longer maturities than 31 days. The SARB Act allows the SARB to grant loans on a secured basis. However, no requirements are prescribed in legislation, or publically elsewhere, with respect to solvency and the types of firms eligible for ELA. While affording flexibility to the SARB to make ELA decisions on a case-by-case basis, this could open the door to quasi-fiscal operations by providing long-term credit or in effect “risk-capital” to a troubled financial institution. The relationship between ELA and the CLF should also be clarified. Currently, there is some uncertainty, for example, as to whether a drawdown of the CLF will trigger a similar regulatory response as ELA, and present similar stigma risk.

36. The SARB has prepared internal guidelines for handling liquidity stress in banks. These assign responsibilities to relevant SARB departments, including with regard to coordination with the NT. While the framework envisages a solvency test for non-systemic banks, it expressly leaves open the possibility of the SARB providing ELA to systemic banks that may not be solvent, subject to a decision by the Governor’s Committee. These guidelines have been discussed at the FSCF, but not adopted formally or made public.

37. The SARB Act limits the SARB’s ability to accept some forms of collateral which might constrain a policy response in a systemic crisis. A prohibition in Section 13 of the SARB Act against accepting mortgage collateral was removed in 2013.³³ However, the prohibitions against taking commercial paper over 120 days and agricultural bonds over six months of maturity remain. A cap on the amount of South African government bonds the SARB can hold, whether obtained via primary or secondary purchases, also remains.

38. The FSAP team recommends a number of measures to enhance the framework for systemic liquidity provision:

- **Solvency requirements:** Consideration should be given to introducing an explicit solvency requirement in the SARB Act, or via regulations made by the minister under the SARB Act. ELA should be given only to institutions judged to be solvent but temporarily illiquid to the best knowledge of the supervisor. This should be based on a forward-looking assessment (e.g., of viability) rather than historic book values. It should be made explicitly clear that any provision of the ELA by the SARB to banks that may not be solvent could only take place with an indemnity from the government.
- **Eligible entities:** Which firms are eligible for ELA should be defined explicitly and conveyed publically in a transparent ELA framework. The authorities should consider the potential liquidity needs of systemic nonbank financial institutions (NBFIs), such as a systemic FMI, and under what circumstances access to ELA may be required to preserve financial stability. The

³³ By the Financial Services Laws General Amendment Act, 2013 (section 53).

framework should clearly establish that a decision to provide ELA to an NBFI, which, typically, should be regulated by the central bank to be eligible, should rest with the SARB.

- **Collateral:** The remaining arbitrary prohibitions in the SARB Act should be removed and replaced with a requirement for the SARB to apply prudent valuation and haircut policies.
- **CLF terms and conditions:** Central banks do not typically take equities as collateral³⁴ due to the increased market risk compared to fixed-income securities. In a stress scenario, equity prices could move significantly more than the 15 percent haircut announced. Accordingly, for example, LCH Clearent applies a 35 percent haircut. The banks do not hold significant volumes of equities and, with the subsequent revisions to the LCR definition, this class could be dropped without a material impact on banks' compliance with the LCR. If retained as an eligible collateral class, a haircut of at least 35 percent should be adopted. The SARB also should not rely on banks and their auditors alone to confirm compliance with the eligibility guidelines set out by the SARB for self-retained residential mortgage-backed securities (RMBS). It should put in place its own diligence checks, including, for example, via sampling of the underlying loan assets. In addition, the SARB should apply a haircut of at least 15 percent, as various aspects of the self-retained securitization structures could present risks to the SARB.³⁵ For these reasons, the minimum haircut applicable to self-retained asset-backed securities at the European Central Bank, for example, is 15 percent (AAA – A-rated).³⁶ Finally, as planned by the SARB, the CLF commitment fee structure should be reviewed on an annual basis to ensure that banks are incentivized to restructure their balance sheets and not rely on the CLF in the long term.

B. Orderly and Effective Bank Resolution

39. Under the current resolution regime, a curator is appointed and given broad powers when a bank is close to insolvency. When a bank is, or will become, unable to repay depositors, the RB may recommend to the MoF that it be placed under the control of a curator (Section 69 of the Banks Act). The curator is appointed by the MoF and has broad powers to take control of the bank and its assets, some of which require the prior approval of the MoF. A previous requirement that written consent was required from the bank's chief executive officer or chairman before the curator could be appointed was recently rescinded.³⁷ Amongst other powers, a bank placed under a curator can benefit from temporary relief from obligations (Section 69(6) of the BA); the curator can cancel contracts, suspend or cancel interest payments to creditors, and make payments to creditors

³⁴ See Table 1 in the European Central Bank's Collateral Eligibility Requirements, A Comparative Study Across Specific Frameworks (July 2013).

³⁵ RMBS issued into the market have standardized clauses, waterfall structures and contingency arrangements (e.g., back-up servicers, swap providers, etc.). In the case of self-retained deals, the originator may structure these features to its own interests, which could limit their potential future marketability.

³⁶ This includes a 5 percent add-on for theoretical valuation.

³⁷ By section 37 of the Financial Services Laws General Amendment Act, 2013.

“in such order and such manner as the curator may deem fit” (Section 69(3) of the BA).³⁸ If authorized by the MoF, the curator may dispose of bank assets and or make other decisions (e.g., approve a merger) that would otherwise be subject to a special shareholder resolution. Section 69 (3) also provides for the minister empowering a curator to consult and negotiate with a bank’s creditors in matters affecting their interests. If the bank is insolvent, the RB may apply for its liquidation under court supervision (Section 68 of the BA) and may propose that the liquidator be appointed by the court. Liquidators are selected from large auditing firms and generally are legally qualified. The court-based liquidation process is based on the ordinary corporate insolvency framework, which does not have financial stability as one of its objectives. In that regard, the liquidator remains under the exclusive supervision of the court, with no role for the Registrar/SARB to direct the liquidator, if necessary, to take carry out liquidation in a manner that helps promote financial stability.

40. While the powers have been used for relatively small bank failures, they lack critical features necessary to deal with a systemic case so as to minimize risks to public funds. Box 2 describes a number of bank failures in which public funds had to be deployed in the interest of stemming deposit contagion and preserving financial stability. This was a common response in those countries worst hit during the GFC, which typically lacked adequate tools to deal with failing systemically importance financial institutions (SIFIs). A key objective of the Financial Stability Board’s Key Attributes of Effective Resolution (KAs) is “to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss...” Adopting a wider range of strong resolution powers, deployable at an earlier juncture, should significantly reduce the contingent risks to taxpayers arising from bank failures. More resolution tools would facilitate the resolution of more systemic financial institutions while reducing the risk of public support being needed for ailing financial firms or their creditors (Figure 1).

41. The resolution regime needs to be reformed to comply with best international practice. In particular, resolution powers should (i) be available at an earlier juncture; (ii) facilitate a wider range of resolution options (e.g., bridge banks); and (iii) not be at risk of being suspended or reversed upon appeal. As a Financial Stability Board member, the authorities are committed to reforming the regime to make it compliant with the KAs by end-2015.³⁹ The draft FSR Bill, published in December 2013, proposes establishing the SARB as the resolution authority for systemic financial institutions, including systemic banks and insurance companies and bank holding companies. A Resolution Policy Working Group comprising the NT, the SARB, and the FSB-SA, with technical assistance from the World Bank, is making progress in formulating the reforms to be included in a new resolution bill planned for 2015. The authorities plan first to issue a consultation paper on the key issues, possibly by end-2014.

³⁸ There appears to be a view held by some commentators that depositors could be preferred in a resolution using these powers. However, it is unclear to staff whether preferential treatment in favor of depositors in derogation from the *pari passu* principle would be legally enforceable under these provisions. Depositor preference is best made explicit in the appropriate legal framework (e.g., banking law, resolution law) to remove any doubt as to its legality.

³⁹ See http://www.financialstabilityboard.org/press/pr_130902.pdf.

Box 2. Examples of Public Support Provided to Problem Banks in South Africa

In a number of past cases of bank distress¹, financial support has been provided by the public authorities:

- **Bankcorp (1985):** Bankcorp got into difficulties following rapid expansion through mergers with a number of weak banks and aggressive lending policies. The SARB provided assistance in the form of a “lifeboat,” a covert loan provided at significantly below market rates, first extended in 1985. The loan was subsequently increased in size a number of times. It was not repaid until 1995, following the purchase of Bankcorp by ABSA Bank (in 1992).
- **Alpha Bank (1990):** Following high-level fraud, the SARB provided R150 million of funding to the bank primarily to protect depositors. After four years of curatorship, Alpha Bank was placed into liquidation.
- **Cape Investment Bank (1991):** The bank failed after it fraudulently failed to disclose significant NPLs in its balance sheet. The SARB provided R5 million to compensate depositors, allocated on a pro rata basis.
- **Pretoria Bank (1991):** Following failed plans for a merger with a participation mortgage bond company (Novabank), both companies failed and the SARB fully repaid all the deposits at Pretoria Bank.
- **Sechold Bank (1994):** After a wholly owned subsidiary incurred significant derivative losses, the SARB extended liquidity into the subsequent curatorship. The bank was subsequently purchased by Investec.
- **Islamic Bank Limited (1997):** Following the bank’s failure due to NPLs (including some related to insider lending), the SARB compensated depositors, up to a maximum of R50,000 per depositor, which covered 80 percent of the deposits.
- **Saambou Bank (2002):** The seventh largest bank in the system at the time (with 1.4 percent of total banking assets) got into difficulties after taking over a microfinance loan portfolio and following corporate governance failures. A deposit run ensued and, after a reported disagreement between the NT and the SARB on resolution, the bank was placed under a curatorship. After the freezing of its deposits by the curator triggered contagion to other banks, Saambou’s deposits (of R12.8 billion) were transferred to First National Bank (a division of FirstRand Bank) along with R4.9 billion of mortgages. The balancing item, a claim on the receivership of Saambou for R7.9 billion, was guaranteed by the SARB.
- **BoE Bank (2002):** Events at Saambou Bank triggered contagion to a number of other banks, including BoE, which was the sixth largest bank in the system (with 4.2 percent of total banking assets at the time). The SARB provided liquidity and issued a joint guarantee with the NT of BoE’s depositors to stem the run. The bank was subsequently acquired by NedBank, with financial support from the SARB, and the guarantee was lifted after nine months.
- **African Bank (2014):** Wholesale funded African Bank was placed under curatorship on August 10, 2014, after record losses on loans to low-income households triggered a loss of confidence by shareholders and creditors. The authorities announced public support (including a ZAR 7 billion injection from the SARB) for a new bank that would include retail deposits at face value (accounting for less than 1 percent of total liabilities), senior debt, and wholesale deposits at 90 percent of face value, and new equity from private and public sector sources. At the time of writing, the details of the resolution were still being negotiated.

¹ In the curatorships of New Republic Bank (1999), FBC Fidelity Bank (1999), and Regal Treasury Bank (2001), depositors were paid out of liquidated assets, or the bank concerned was taken over by another bank.

42. The FSAP team recommends introducing a special resolution regime for banks and systemic NBFIs with the following features:

- **Powers.** The full range of resolution powers should be available, including the power to override shareholder and creditor rights and the power to liquidate a failed bank/SIFI under a special resolution regime administered by the SARB instead of court-supervised corporate insolvency proceedings. To enable resolution authorities to exercise resolution powers with the necessary speed and flexibility, the resolution toolkit should include all of the powers listed in the KAs (Figure 2). Experience shows that such powers help to promote effective and orderly resolution (Figure 3).

Figure 2. Select Resolution Powers under the Key Attributes

The KAs set out a wide range of powers needed for effective resolution, including powers to:

Prepare for resolution

- Require recovery and resolution planning
- Require changes to firms' business practices, structures, or organization to enhance resolvability

Resolution Tools

- **Replace management**, claw-back salaries/bonuses, etc.
- Appoint an **administrator**
- **Assume shareholders rights** to approve merger, sale, or capital injection
- **Transfer** assets, liabilities to an existing entity, a **bridge bank** or an **asset management company (AMC)**
- **Bail-in** creditors to recapitalize the failed bank or successor entity
- **Liquidate** with timely payout of insured depositors (e.g., 7 days)

Support resolution

- Deviate from pari passu treatment
- Allow for temporary exemptions from market disclosure requirements
- Temporarily stay (for 48 hours) early termination rights
- Oblige group entities to continue essential services and support functions
- No creditor worse off and associated compensation arrangements

- **Triggers.** The triggers for the resolution tools should be harmonized at a significantly earlier juncture, based upon non-viability rather than under the current conservatorship regime. These should include both quantitative triggers (tied to capital adequacy and liquidity ratios, etc.) and qualitative triggers (e.g., breaches of laws and regulations, carrying on business in a manner detrimental to the interests of depositors).
- **Scope of regime:** The resolution regime should cover all deposit takers and systemic (at the point of failure) NBFIs. In line with the KAs, it should also extend to (i) holding companies of the firm in resolution; (ii) non-regulated operational entities within the financial group or

conglomerate that are significant to the business of the group or conglomerate; and
 (iii) branches of foreign firms

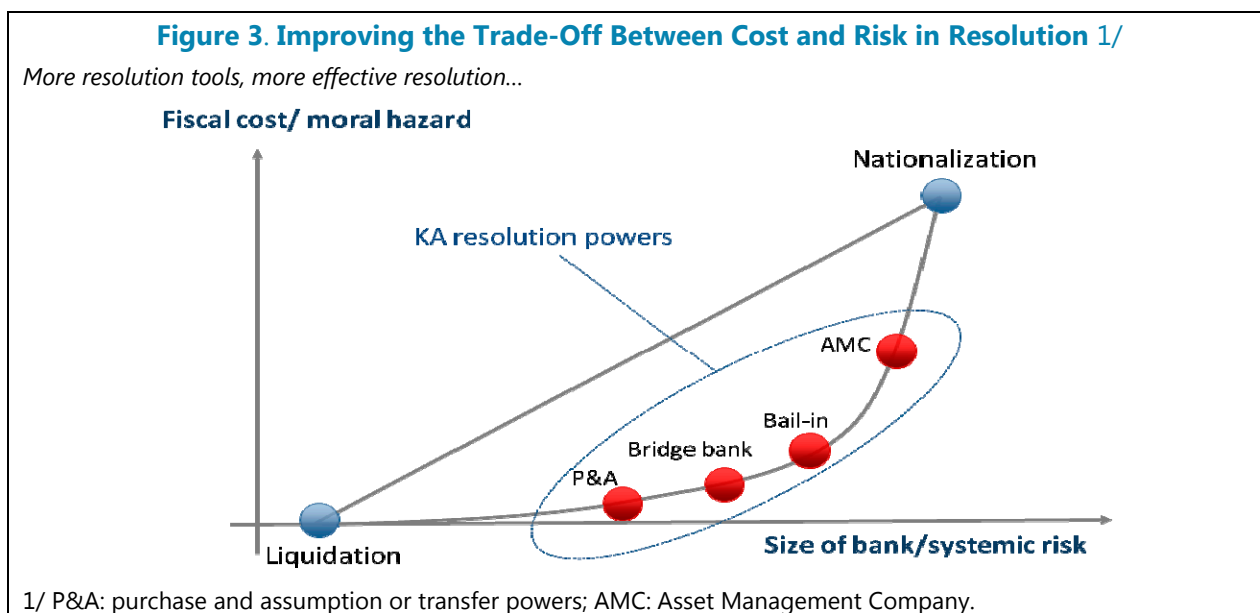
43. Only one authority should be assigned responsibility for the resolution of banks. The FSAP team recommends that only one authority be made the resolution authority (RA) for deposit takers. At the time of this assessment, consideration was being given to assigning responsibility for the resolution of systemic banks to the SARB, and for non-systemic banks to the Prudential Authority (PA). The FSAP team would caution against dividing this responsibility between two institutions for deposit takers, as the determination of systemic risk will be context-specific and could change rapidly, given the “run risk” inherent in banks’ balance sheets.

44. The resolution authority should develop a comprehensive manual for implementing the new resolution powers. The designated RA for deposit takers should develop internal guidelines and procedures (including preparing draft contractual arrangements for a bridge bank and a transfer of assets and liabilities)⁴⁰ for undertaking the new resolution powers, e.g., in the form of a resolution handbook. While this should very much be tailored to the South African context, benefit could be derived from building on other countries’ approaches and guidelines, including potentially through technical assistance. .

C. Resolution of Nonbank Financial Institutions

45. The authorities are considering whether powers under the existing sectoral legislation will remain or be replaced in the proposed Resolution Bill for non-systemic firms. There are pros and cons to either approach; however, the FSAP team suggested that there would be less execution risk in taking a sequenced approach and focusing on deposit takers and only systemic NBFIs, at least in the first instance. Existing legislation for the nonbank sectors provides the supervisors with powers which, with amendments, may be adequate and benefit from having an established track record for non-systemic cases (Appendix II). If this approach were adopted, however, these powers should be strengthened, e.g., to provide for autonomy of the supervisory authorities to require early remedial action and to initiate resolution actions such as the appointment of a curator or to exercise transfer powers, dispensing with requirements for approval by the minister. In the case of NBFIs deemed non-systemic at the point of failure, the RA should be the lead regulator of the firm (either the PA or the MCA depending upon the institution). Arrangements for close coordination and cooperation between the RAs will also be required. Finally, the FSAP team recommended seeking technical assistance from the Fund, in conjunction with ongoing assistance from the World Bank, when drafting the new legislation.

⁴⁰ Also known as a “purchase and assumption” or P&A.



D. Review and Legal Protection

Judicial and administrative review

46. Best practice requires that jurisdictions establish a legal framework in which resolution decisions may not be restrained or suspended while under review by the courts or administrative tribunals. In the interest of the public good, reviewing authorities should defer to the technical expertise of supervisory and resolution authorities. The legal framework should therefore limit the scope of judicial or administrative review, such that the standard for review is limited to an enquiry as to whether the supervisory or resolution authorities acted in bad faith, unconstitutionally (or otherwise illegally), or with gross negligence. Reliefs provided to claimants whose claims are upheld on the basis of this standard should be limited to monetary compensation and should not include a suspension, variation, or reversal of the actions complained about. This approach creates a fair balance between the claimant's rights to relief on the one hand, and the policy objective of avoiding legal uncertainty and disorderly resolution that could result from a suspension, variation or reversal of a resolution decision, with likely negative consequences for financial stability.

47. The existing legal framework reflects provisions on judicial and administrative review of resolution actions that could potentially render the resolution regime ineffective. In particular:

- The Constitution and the Promotion of Administrative Justice Act, 2000 (PAJA), as amended, provides a strong administrative justice regime that governs the review of administrative action by the judiciary. The Constitutional Court or High Courts have power to review the substantive and procedural aspects of any decision or action of an administrative nature, on the application of an aggrieved person. A court reviewing a decision or action may prohibit

the administrative agency from taking action, or may confirm, set aside or vary the relevant decision on the grounds that it was illegal, biased, procedurally unfair, in bad faith, or arbitrary or capricious, or otherwise unconstitutional. In certain cases, a Court may refer the matter back to the Registrar to reconsider his/her decision or action if the circumstances permit. The Court may also direct the administrative agency to act in a manner the court requires, or prohibit the agency from acting in a certain manner.

- Under section 9 (1) of the Banks Act, a person aggrieved by the decision of the Registrar may apply for a review of the decision within a prescribed period, to the Board of Review established under section 9 (2). The members of the Review Board⁴¹ are appointed by the minister and empanelled as and when a review is requested. While the scope of the Board's review of decisions is limited to enquiring into whether the Registrar exercised proper discretion and good faith, it may, by majority decision, confirm, set aside, or vary the decision reviewed.
- Under the Banks Act, any fine imposed by the Registrar on a bank or controlling company may be overturned by the minister or the High Court on the application of the affected party.
- The FSB Appeals Board (for nonbanks) established under section 26 of the FSB Act, whose members⁴² are appointed by the minister, may confirm, set aside or vary the FSB's decision pursuant to an appeal filed by an aggrieved person. It may also remit the matter for further consideration by the relevant decision-maker in accordance with directions given by the Appeals Board. An order of the Appeals Board has legal force and is enforceable in civil proceedings against the FSB in a division of the High Court.

48. The FSAP team recommends substantial legal amendments to ensure that review procedures do not unduly constrain supervisory and resolution authorities or create legal uncertainty. Among other things:

- The minister's power to suspend or overturn administrative fines imposed by the RB should be dispensed with as it undermines the operational autonomy of the Registrar.
- The minister's role in appointing the Review Board of the SARB as well as the FSB Appeals Board⁴³ should be reconsidered in order to promote the operational authority of the supervisory authorities.
- Furthermore, the power of the review mechanisms established by the minister (Review Board and Appeals Board) to suspend or overturn the decisions of the Registrars should be

⁴¹ These are a chairperson knowledgeable in law, a person with wide experience in the banking industry, and a registered accountant/auditor.

⁴² These include at least two advocates or attorneys, judges, and at least four persons with knowledge and expertise in the financial services industry.

⁴³ Section 26 of the FSB Act.

circumscribed, such that their power is limited (at least in the case of early intervention and resolution) to making recommendations to the SARB or FSB as the case may be, to pay compensation to affected persons if their claims are found to have merit.

- The Banks Act should provide explicitly for a judicial review of early intervention or resolution actions that ensures that (i) courts do not restrain the Registrar, a curator, or a resolution authority from exercising such powers, or suspend or reverse any such actions as a result of the review process; (ii) the standard for review is limited to an enquiry as to the good faith, constitutionality or legality of the action; (iii) the courts defer to the technical competence of the authority involved in arriving at its decision; and (iv) the only relief available to a claimant is monetary compensation, if a claim is found to have merit.

49. The FSAP team recognizes that implementation of the above recommendations may face resistance from stakeholders, but urges the authorities to use effective stakeholder engagement early on, to build broad consensus. The success of the reform process would hinge on a communications strategy that highlights the need for a fundamental shift in the legal system and jurisprudence toward a more balanced approach to judicial review of early intervention and resolution powers. It is important that due-process rights are viewed in the broader context of key public policy objectives of safeguarding financial stability and a careful balance reached in the process. The role of the judiciary (in particular, the Constitutional Court) in this process is also critical, and early engagement with them in this regard should be useful.

Legal Protection

50. Directors, officers, and employees of supervisory agencies and resolution authorities should be able to exercise their professional judgment and take necessary action where the circumstances require without fear of lawsuits against their actions. In the context of early intervention and crisis management, liability may occur when (i) the supervisory or resolution authority has failed to take any action, notwithstanding the knowledge of serious problems in the bank; (ii) measures were inadequate in response to the problems; or (iii) a shareholder or creditor of a bank challenges resolution measures on the basis of infringement of individual rights. It is important that liability should accrue only in the event of gross negligence or willful misconduct on the part of the supervisory authority, resolution authority, or its employees. Further, if the employees face personal action and have to defend the proceedings, they should have recourse to resources for defending the proceedings, including being indemnified for legal costs and expenses.

51. The existing legal framework provides legal protection for the SARB, its Board members, officers, and employees. Section 88 of the Banks Act provides immunity from liability in favor of members of the SARB Board, officers, or employees of the SARB, whether in their official or personal capacity for any loss sustained by or damage caused to any person as a result of anything done or omitted by such member in the bona fide performance of any function or duty under this Act. The immunity extends explicitly to the RB, bank inspectors appointed under section 11 or 12 of the SARB Act or to a repayment administrator duly appointed in terms of section 84 of the

Banks Act. There is no clear language under section 88 providing indemnity for the costs of defending actions by the persons covered under the immunity.

52. There are no legislative provisions extending legal protection to key persons involved in the management of the affairs of a bank under curatorship. In particular, there are no explicit legal protections for (i) a curator; (ii) a person appointed by the Registrar to assist the curator in the management of a bank under section 69 of the BA; (iii) a commissioner appointed by the Registrar under section 69A to investigate the affairs of a bank under curatorship; and (iv) the minister,⁴⁴ for their good faith actions and within the boundaries of applicable law. In the case of curators, it is also unclear whether they act as agents of the minister or the SARB, given that they are appointed by the minister on the recommendation of the RB and operate under the supervision of the RB.

53. The FSAP team recommends that:⁴⁵

- The BA should clarify who is responsible for the actions of the curator, and, in particular, that the SARB as the resolution authority should appoint the curator and be responsible for the curator. This is consistent with our recommendation in paragraph 43 that the curator should be appointed by the SARB.
- Section 88 of the BA should be amended to explicitly provide for indemnity for (i) a curator; (ii) a person appointed by the Registrar to assist the curator in the management of a bank under section 69 of the Banks Act; (iii) a commissioner appointed by the Registrar under section 69A to investigate the affairs of a bank under curatorship; and (iv) any employees or officers of the National Treasury (including the minister who may be involved in crisis management) for their lawful and good faith actions.
- Section 88 of the BA should also provide for indemnity for the costs of legal suits. The persons covered by the immunity under that section should be indemnified by the SARB for the costs of defending legal actions that are found to be in good faith and lawful under the Banks Act.

E. Deposit Insurance

54. The authorities have been considering introducing a deposit insurance scheme (DIS) for some time. Experience in the GFC emphasized the importance of an effective safety net for depositors. In particular, a high degree of confidence that depositors will have quick access to their deposits in full up to an insurance limit can stem the risk of depositor contagion. At the time of the Financial Stability Board's 2012 Thematic Review on Deposit Insurance Systems, South Africa was

⁴⁴ It would appear that the minister may enjoy immunity from personal liability for any good faith action pursuant to the Banks Act, which liability may be borne instead by the State under the State Liability Act and Treasury Regulation 12 under the Public Finance Management Act of 1999. This could, however, be made more explicit under the Banking Act.

⁴⁵ We assume below that a curator may still be appointed under the new regime, e.g., with respect to the KA powers that authorize the "administrator to take control of and manage the affected firm."

one of only three (with China and Saudi Arabia) out of 24 Financial Stability Board members yet to introduce a DIS. Accordingly, the FSAP team recommends that the authorities introduce an ex ante funded DIS as part of the reforms and has made a number of recommendations with regard to its features.

Scope

55. Membership should be compulsory to all deposit-taking institutions regulated by the PA. All retail deposit takers supervised by the PA should be covered under the DIS, including Postbank, which is state owned.⁴⁶ Given the differences in creditor hierarchy, there might be a case (e.g., if the mutual sector were to grow significantly) to have the deposit insurer establish separate funds for the nine commercial banks versus the three mutual banks and 18 cooperatives.

Coverage

56. Only depositors most in need of protection should be covered by the scheme. Given the low levels of foreign currency deposits in the system, these could likely be excluded without undermining the financial stability objectives of the scheme. Retail deposits in South Africa should be covered independently of nationality and residency. There may be sound policy grounds for covering the deposits of small and medium-sized entities (SMEs), despite the added complexity this entails. However, deposits from large firms, as with wholesale deposits, could be excluded as these agents should be better informed about credit risks. Given the skewed distribution toward low-value deposits in the system, an insurance cap at the R50,000 level, historically afforded in some past bank failures, would provide adequate protection to small depositors. It would cover 96 percent of retail and SME depositors in full and 22 percent by value. This compares well to a metric which seeks to balance the protection of small depositors with moral hazard, and would aim for full protection for approximately 80 percent of depositors, but only 20 percent of deposits by value.⁴⁷

Funding

57. The FSAP team recommends establishing an ex-ante funded scheme, with credible back-up funding from the state. Ex-ante schemes underpin the credibility of the deposit guarantee by providing reassurance to depositors on the ability of the DIS to make a fast payout. It also reduces the pro-cyclical impact of levying ‘surviving’ banks only after a disbursement, and contributes toward perceived fairness by securing contributions from the bank before it fails. This recommendation is consistent with the trend in other countries to establish ex ante funding, including in the European Union.⁴⁸ A Guidance Paper from the International Association of Deposit

⁴⁶ Under the International Association of Deposit Insurers (IADI) core principle 8, membership should be compulsory for all financial institutions that accept retail deposits. The other publically owned bank, the Land and Agricultural Development bank, does not take retail deposits.

⁴⁷ See page 14 of the “The Design and Implementation of Deposit Insurance Systems” (Hoelscher et al, 2006).

⁴⁸ The Draft Deposit Guarantee Scheme Directive (DGSD), which the European Parliament adopted in March, will require ex-ante funding for European deposit insurance schemes.

Insurers⁴⁹ suggests aiming for a target level that would be sufficient to cover about “five or six small banks or several medium-sized banks.” To ensure credible back-up funding for the DIS, including in the years it will take to build up to a prudent target funding level, an unsecured credit line from the authorities, preferably the NT, should be made available at market interest rates. The operational footprint and costs of the scheme should also be minimized, given the low frequency of bank failures, by housing it within the SARB and giving it a relatively narrow mandate to collect and invest levies, pay out depositors in the event of liquidation, and make funds available to the Resolution Authority (RA) for other types of resolution.

Use of DIS to facilitate resolution powers

58. The DIS fund should be available to fund resolution powers subject to strict safeguards. Without effective financing mechanisms, the new resolution powers might exist only on paper. A deposit and asset transfer, for example, will typically require funds to close the gap between transferred deposits and the good assets remaining on the firm’s balance sheet. KA6.3 requires jurisdictions to have privately-financed deposit insurance or resolution funds, or a mechanism for ex post recovery from the industry, of the costs of providing temporary financing to facilitate the resolution. However, safeguards should be adopted with respect to the use of DIS resources in resolution. International experience suggests that the costs of open bank assistance often prove larger than expected because the extent of the problems is initially underestimated. For these reasons, the FSAP team recommends that the DIS fund should only be available to support resolution measures under the following conditions:

- A statutory test should apply that any resolution funding provided by the DIS must be least-cost, net of estimated recoveries; and
- DIS funding should be limited to supporting the resolution powers once the resolution regime has been triggered, such that they cannot be used, for example, to provide solvency or liquidity support to an open bank that has not been placed into resolution.

Rapid payout

59. DIS members should be required to implement single customer view (SCV) recordkeeping to facilitate a rapid payout. SCV recordkeeping is critical to enable the quick reimbursement of insured deposits in a seven-day period or less. In the absence of such a system, the DIS will have to sort and aggregate accounts itself, which would significantly delay payments, except with very small deposit takers. Members should be given a reasonable period in which to phase in (e.g., one to two years) the necessary information system and other reforms to enable a seven-day payout.

⁴⁹ http://www.iadi.org/docs/Funding%20Final%20Guidance%20Paper%206_May_2009.pdf

Public awareness

60. A communication strategy should be put in place to explain the scheme to the public.

A budget should be provided and a program implemented by the scheme manager and member institutions to raise public awareness of the existence and limits of a DIS. This should focus on ensuring clarity as to what institutions, instruments, and values are covered by the scheme, and conveying this information through media in a form most accessible to retail depositors.

F. Depositor Preference

61. The FSAP team also recommends introducing depositor preference (DP). Under the Insolvency Act, which applies to banks in liquidation, all unsecured creditors, including depositors, rank equal (*pari passu*) after preferred creditors,⁵⁰ who follow after secured creditors. Introducing DP would minimize the potential costs of the DIS⁵¹ and facilitate resolution powers, such as purchase and assumption (P&A) and bail-in, by reducing the compensation and litigation risks, which may arise when the treatment of creditors in resolution differs from how they would have been treated in insolvency (Figure 5). The DP rules introduced should not discriminate by location of deposits or nationality of depositors.⁵²

62. The form of DP (Figure 4) adopted should be informed by quantitative impact assessment. In the long run, altering creditor hierarchies might not significantly change average bank funding costs (e.g., higher costs for less-preferred creditors might be offset by lower costs on more preferred unsecured funding). However, in the short term, the higher cost or reduced availability of wholesale funding might impact on wholesale funding costs.

Figure 4. Current and Possible Depositor Hierarchies

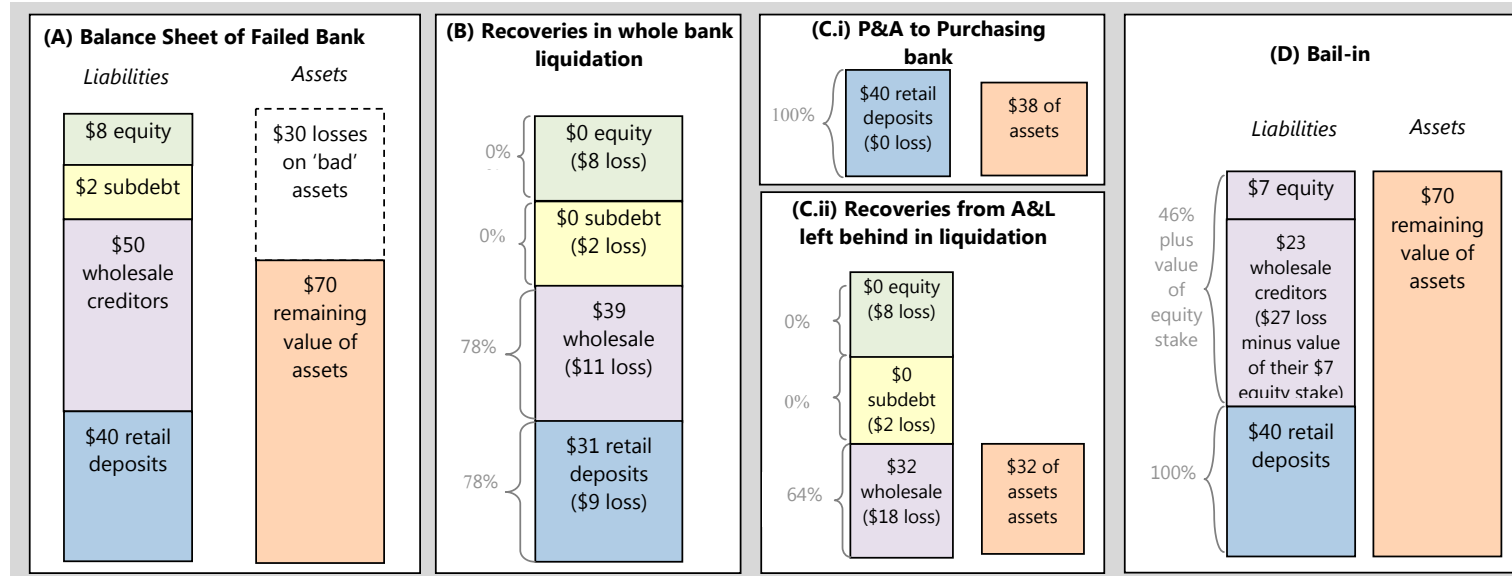
Current Hierarchy in Liquidation		Tiered Deposit Preference
Retail deposits	Other senior unsecured creditors e.g., wholesale deposits	Retail deposits under the insured amount e.g., R50,000 and the DIS (subrogated for insured deposits)
		Retail deposits over the insured amount
		Other senior unsecured creditors e.g., wholesale creditors

⁵⁰ These are in order of preference - (i) costs of liquidation; (ii) salaries and wages of employees; and (iii) statutory obligations (workman's compensation and taxation).

⁵¹ By increasing the recoveries of the DIS, following a pay-out of the deposits and liquidation of the assets of a bank.

⁵² See KA 7.4.

Figure 5. Litigation and Compensation Risks if Creditor Treatment Diverges



The example shows how a P&A (panel C) or bail-in (panel D) could disadvantage other creditors, giving them grounds to pursue compensation claims/litigation, if retail deposits are protected in a bank resolution but would rank *pari passu* with wholesale/other senior unsecured creditors in liquidation. Panel A shows a simple balance sheet of a bank which is insolvent due to a \$30 loss on assets. Panel B shows estimated creditor recoveries in a whole bank liquidation assuming no liquidation costs (it should be noted that these would typically be high). Panels C and D show recoveries if resolution powers were instead used to effect a P&A or bail-in respectively, and in both all retail deposits are fully protected.

P&A: Panel C.i assumes that the purchaser accepts \$2 more of liabilities than assets in the P&A with the difference constituting a purchase premium for acquiring deposits and assets. Equity, subordinated debt and wholesale deposits, together with remaining assets, are left behind and liquidated. If the bank's \$100 book value of assets were worth only \$70 in insolvency, the percentages in grey represent the net recoveries as a proportion of the original claims of each creditor class. Wholesale creditors incur an extra loss of \$7 directly as a result of the transfer compared to whole bank liquidation, as in the latter they would have had an equal claim over the \$70 remaining value of the assets with the transferred depositors and would have received \$39 (78 percent of \$50) instead of \$32 (64 percent of \$50).

Bail in: In panel D, bail-in powers are used to write down to zero equity and subordinated creditors, write down a portion of wholesale creditors' claims and convert a further portion of their claim into equity, without imposing losses on depositors. Wholesale creditors incur an extra loss of \$16 minus the market value of their equity stake, compared to their losses in insolvency.

Appendix I. Early Intervention Powers of the Banking Registrar

The Banking Registrar (RB) may:

- a) Issue written directives to a bank or a bank controlling company to take specified action to remedy a situation or to refrain from engaging in any action or conduct;⁵³
- b) Increase a bank's capital requirements or require the bank to strengthen its risk management and internal controls;⁵⁴
- c) Restrict the activities of a bank as it deems fit and subject to conditions it may specify;
- d) Approve a transaction relating to a merger or transfer of assets and liabilities involving a bank;⁵⁵
- e) Take action in court against bank directors or management for breach of their duties under the Companies Act (CA)⁵⁶ and use any amounts recovered to repay the Registrar, a deposit insurance scheme, or government body, as part or full compensation for any losses suffered by depositors as a result of the bank being unable to repay their deposits;
- f) Object to the continued employment of a director, CEO, or executive officer of the bank, branch, or controlling company if the Registrar reasonably believes that such person is no longer fit and proper or that is not in the public interest to keep such person in office;⁵⁷
- g) Remove an external auditor of a bank and replace such auditor;⁵⁸
- h) Impose administrative fines on a bank or controlling company for failure or inability to meet prudential requirements (minimum share capital or unimpaired reserved fund, or minimum liquid assets ratio) or for non-compliance with the Banks Act;
- i) Cancel or suspend a banking license -
 - i. In the case of a foreign branch authorized to operate in South Africa, for non-compliance with the conditions of its authorization, or in the event its home license is revoked;⁵⁹ and
 - ii. In the case of other banks, if it has ceased to conduct banking business or is no longer in operation.
- j) Recommend to the minister that the bank be placed under curatorship.

⁵³ Section 6(6). Non-compliance with such directive is deemed an offence under section 6(6)(e).

⁵⁴ Regulation 38(4) of the Regulations relating to Banks.

⁵⁵ Section 54(8A) of the Banks Act.

⁵⁶ CA section 77 or 424.

⁵⁷ Section 60 (6).

⁵⁸ Section 61 (3) (b) and section 62 (1).

⁵⁹ Section 18B of the Banks Act.

Appendix II. Resolution Legislation for Different Types of Financial Entity

The current framework for dealing with failing nonbank financial institutions (NBFI) is being reviewed in order to identify shortfalls and strengthen the framework where needed. KA1 requires that any financial institution that could be systemically significant or critical if it fails should be subject to a resolution regime that complies with the KAs. The current regimes vary but can be collectively described as modified insolvency regimes:

- Securities firms and intermediaries:** Under section 38B of the Financial Advisory and Intermediary Services Act of 2002 (Act 37), the Registrar (FSB) may apply to court for a liquidation order against a financial intermediary if it is satisfied that it is necessary to protect the interest of the clients of the institution whether or not the institution is insolvent under the Companies Act (CA) or the Insolvency Act (IA). On agreement with the firm (only), the RB may also appoint a statutory manager in respect of a financial institution regulated by the FSB (Financial Institutions (Protection of Funds) Act 2001, section 5A).⁶⁰ The Registrar may apply to court for the appointment of a curator for the business of a financial institution (FMA section 96 (b) and section 5 of the Financial Institutions (Protection of Funds) Act).
- Insurance firms:** The Insurance Acts provide for the winding up of an insurer by Court order. The provisions of the CA and the IA, apply in respect of winding-up processes and procedures. The latter Act specifies when winding-up may take place (including the actions that are regarded as an “act of insolvency”). (LTIA s42, s13; STIA s41, s13). Under s. 42 (2) of the Long-Term Insurers Act (Act 52 of 1998) as amended, the Registrar may, with the written approval of the minister, apply to court for winding up of a long-term insurer if it is satisfied that it is in the interest of policy makers to do so.
- Financial market infrastructures:** The Registrar has power under section 60 of the FMA to suspend or revoke the license of an FMI (CSD, clearing house, exchange, trade repository) and immediately transfer its business to a similar FMI, or apply to court for a winding up order against it, in the interests of clearing members, authorized users or participants’ members, or clients.

⁶⁰ A statutory manager may be appointed in the event of material non-compliance with the law, or in the case of an unsound financial position or mismanagement, or otherwise if the Registrar finds it to be in the interest of the clients of the financial institution, the safety and soundness of financial institutions in general, or for the stability, fairness, efficiency, and orderliness of the financial system.