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TECHNICAL NOTE ON FINANCIAL SAFETY NET AND CRISIS MANAGEMENT

This technical note on Financial Safety Net and Crisis Management was prepared by a staff team of the International Monetary Fund in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP). It is based on the information available at the time it was completed in June 2021.

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June 2, 2022

TECHNICAL NOTE

FINANCIAL SAFETY NET AND CRISIS MANAGEMENT

Prepared By

Monetary and Capital Markets Department

This Technical Note was prepared in the context of the Financial Sector Assessment Program in South Africa during June 2021 mission led by Jennifer Elliott, IMF and Eva Gutierrez, World Bank and overseen by the Monetary and Capital Markets Department, International Monetary Fund, and the Finance, Competitiveness and Innovation Global Practice, World Bank. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

AMC	Asset Management Company
BCP	Business Continuity Plan
CEO	Chief Executive Officer
CET1	Common Equity Tier 1
CMG	Crisis Management Group
CODI	Corporation for Deposit Insurance
DIS	Deposit Insurance Scheme
ELA	Emergency Liquidity Assistance
EWI	Early Warning Indicators
FM Act	Financial Markets Act 2012
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSCA	Financial Sector Conduct Authority
FSCF	Financial Sector Contingency Forum
FSCR	Financial System Council of Regulators
FSD	SARB Financial Stability Department
FSLAB	Financial Sector Laws Amendment Bill
FSOC	Financial Stability Oversight Committee
FSR Act	Financial Sector Regulation Act 2017
G-SIB	Global Systemically Important Bank
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions
MOF	Minister of Finance
MOU	Memorandum of Understanding
MPE	Multiple Points of Entry
NCWOL	No Creditor Worse Off than in Liquidation
NT	National Treasury
PA	Prudential Authority
RPD	Resolution Planning Division [of the Financial Stability Department]
RPP	SARB Resolution Policy Panel
SADC	South African Development Community
SARB	South African Reserve Bank
SARB Act	South African Reserve Bank Act 1989
SCV	Single Customer View
SIFI	Systemically Important Financial Institution
SPE	Single Point of Entry

EXECUTIVE SUMMARY

This Technical Note sets out the findings and recommendations of the Financial Sector Assessment Program (FSAP) for South Africa on financial safety net and crisis-management arrangements. It primarily focuses on the arrangements for early intervention, recovery, resolution, and financial safety nets for banks in South Africa. To a lesser extent, the note also addresses issues relating to recovery and resolution applicable to insurers and Financial Market Infrastructure (FMI).

The institutional arrangements for resolution and crisis management will be considerably strengthened with the implementation of new resolution regime and deposit insurance scheme (DIS). The Financial Sector Laws Amendment Bill (FSLAB) will allocate responsibility for the resolution of banks and other systemically important financial institutions to the South African Reserve Bank (SARB) and establish a DIS administered by the Corporation for Deposit Insurance (CODI). The CODI will be a subsidiary of the SARB, with its own statutory mandate and governance arrangements.[1]

Strengthening domestic coordination arrangements for bank resolution and crisis management is a priority. The current arrangements, as set out in the Financial Sector Regulation Act 2017 (FSR Act) are statutorily prescriptive but not sufficiently developed in practice. Mandates of the different coordination bodies could be clarified through charters or Memorandum of Understanding (MOU), and the Financial Stability Oversight Committee (FSOC) should be assigned a greater role in overseeing the coordination. Cross-agency coordination of these matters would be enhanced by the establishment of a financial crisis management working group under the auspices of the FSOC, chaired by the SARB.

Strengthening the early detection of risks in the banking system and development of a structured early intervention framework and contingency planning for weak banks will facilitate timely response to emerging stress. The PA and the SARB undertake proactive risk assessments and use some stress testing and Early Warning Indicators (EWIs). It would be desirable to further strengthen these arrangements to enable a stronger capacity to detect and respond to emerging stress at an early stage, including through enhanced stress testing (top-down and bottom-up), reverse stress testing, and greater use of early-stage EWIs. Moreover, the authorities should (i) seek to strengthen the PA's corrective and remedial powers; (ii) introduce a structured framework for early intervention, with escalating triggers and corresponding response actions, but with scope for supervisory discretion in the application of the framework; and (iii) develop and regularly test contingency plans for dealing with bank stress. Similar arrangements should be established for insurance firms and FMIs.

Bank recovery plans have been in place for all banks since 2016. These requirements are relatively comprehensive and broadly consistent with the Financial Stability Board Key Attributes of

[1] The mission's findings are based on a review of the draft Financial Sector Laws Amendment Bill that was passed by the National Assembly in September 2021. Following signing by the President in January 2022, the final legislation is now referenced as the Financial Sector Law Amendment Act.

Effective Resolution Regimes for Financial Institutions (KA) and good international practice. Further strengthening would be facilitated by the PA providing the banking industry with more guidance on minimum expectations for recovery plans and strengthening its supervisory assessment of recovery plans. It would be desirable to place greater emphasis on integration of banks' recovery plans with their risk management frameworks and other contingency plans. The upcoming extension of recovery planning requirements to FMIs is a welcome development. It is recommended that the PA establish recovery planning requirements for all insurers in the medium-term.

The recent enactment—and ongoing implementation—of the FSLAB will help rectify many gaps in the current resolution framework. The FSLAB brings South Africa broadly into line with the KA and best international practice. Still, some elements of the new legislation would benefit from further review, including elements pertaining to group resolution and SARB funding in resolution. Over the medium-term, it is recommended that the authorities review laws relating to insurance and FMI resolution to ensure closer alignment with the KA. The SARB should focus initially on the development of a comprehensive "resolution toolkit" that sets out guidance on the key resolution options and associated processes, and then move to bank-specific resolution plans, starting with the domestic Systemically Important Financial Institutions (SIFIs). Particular attention needs to be given to the structure and calibration of bail-in instruments to be required to avoid excessive costs for the industry while ensuring that bail-in does not transmit excessive losses to other parts of the financial sector (which would otherwise undermine the feasibility and credibility of bail-in).

The DIS under the FSLAB is broadly aligned with international principles. The funding structure, however, is somewhat unorthodox, given the absence of a specific quantitative target size for the loss absorbing ('equity') tranche of the scheme (which, together with the accumulation period, would inform the annual premiums); and the use of interest-bearing deposits placed by the banks in the deposit insurance agency as a liquidity tranche. To further strengthen the DIS, the authorities should consider replacing the liquidity tranche with a larger equity component, calibrated to meet an explicit target (relative to covered deposits and therefore increasing in line with deposit growth) that is sufficient to absorb losses after liquidation, and would be funded via nonrepayable (ex-ante) industry contributions. It will also be essential to formalize the proposed SARB liquidity facility for the DIS as quickly as possible.

The authorities have designed the resolution framework with the objective of avoiding the use of public funding. While this is an appropriate perspective, it needs to be recognized that there may be occasions when some public funding or guarantees are required, including when the bail-in option is either not feasible or insufficient. A contingency plan to identify potential public funding needs for the resolution of a systemically important financial institution (SIFI)—with clear guidance on steps to limit moral hazard and enable recoveries—is therefore important. The proposed reliance on the SARB for liquidity funding in a resolution situation (and more broadly) should be refined, with clearer statutory objectives, a solvency /medium-term viability provision, and other safeguards. The statutory power for the SARB to acquire equity in a bank should be repealed. A new statutory framework that sets out the objectives, preconditions, and safeguards of a public funding structure for situations of systemic bank resolution should be considered, including for the possibility of imposing ex post levies on banks to recover costs net of recoveries from the assets and cashflows of the resolved bank and/or any proceeds from the sale of the bridge bank. Any such funding should be sourced from the NT and not the SARB, and any equity holding (e.g., for a bridge bank) should be held by the government via an appropriate government agency (not being the SARB).

Cross-border cooperation arrangements should be strengthened as part of the resolution framework. It is suggested that the authorities further develop clear policy guidance on cross-border coordination of recovery, resolution and financial crisis management. In due course, MOUs with foreign authorities in the region will need to be established for resolution cooperation and coordination, together with bank-specific crisis management groups. Consideration should be given to the establishment of crisis management groups or extensions of supervisory colleges for the major South African banks with extensive cross-border operations.

Table 1. South Africa: Key Recommendations on Financial Safety Net and Crisis Management

Recommendations	Responsible Authority	Timing[1]
Institutional Framework		
1. (¶13) Strengthen mandate of FSOC on financial crisis management	SARB/NT/PA/FSCA	I
Early intervention and recovery planning		
2. (¶19-21) Further strengthen the systems for early detection of bank stress	PA	ST
3. (¶23-26) Establish a structured early intervention framework for banks and address residual gaps in the PA's powers for remedial and corrective action	PA	ST
4. (¶27) Develop contingency plans for dealing with banks in stress situations	PA	ST
5. (¶27) Undertake regular testing of early intervention arrangements	PA	ST
6. (¶33) Issue comprehensive guidance to banking industry on recovery planning	PA	I
7. (¶33) Strengthen supervisory assessment of bank recovery plans and testing	PA	I
8. (¶34-36) Introduce recovery planning requirements for non-banks (e.g., insurance firms, FMIs)	PA	ST/MT
Resolution regime and resolution planning		
9. (¶50) Introduce future legislative amendments to further enhance resolution regime in line with KA, including limiting role of MOF to situations in which public funding is needed	SARB/NT	ST
10. (¶54-55) Develop comprehensive generic resolution strategies and implementation guidance with cross-agency input	SARB/PA/NT	ST
11. (¶59-60) Design new loss-absorbing instruments ("FLAC") to avoid excessive cost impacts on banks and contagion risk to non-bank institutions	SARB	I
12. (¶61) Develop framework for bank-specific resolution plans and resolvability assessments	SARB	ST
13. (¶64-67) Implement resolution plans for SIFIs, then for other banks	SARB	ST
14. (¶71) Consider development of an insurance policyholder compensation scheme	PA/SARB/NT	MT
15. (¶72) Strengthen resolution law and policy for non-designated insurers	SARB/PA/NT	MT
Deposit insurance schemes and resolution funding		
16. (¶89) Develop a draft liquidity facility between CODI and SARB	SARB	ST
17. (¶91) Formalize a target size for, and increase reliance on, the loss-absorbing tranche of the deposit insurance fund	SARB	ST
18. (¶93) Progress operationalization of DIS	SARB	ST
19. (¶97) Develop a policy framework for contingent public resolution funding, including options for recovering losses incurred by the state (e.g., via ex post levies)	NT/SARB	ST
20. (¶98) Repeal provision in South African Reserve Bank Act 1989 (SARB Act) enabling SARB to inject equity into a bank	SARB/NT	ST
21. (¶99) Introduce further safeguards for lending in resolution	SARB/NT	ST

Table 1. South Africa: Key Recommendations on Financial Safety Net and Crisis Management

Recommendations	Responsible Authority	Timing[1]
Contingency planning and crisis management		
22. (¶80) Undertake regular domestic crisis simulation exercises	SARB	ST
23. (¶81) Seek to undertake periodic cross-border crisis simulation exercises	SARB	MT
24. (¶103) Establish MOU between CODI, SARB and PA	CODI/SARB/PA	ST
25. (¶104) Develop contingency plan for systemic crisis management	SARB/NT/PA/FSCA	I
26. (¶106) Strengthen cross-border cooperation arrangements for recovery and (in due course) resolution planning with relevant home and host authorities	SARB/PA	ST/MT
27. (¶107) Establish domestic cross-agency protocol on crisis management	SARB/NT/PA/FSCA	ST

[1] I−immediate: within one year; ST−short-term: one to three years; MT−medium-term: three-five years.

INTRODUCTION

1. **This Technical Note[2] sets out the findings and recommendations of the Financial Sector Assessment Program (FSAP) for South Africa on financial safety net and crisis-management arrangements**. It primarily focuses on the arrangements for early intervention, recovery, resolution, and financial safety nets for banks in South Africa. However, to a lesser degree, the note also addresses issues relating to recovery and resolution applicable to insurers and FMI.

2. **In preparing this note, the IMF mission has reviewed a wide range of material.** This includes the authorities' responses to the questionnaire on financial crisis management; relevant laws; the draft Financial Sector Laws Amendment Bill (FSLAB); and policy documents issued by the SARB. Reference was also made to Financial Stability Board (FSB) peer review of the bank resolution arrangements in South Africa conducted in 2019. The mission's findings have also been informed by meetings with the SARB, National Treasury (NT), Prudential Authority (PA), several banks and various other parties.

3. **The findings and recommendations in this note are made in the context of relevant international standards.** In particular, the mission's assessment of the resolution and financial safety net arrangements for banks in South Africa was undertaken having regard to (i) the FSB's *KA*; (ii) the International Association of Deposit Insurers' (IADI) *Core Principles for Effective Deposit Insurance Systems* Core Principles); and (iii) the Basel Committee on Banking Supervision's (BCBS) *Core Principles for Effective Banking Supervision* (BCP); even though formal assessments of observance against these standards were not undertaken. Although adherence to these international standards is generally expected of G20 countries, the mission recognizes that each country will appropriately tailor its resolution and financial safety net arrangements to its particular needs, taking into account institutional and financial system characteristics. Accordingly, the mission has been mindful of the need to focus its assessment, findings and recommendations in a manner that recognizes that the resolution and financial safety net arrangements should be 'fit for purpose' for

[2] Prepared by Geof Mortlock (IMF Consultant) as part of the 2020 FSAP for South Africa. The author would like to thank the South African authorities for their excellent engagement and warm hospitality throughout the FSAP process.

South Africa. Moreover, the mission's assessment also takes into account wider factors, such as international good practice and policy guidance developed by the IMF and other international bodies, where appropriate.

4. The mission is grateful to the authorities for the excellent FSAP preparation. The comprehensive response to the questionnaire, provision of policy papers, and candid discussions with the authorities have greatly assisted the mission in its assessment.

INSTITUTIONAL FRAMEWORK

South African Reserve Bank

5. The SARB has responsibility for overseeing the stability of the financial system, the provision of liquidity assistance to financial institutions and oversight of the payment system. The SARB's Deputy Governor responsible for financial stability is a member of the Prudential Committee that oversees the overall management and administration of the Prudential Authority (PA), which is established as a juristic person operating with the administration of the SARB. The FSLAB formally designates the SARB as the resolution authority for banks, as well as designated (non-bank) financial institutions.

6. The SARB already has some responsibility for elements of financial crisis management under existing law. The FSR Act seeks to preserve and enhance financial stability in South Africa by conferring the financial stability mandate on the SARB. Under Section 11 of the FSR Act, the SARB is responsible for: (i) protecting and enhancing financial stability and (ii) if a systemic event has occurred or is imminent for restoring or maintaining financial stability. To this end, the SARB must act within a policy framework as agreed between the governor and the Minister of Finance (MOF). Under the SARB Act, the SARB is also responsible for the regulation and supervision of payment, clearing, and settlement systems. The National Payment System Act 1998 gives effect to the SARB's powers and duties as set out in the SARB Act. Although the SARB is not yet the resolution authority in law, it has taken the lead in developing resolution policy and, with the NT, promoting the development of the FSLAB. Within the SARB, the Resolution Planning Division (RPD) in the Financial Stability Department (FSD) is responsible for the development of the resolution planning framework. Against this backdrop, the SARB has established an internal Financial Stability Committee, as well as a Resolution Policy Panel, the latter being a working-level committee on bank resolution and financial crisis management. Both committees include PA staff.

7. The FSR Act creates the framework for managing a financial crisis to the extent that such financial crisis constitutes a systemic event. The Act defines a "systemic event" as … "an event or circumstance, including one that occurs outside [South Africa], that may reasonably be expected to have a substantial adverse effect on the financial system or economic activity in [South Africa]". The Act sets out the process to be followed by the governor in determining whether an event is systemic and sets out the functions of the SARB in preventing a systemic event, mitigating the effects of a systemic event and/or managing the systemic event.

8. **The failure of banks is currently dealt with under a curatorship model for commercial and mutual banks, and via liquidation for banks.** The process and grounds for placing a bank in curatorship is contained in Section 69 of the Banks Act 1990 (Banks Act). This enables the MOF, on the recommendation of the PA, to appoint a curator if it is determined that a bank will be unable to repay its deposits when legally obliged to do so, or will probably be unable to meet any other of its obligations. The authorities have relied on curatorship in recent years to address idiosyncratic problems in a commercial bank and a mutual bank. Moreover, under section 30(1)(iii) of the Cooperative Banks Act, judicial management (which is similar to curatorship) is an avenue that can be used for the resolution of cooperative banks via application to the court.

9. **Enactment of the FSLAB has significantly strengthened the framework for dealing with failing banks.** Under the new framework, the SARB will be the sole resolution authority for all banks, as well as for any non-bank financial institution designated by the governor as being systemically important. Under the proposed framework, a financial institution can be designated by the governor at any time, including at the point of failure. The resolution of insurers that are not designated as being systemically important will remain under the Insurance Act 2017 (Insurance Act) under the control of the PA and courts.

Prudential Authority

10. **The PA has responsibility for prudential regulation and supervision of banks and insurers.** In that capacity, the PA has responsibility for undertaking early intervention should a bank or insurer come under stress or fail to comply with prudential requirements. In the case of banks, the PA has responsibility for overseeing bank recovery plans. The PA is responsible for determining if a bank is able to restore itself to viability through recovery actions or other remedial measures, or making the determination that it is non-viable. No recovery plan requirements have yet been put in place for insurers. With the enactment of the FSLAB, the PA's responsibility under the Banks Act for the resolution of banks through a curatorship model has ceased, although this framework remains applicable to non-designated insurers under the Insurance Act.

National Treasury

11. **The NT is responsible for overseeing financial legislation and high-level policy.** This is done through the Financial Sector Policy Unit of the NT. The NT is the principal economic adviser to the MOF and has responsibility for the country's fiscal affairs. In a bank failure situation, the NT, through its Fiscal Liability Committee (FLC), would have lead responsibility for advising the government on any matters relating to the provision of public funding or government guarantees or indemnities. The NT has been closely involved, together with the SARB, in the development of the FSLAB and related policy matters.

Financial Sector Conduct Authority

12. **The FSCA is the responsible regulatory authorities for the securities market and market conduct.** It has responsibilities in relation to the regulation and supervision of market infrastructures (FMI, as defined in the Financial Markets Act, 2012), including (with the PA, in its capacity as prudential regulatory authority responsible for the safety and soundness of FMI) the development

currently of recovery planning requirements for FMIs. In a bank resolution, the main responsibilities of the FSCA would relate to market disclosures by the bank(s) in resolution and related matters.

Institutional Arrangements for Domestic Coordination

13. Institutional arrangements for bank resolution and financial crisis management are satisfactory, but domestic coordination arrangements for bank resolution and financial crisis management should be further strengthened. There is a clear and well-understood allocation of responsibility for the different functions across the agencies, particularly the SARB, PA, NT, and FSCA. The enactment of the FSLAB will further strengthen these arrangements by formalizing the SARB's role as the resolution authority for banks and designated (non-bank) financial institutions. However, interagency coordination in the area of bank resolution and financial crisis management requires further attention, as the current arrangements, as set out in the FSR Act (Box 1 below), are statutorily prescriptive but not sufficiently developed in practice. The following considerations seek to provide further guidance on potential reforms:

- First, there is a risk of duplication of functional responsibility between the Financial System Council of Regulators (FSCR) and Financial Stability Oversight Committee (FSOC) unless further clarified by way of new or revised charters or other forms of mandate issued by these bodies. In that regard, it is suggested that the FSCR be focused primarily on overseeing regulatory developments in the financial system, with a view to facilitating cooperation and coordination consistent with meeting policy objectives, and that its current terms of reference be amended to provide further clarity on this.

- Second, the FSOC mandate to advise the Governor and Minister on financial stability, bank resolution, and financial crisis management could usefully be made clearer by way of a published charter, with a focus on regularly reviewing progress in crisis management preparedness, as well as assessing the stability of the financial system. This recognizes that effective financial crisis management arrangements require close cooperation and coordination between all relevant agencies, particularly (in South Africa's case) the SARB, PA, NT, and FSCA and (once established) CODI. A cross-agency working group on financial crisis management, resolution planning and related matters, comprising representatives of all relevant agencies, would be desirable as a mechanism to facilitate closer cooperation and coordination on the development and maintenance of financial crisis management and resolution policies and practices.

- Third, the effectiveness of the FSCR and FSOC would be enhanced by meeting more frequently than is currently the case, such as quarterly.

- Finally, transparency and accountability would be strengthened by the FSCR and FSOC publishing annual reports on their activities and websites that set out information on their respective mandates and activities.

Box 1. Interagency Coordination

The FSR Act established a multi-tiered structure to facilitate coordination between the domestic financial sector agencies.

- The FSCR has nine members and meets a minimum of twice a year, chaired by the director-general of the NT. It is a forum to facilitate cooperation and collaboration, and where appropriate consistency of action, between the institutions represented. The FSR Act established nine working groups under the umbrella of the FSCR.
- The FSOC comprises ten members and meets a minimum of twice a year, chaired by the SARB. It is an advisory committee to the governor, the SARB and the minister, and its mandate covers financial stability, crisis management, and prevention.
- The FSOC is assisted by the Financial Sector Contingency Forum (FSCF), comprising eight members including financial sector industry representatives. The FSCF's main role is to identify potential financial risks, and to coordinate and mitigate these risks.
- Finally, the Financial Sector Inter-Ministerial Council (FSMC) has been established to facilitate co-operation and collaboration between cabinet members responsible for administering legislation that is relevant for the financial sector supervision and regulation, by providing a forum for discussion of matters of common interest. It is designed to have four members, operating under the chairmanship of the MOF, but is yet to convene.

Although some of these fora have proved useful for coordination of issues pertaining to supervision and regulation, none of them have been used to any significant degree for bank resolution and financial crisis management decision-making. Given that the absence of an interagency forum for crisis management may impede policymaking and hamper coordinated communications—a key aspect of effective crisis management—the authorities are highly recommended to operationalize more structured coordination mechanisms.

14. **Coordination on bank resolution planning and financial crisis preparedness would be further enhanced through the establishment of a working group under the auspices of the FSOC.** This would enable the NT and FSCA to have a more structured input into the formulation of bank resolution and financial crisis management in areas relevant to their respective statutory mandates (e.g., public funding in the case of the NT and market disclosures in the case of the FSCA). The formation of a FSOC working group on resolution and financial crisis management plans would also help to elevate the role of key staff working on these issues and promote strengthened interagency coordination at a senior working level. It is therefore suggested that a working group be established under the auspices of the FSOC, chaired by the SARB, and which reports at least quarterly to the FSOC. Detailed policy development on resolution-related matters, particularly on issues under the leadership of the SARB, could continue to be handled under the oversight of the SARB Resolution Policy Panel (RPP) and FSC.

15. **The mandate of the FSMC would benefit from review.** Under the FSR Act, the FSMC is required to commission an independent evaluation of the effectiveness of the cooperative and collaborative mechanisms between the financial sector regulators. The FSAP mission understands that the FSMC has not yet commissioned an evaluation or taken any other actions. The development of a charter or other form of mandate for the FSMC could help clarify its purpose and functions and minimize the risk of the FSMC conducting itself in a manner that compromises the operational independence and effectiveness of the regulatory agencies.

Recommendations

16. It is recommended that:

a. The mandates of the FSCR and FSOC be further clarified so as to minimize overlap between the two and to ensure that the FSOC (or an alternative body, if appropriate) has oversight of coordination between the agencies on financial stability, bank resolution planning, and financial crisis management preparedness.

b. The effectiveness, transparency and accountability of the FSCR and FSOC be strengthened, including through the issuance of annual reports, published charters and more frequent meetings (e.g., quarterly).

c. The FSOC (or an alternative body, if appropriate) establish a working group on resolution planning and financial crisis preparedness and management, chaired by the SARB, and comprising representatives of the other relevant agencies, to oversee the detailed coordination between the SARB, PA, NT, and FSCA on all aspects of resolution and crisis management. Cross-agency coordination in actual crisis could be achieved either through the proposed working group or via a smaller group of senior management drawn from the relevant agencies. It is suggested that the authorities formalize these coordination arrangements.

d. The mandate of the FSMC be clarified, including through future amendment of the FSR Act, to avoid any risk of compromising the operational independence of regulatory agencies or distorting their respective mandates.

EARLY INTERVENTION AND RECOVERY PLANNING

A. Early Detection of Bank Risk and Early Intervention[3]

Early Detection of Bank Stress

17. An important element in dealing with financial institution distress is the need for a framework to identify emerging stress in banks at an early stage. In this context, the supervisor should have a comprehensive system of EWIs to detect early signs of stress in individual banks and the banking system as a whole. It should also take a comprehensive approach to the identification of risks and risk-management capacity in banks, including through the assessment of a bank's risk management framework, risk appetite and governance, and through regular stress testing of and by the banks.

18. The PA has developed some capacity for the early detection of bank stress, but there is considerable scope for improvements. The PA undertakes periodic stress tests of the larger banks and routinely evaluates banks' risk management systems and controls (albeit with considerable reliance on external auditors). Banks are required by the PA to undertake regular stress tests of their

[3] Also see the TN on Banking Supervision and Regulation.

balance sheets for liquidity stress evaluation purposes. The PA monitors a range of EWIs, but the indicators tend to be mainly on current indicators of financial condition rather than predictive indicators of emerging stress. The risk-based approach to supervision adopted by the PA also provides a helpful context within which a proactive approach to the detection of emerging stress can be maintained, but further improvements should be considered to increase supervisory focus and optimize resource allocation. As outlined in the FSAP's technical note on banking regulation and supervision, further internal guidance should be developed to support more granular risk assessments. The PA is encouraged to further develop its capacity to undertake thematic and "deep dive" assessments of banks' governance, risk management, and contingency planning arrangements, rather than placing excessive reliance on external auditors in these areas.

19. **Stress testing of banks should be a routine part of supervision, both bottom-up and top-down.** The PA should undertake stress testing of the banks annually (including macrofinancial scenario testing, liquidity stress testing, and single-factor sensitivity testing) and require, at a minimum, the largest banks to develop comprehensive stress testing capacity as part of their risk management arrangements. The results of stress tests should be incorporated into banks' risk appetite statements, particularly as regards the minimum tolerance levels for capital and liquidity, and the maximum exposures to particular categories of risk. Stress tests undertaken by the PA and SARB can then be used to inform decisions in relation to capital and liquidity requirements for banks, as well as macroprudential policy settings. Reverse stress testing should be promoted against a set of PA-specified minimum impacts on capital and liquidity as part of the scenario development for recovery plans. Fundamentally, it is recommended that stress testing – both top-down and bottom-up – is closely integrated into the supervisory process, including with respect to informing the calibration of capital and liquidity requirements, the focusing of off-site surveillance, and the prioritization of on-site examinations.

20. **EWIs should be further developed for the banking system as a whole and in respect of individual banks.** EWIs should be selected for their predictive capacity in relation to a range of risk factors, including borrower stress (and therefore probability of default), collateral values (and therefor loss given default), asset quality, profitability, liquidity, capital, exposure concentration, parent bank stress (where applicable), intra-group contagion, inter-banking funding, funding costs and operational risks. A useful approach is to require banks, as part of their recovery plans, to (further) develop EWIs in relation to the triggers for their recovery plan, as well as a wider range of EWIs in relation to all material risks. These EWIs should be reported to the PA regularly (e.g., monthly or quarterly) and be used by the PA to assess emerging stress and to facilitate a proactive approach to early intervention, including the required activation of recovery plans where appropriate.

Early Intervention and Remedial Action

21. **Supervisory authorities needs to have adequate powers to take timely corrective action, impose sanctions, and facilitate a bank's recovery or transition to resolution.** Under international standards and best practice, the menu of corrective and remedial actions available should include the power to: (i) impose more stringent prudential requirements; (ii) restrict the activities of the financial institution; (iii) prohibit new activities or acquisitions; (iv) restrict or suspend dividend payments; (v) restrict asset transfers; (vi) replace or restrict the powers of controlling

shareholders, board members, or managers; (vii) appoint a temporary administrator; (viii) bar individuals from the relevant industry sector; (ix) facilitate a merger or acquisition of the financial institution; and (x) revoke the financial institution's license. Intervention should take place when a financial institution engages in practices or activities that are unlawful or unsafe, so they can be addressed at an early stage and while the institution is still viable. In addition to the need for robust legal powers, the supervisory authority needs to maintain a policy framework that sets out the triggers and responses, escalating from mild to severe situations. It also needs to develop, maintain and regularly test contingency plans for dealing with banks in a range of stress scenarios.

22. The enactment of the FSR Act has granted a suite of new powers to the PA, providing it with a broader range of supervisory tools at its disposal. New powers include enforceable undertakings, debarment orders and the issuance of directives to a key person of a financial institution. However, the requirement for the PA to give 30-day prior notice when suspending registration or restricting activities of a bank or controlling company could delay supervisory responses and undermine confidence if market rumors remain unchecked; it is recommended that this notice period be removed. The 'Regulatory Action Blueprint'[4] lists the actions the PA can take and the delegation of powers to heads of division and heads of department by the Chief Executive Officer (CEO). The Prudential Regulatory Action Committee (PARAC), created under the FSR Act, recommends regulatory actions to the CEO of the PA. The PARAC is composed of nine members, including SARB representatives.

23. The PA identifies supervisory concerns in relation to a bank at an early stage. However, a formal classification of the severity of the issues, a clearer prioritization of actions and a structured escalation process to the bank's board would significantly strengthen the effectiveness of this process. Following onsite meetings and offsite reviews, the PA submits its key findings or issues identified in the form of feedback letters. In the work on banking supervision, the mission reviewed several feedback letters and found them comprehensive and substantive. However, based on the material reviewed, it was difficult to determine the nature and the severity of the matters raised. Indeed, the wording of the feedback letters does not clearly distinguish between concerns that reflect deficiencies and concerns that require strengthening of risk management practices but are not deficiencies. A more formal classification of the nature and severity of the issues raised and a clearer articulation of the urgency for the bank's management to address them is recommended.

24. The FSLAB eliminates the power to place a bank under official control through a curator, thus removing an essential tool from the PA's supervisory toolkit. While this is appropriate in resolution situations, given that the SARB will assume sole responsibility for entry into resolution and management of the resolution process, the absence of a power to place banks under control (akin to "temporary administrators" or "special managers" in other jurisdictions) in non-resolution remedial situations leaves a significant gap in the PA's capacity to address a stress event in a bank, particularly where the PA has lost confidence in the ability or willingness of a bank's board and management to address the situation (including, but not limit to, situations of fraud or

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[4] The Regulatory Action Blueprint came into effect on March 1, 2020 and sets out the PA's internal approach to exercising the regulatory action powers given to it by the FSR Act, the other financial sector laws and the Financial Intelligence Centre Act (FICA). It includes comprehensive delegations of authority for various statutory powers.

managerial misconduct). The appointment of an administrator with extensive powers (including those of the bank's board of directors) is a basic intervention tool that allows the supervisor to temporarily take control of a bank, prior to the initiation of resolution proceedings, to facilitate remediation. The power for the PA to place banks under official control should be retained for situations other than bank resolution, subject to appropriate triggers (such as the PA being satisfied, on reasonable grounds, that a bank's viability is potentially at risk and that timely remediation of the identified problems is unlikely to be achieved while the bank's current management remains in control).

25. The absence of a clearly structured early intervention framework increases the risk of delayed or inconsistent supervisory responses to deterioration in a bank's financial or risk condition. It also creates a higher risk that remedial measures will be insufficient, potentially leading to non-viability, and risks of contagion. Early intervention frameworks are designed to provide a structured approach to calibrating supervisory responses to a bank's financial and prudential condition. They typically involve a set of escalating triggers and responses, where the triggers include supervisory risk and impact assessments, as well as specific quantitative triggers (e.g., for capital, liquidity, asset quality, exposure concentration, EWIs, etc.). Some countries, such as the United States, adopt a relatively prescriptive set of responses in relation to particular triggers, but most countries apply a more flexible arrangement, where the early intervention framework involves a considerable degree of discretion by the supervisory authority. In either case, the early intervention frameworks help to avoid undesirable regulatory forbearance and associated moral hazard and promote a more consistent approach to dealing with bank stress, inadequacies in risk management and regulatory non-compliance. The PA has not implemented a structured early intervention framework, with triggers (qualitative and quantitative) and indicative response actions in relation to triggers that are informed by early warning indicators and supervisory assessments. It is recommended that such a framework be developed and implemented.

26. The PA has not yet developed contingency plans for dealing with weak banks. Typically, contingency plans include checklists of the actions, strategies, and coordination arrangements, the PA might appropriately take in a range of scenarios of emerging bank stress. These contingency plans are helpful in establishing preparedness for dealing with weak banks. The assessors recommend the PA develop contingency plans and undertake regular testing of their capacity in this area.

27. Introducing viability assessments will further strengthen the PA's ability to fully understand and respond to weakening conditions in an institution. The PA will need to have the ability to undertake viability assessments for several purposes, including for the determination of escalation in supervisory responses, for the escalation of recovery measures, and for determining the point at which the PA advises the SARB that recovery is not feasible, and a bank must be transitioned into resolution. Viability assessment will also be necessary where a bank requests Emergency Liquidity Assistance (ELA) from the SARB. In that situation, the SARB could be expected to request the PA to provide it with an assessment of the bank's overall viability (including adequacy of governance and management), capital ratio, solvency (i.e., leverage ratio) and liquidity. The assessments of capital, solvency and liquidity should be both on a current basis as well as on a stress-tested prospective basis. Although the PA may be able to rely to some extent on external auditors for some aspects of these assessments, it needs to build, and regularly test, its internal capacity in these areas. This is particularly the case in situations where such assessments may need to be made under urgency and where a lengthy period of due diligence is not feasible. To that end, it is suggested that the PA, in coordination with the SARB, develop the data templates needed for such assessments, pre-position the banks to be able to provide such data on short notice, implement bank data testing arrangements, and develop the methodology needed for approximate asset quality assessments and other valuations under acute time pressure. There should be regular testing of these arrangements.

Recommendations

28. It is recommended that:

a. The PA develop a more comprehensive set of EWIs, to support the early detection of emerging bank stress.

b. The PA further progress the stress testing requirements for all banks, with particular focus on the largest banks, including macrofinancial stress tests, single factor sensitivity tests, and reverse stress tests (based on PA-provided points of non-viability), and that banks be encouraged to integrate the results of stress tests into their risk appetite, risk management, and recovery plans.

c. The PA strengthen the link between stress testing, risk-based supervision, and the response to identified risk and impact ratings by integrating supervisory ratings into a structured early intervention framework, with escalating triggers and corresponding supervisory actions.

d. The PA develop and regularly test contingency plans for dealing with weak banks.

e. Further strengthen the legal framework for corrective and remedial actions, notably by removing mandatory notice periods and providing the PA with the power to assume temporary control of a supervised institution (through an administrator or other duly appointed official) in defined circumstances, with the aim to effect orderly rehabilitation.

f. The PA is recommended to review the arrangements for the early detection of stress in insurers, including EWIs and stress testing, with a view to strengthening those arrangements where appropriate, and to implement a structured early intervention framework and supervisory contingency planning for insurers in stress.

g. The PA, in coordination with the SARB, develop and regularly test its capacity for undertaking viability assessments (including solvency assessments) of banks.

B. Recovery Planning

29. Recovery planning is important to facilitate the restoration of banks in anticipation of, or following, the materialization of stress. Banks should be required to have recovery plans that set out the means by which they would restore themselves to financial soundness and compliance with prudential requirements following an adverse financial impact. Recovery plans should be reviewed regularly by banks and kept up to date and be subject to supervisory approval. They should also be subject to regular testing by the banks as part of their contingency planning arrangements. The supervisory authority should specify the requirements for recovery plans, including the types of scenarios for which they should be designed, the triggers for invoking the plans, the minimum restoration points for capital and liquidity, the identification of critical functions and systems, the timeframe required for recovery actions to be completed, the identification of the financial contribution of each recovery action, the governance arrangements and the testing arrangements.

30. In 2015 the PA introduced recovery planning requirements for all banks. The requirements are relatively comprehensive and broadly consistent with the KA and good international practice. The PA requires banks to include the following in their recovery plans:

- Governance requirements;
- Group structure and key information on legal entities;
- Triggers;
- Stress scenarios; and
- Recovery options.

31. Banks have produced recovery plans in accordance with these requirements for several years. The plans have been subject to supervisory assessment by the PA, with input from the RPD, and have been under a process of ongoing refinement by the banks. The larger banks have undertaken reverse stress tests as part of the recovery planning process. Some banks have undertaken testing of their recovery plans, although live simulation testing does not seem to have been done by all banks as yet.

32. In most respects the recovery planning requirements for banks are consistent with good international practice. South Africa is ahead of some G20 countries by applying recovery planning requirements to all banks. However, some aspects of the recovery planning arrangements would benefit from further attention. These include the need to further strengthen supervisory oversight of the recovery plans, notably for smaller banks, with a view to ensuring that they are sufficiently comprehensive, have practicable recovery options and implementation guidance, and that they are fully integrated into banks' risk management frameworks, ICAAP, ILAAP, and BCP processes. More attention to minimum 'restoration points' for banks' capital and liquidity would be desirable, taking into account the need for banks to be able to restore themselves to capital and liquidity levels that provide a reasonable cushion above minimum regulatory requirements and consistent with the restoration of market confidence. It would also be desirable for the PA to provide industry-wide guidance on recovery plans, as has been done by many supervisory authorities, notably to help improve the quality of recovery plans for smaller institutions. In addition, it is suggested that the PA provide more guidance to banks on the level of non-viability for capital and liquidity for the purpose of the calibration of reverse stress tests and recovery plan scenarios.

33. Recovery planning requirements are under development for FMIs. The FSCA and the PA have prepared a draft jjoint standard on recovery plans for FMIs pursuant to Section 108(1)(n) of the FSR Act. The draft joint standard sets out the PA's and FSCA's minimum requirements to be complied with by FMIs in the formulation and implementation of their recovery plans. The recovery plans of FMIs must be consistent with the requirements set out in the standard, which include the following:

- Governance requirements;
- Group structure requirements;
- Requirements for early warning indicators and triggers;
- Stress scenarios requirements;
- Recovery tools; and
- Considerations in respect of recovery options.

34. The development of a requirement for FMI recovery plans is positive and, if well implemented, will help to strengthen risk management and remedial capacity for FMIs. As with bank recovery plans, it will be necessary for the PA and FSCA to provide guidance to FMIs on minimum expectations for recovery plans, to undertake effective supervisory assessment of the plans and to provide FMIs with feedback. Among other matters, the authorities are encouraged to focus on the adequacy of triggers and the practical implementation of recovery actions in FMI recovery plans. It will also be important to ensure that recovery plans are effectively integrated into FMIs' risk management systems, risk appetite, and BCP arrangements. FMI recovery plans should be subject to regular testing once the first few iterations of the recovery plans have been completed. The PA and FSCA will also need to ensure that their early intervention arrangements for FMIs incorporate the triggers for activation of recovery plans and the supportive actions of the authorities that might be needed to enable successful recovery by FMIs. In that context, the PA and FSCA are encouraged to develop more comprehensive early intervention arrangements for FMIs, including contingency plans for dealing with FMI stress events, and to undertake regular testing of these arrangements.

35. No recovery planning requirements are in place for insurers. This is not surprising, given that recovery planning for insurers globally is at a fairly early stage of development. Nonetheless, the PA is encouraged to develop and implement recovery planning for all insurers, in consultation with the insurance industry. Recovery planning requirements should be broadly modeled on those applicable to banks, with requirements in relation to the identification of critical functions and systems, triggers (and associated EWIs), recovery actions, restoration points for solvency and liquidity, governance and testing. Insurance recovery plans should be designed to address both idiosyncratic and system-wide stress events, with guidance being provided by the PA as to the level of impact expected in recovery plan scenarios. It is recommended that recovery planning requirements be applied to all insurers, but with initial emphasis on the larger insurers and those with dominance in market niches considered to be important to the economy. Recovery plans should be subject to effective supervisory oversight by the PA, with a focus especially on the practicality of the recovery options identified in recovery plans and the integration of recovery plans with insurers' risk management frameworks, capital planning and BCP arrangements. Insurers should be required to undertake regular testing of their recovery plans. The PA should review and strengthen its early intervention arrangements for insurers to incorporate activation of insurers' recovery plans, together with an identification of the supportive measures that might need to be taken by the PA and other regulatory authorities to facilitate effective recovery by insurers.

Recommendations

36. It is recommended that:

a. The PA provides more comprehensive guidance to the banking industry on recovery plan expectations.

b. The PA increases its supervisory oversight of banks' recovery plans, including to ensure effective integration of recovery plans with risk management frameworks and other bank contingency arrangements.

c. The PA incorporate recovery plan activation and support measures into a revised and strengthened early intervention framework.

d. The PA and FSCA implement the intended recovery planning requirement for FMIs and, in parallel, develop effective early intervention arrangements and contingency planning for FMI stress events, and undertake regular testing of these arrangements.

e. The PA develop and implement recovery planning requirements for insurers and integrate recovery plan activation and support into the PA's arrangements for insurer early intervention.

BANK RESOLUTION REGIME AND RESOLUTION PLANNING

A. Overview of the Resolution Regime

37. Resolution regimes form a necessary complement of early intervention and recovery planning frameworks. Although recovery plans may help to address many situations of financial stress, there will be occasions when a financial institution cannot be restored to financial soundness through its recovery plan or other remedial actions. In these situations, some form of resolution will be required.

38. As indicated in the KA, an effective resolution regime should apply to all institutions whose failure could adversely impact the stability of the financial system. In addition to licensed institutions, the regime should include holding companies and subsidiaries, as well as branches of foreign banks and any locally incorporated subsidiaries associated with the financial institution. Although the KA are mainly designed for application to SIFIs, many of the elements set out in the KA are equally relevant for non-systemic banks. In that regard, a resolution framework for all banks would desirably have most of the features in the KA.

39. In assessing the financial crisis management arrangements for banks in South Africa, the mission had close regard to the KA. In particular, regard was given to the clarity and comprehensiveness of:

- The statutory objectives of resolution;
- The entities covered by the resolution framework;
- The triggers for resolution;
- Resolution powers;
- Resolution safeguards; and
- Resolvability assessments and resolution planning.

40. Prior to the enactment of the FSLAB, bank failures were dealt with via curatorship or liquidation. Under the curatorship regime, the MOF made the decision to put a bank into curatorship on the recommendation of the PA. The curator, acting under the supervision and direction of the PA, controls and manages the bank and its assets (including the transfer of assets and liabilities without shareholder approval), seeking temporary relief from creditors, and taking decisions that would otherwise be subject to a special shareholder resolution. Although the existing bank resolution framework has a number of positive features, it falls well short of the principles set out in the KA and in international best practice. In particular, it lacks a clear designation of resolution authority, conflates supervisory and resolution functions in the same authority, is excessively reliant on court-based processes, and lacks a number of the resolution powers needed, especially bail-in. It also lacks appropriate safeguards and a 'no creditor worse off' framework. These deficiencies are well understood by the authorities and major legal reform initiatives to address the issues have been under way for several years.

41. A new resolution regime is being implemented, following the enactment of the FSLAB. The FSLAB has been subject to considerable consultation with banks and various other stakeholders since its release in draft form in 2018. Under the new framework, the SARB will be the sole resolution authority for designated financial institutions in South Africa. All commercial banks, mutual banks, and cooperative banks, as well as the financial conglomerates of which they form part, will fall under the resolution authority of the SARB. The same will apply in respect of non-bank financial institutions (and their holding companies) that are designated as Systemically Important Financial Institution (SIFIs) by the SARB governor, such as FMIs and large insurers. As the current curatorship provisions applicable to banks have been repealed with the enactment of the FSLAB, the PA will cease to have responsibility for resolution in respect of banks.

42. The FSLAB clearly specifies the objectives of the SARB in relation to resolution. It states that the objective of the SARB in performing its resolution functions is to assist in maintaining financial stability and protecting the interests of depositors of banks through the orderly resolution of designated institutions that are in resolution. The FSLAB includes several considerations to which the SARB must have regard in exercising its resolution functions, including to have regard to, and seek to minimize any adverse impact on, the interests of shareholders and creditors of other members in the group of companies of which the designated institution forms part, and to observe relevant labor laws. The bill also enables, but does not require, the SARB to consider the possible impact that its actions may have on the financial stability of a foreign jurisdiction where the designated institution is registered.

43. **The FSLAB provides high-level triggers for entry into resolution, but further elaboration by the SARB would be welcome.** Under the FSLAB, the resolution trigger (defined as being the "point of resolution") is when the SARB determines that a firm is unable (or likely unable) to meet, or will likely be unable to meet, its obligations, and where resolution action is required to maintain or protect financial stability. The trigger is not quantitatively specified under the FSLAB or linked to any specific metrics (such as a Common Equity Tier 1 (CET1) ratio). It is qualitatively determined by the SARB and can be exercised on a prospective basis, allowing for early entry into resolution prior to balance sheet insolvency. When assessing the financial position of a firm, authorities may base their decision on a preliminary internal valuation, rather than having to rely on a definitive valuation carried out by an independent valuation expert. While these mechanics, in combination, provide the SARB with ample flexibility to initiate resolution proceedings, the further clarification of the factors determining the SARB's resolution decisions would be useful, both to guide industry behavior and promote consistency and evenhandedness when operating the framework. In that regard, it is suggested that the SARB develop, and eventually publish, guidance as to the factors to which the SARB would have regard when assessing whether a point of resolution has been met. This will help to promote greater transparency and accountability for decisions and reduces the risk of inconsistent application of resolution triggers.

44. **Under the FSLAB, the decision to place a bank or other institution into resolution is determined by the MOF on the recommendation of the SARB.** The authorities have argued that the vesting of this power in the MOF, rather than in the court (which the authorities have argued is the alternative option), is justified on the grounds that it provides a more certain and faster mechanism for implementing resolution. In discussion with the authorities, the mission team noted that the international norm is generally for the decision to place a bank into resolution to be vested in the resolution authority (in this case the SARB), rather than a minister, in order to reduce the risk of unwarranted political influence and to quicken the process for initiating resolution. The authorities argued that the proposed formulation provides a check on the powers of the SARB and reduces the risk of abuse of power. It is consistent with the existing resolution mechanism, under which the MOF appoints a curator to a bank on the recommendation of the PA.

45. **The vesting in the MOF of the power to place an institution into resolution is not fully consistent with the KA.** It risks introducing a political dimension to resolution decisions and creates a risk of undesirable delay of entry into resolution. An argument can be made that the MOF should only be involved in determining entry into resolution if the government is being requested to make public funding available for the resolution. That said, it is not uncommon for jurisdictions to vest in a cabinet minister the power of entry into resolution, subject to the safeguard (as in South Africa) that

this can only be done on the recommendation of the resolution authority and only where the resolution trigger has been met. In that sense, the mechanism in the FSLAB is a form of "double veto", such that neither the SARB nor the MOF can act alone in placing a financial institution into resolution; it requires both the recommendation from the SARB and the agreement of the MOF. One amendment that the authorities could consider is to require the MOF to make a determination within a given period (e.g., 48 hours) of a recommendation being made by the SARB and to limit the ability of the MOF to decline approval for entry into resolution—e.g., either on the grounds that the MOF concludes that the trigger for resolution is not satisfied or that financial stability can best be assured via alternative measures (i.e., public sector support) to restore the institution to viability (thereby obviating the need for resolution).

46. Under the FSLAB, resolution interventions will be carried out by a "resolution practitioner" appointed by the SARB to execute the resolution strategy determined by the SARB. The courts will not have resolution powers under the FSLAB, and resolution actions will not depend on court approval. However, the courts will continue to have jurisdiction in ordering the winding up of a bank on the application of the SARB, and to grant relief to creditors and other stakeholders in the event the SARB has acted beyond its powers during resolution.

47. The FSLAB significantly expands the range of available resolution powers. These will include the powers for the SARB to transfer assets and/or liabilities without creditor or shareholder consent to another entity (which could be an existing licensed financial institution or a bridge entity or asset management company), establish a bridge institution, and apply a statutory bail-in of unsecured creditors.[5] The bail-in power must be used in accordance with the creditor hierarchy in insolvency law, which will be amended under the FSLAB, and to treat creditors of the same class in a *pari passu* manner (unless departing from the creditor hierarchy is necessary to contain the systemic impact of a bank's failure) and to confer a preferential ranking for covered depositors. The statutory bail-in power for resolution purposes will be in addition to the existing powers for the PA to write down or convert capital instruments at the point of non-viability in a recovery context. The FSLAB incorporates a safeguard designed to ensure that no creditor is left worse off than under a conventional liquidation (i.e., the "NCWOL" provisions).

48. The FSLAB provides a robust legislative framework for resolution, largely consistent with the KA. However, there are some matters on which further reflection by the authorities would be desirable, with a view to pursuing further amendments in due course, as needed.

- *Group resolution powers.* The FSLAB does not enable the SARB to exercise resolution powers directly in relation to subsidiaries of designated institutions. Instead, it relies on the ability of the SARB, through the resolution practitioner, to exercise the designated institution's shareholder powers to cause subsidiaries to take the necessary actions. This potentially impedes effective group-wide resolution and does not accord with the KA or best practice. It is suggested that the statutory framework be widened to enable resolution powers, moratorium and stay provisions to

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

be applied to all entities in a regulated group (including all subsidiaries of a designated institution) unless excluded by the governor of the SARB.

- *Valuation requirements.* The FSLAB requires the SARB to obtain an independent valuation before it undertakes resolution transactions, such as bail-in. This appears to be an unnecessary requirement and creates a major risk of delays in the implementation of a resolution, especially where there is a pressing need to implement the resolution quickly due to adverse market conditions (e.g., depositor withdrawals, cutting of inter-bank funding lines, etc.). The more appropriate mechanism would be for the SARB to be able to implement resolution based on its own valuations, generally applying a conservative valuation of assets, and where an independent valuation is only required at a later stage to determine the comparison of creditor outcomes under the resolution relative to the counter-factual outcome under a liquidation for NCWOL purposes.

- *Resolution trigger.* As noted earlier, it is suggested that the SARB develop and publish guidance on the criteria it will use, and associated methodology, to determine entry into resolution.

- *Role of Minister of Finance in resolution.* It is suggested that the FSLAB be amended to constrain the involvement of the Minister of Finance in the resolution process to situations where public funding is likely to be required. This would ideally involve amending the law so that the decision to invoke resolution rests solely with the SARB, after consultation with the Minister of Finance, and the Minister's involvement be limited to determinations of whether to provide public funding and, if so, on which terms.

- *Temporary stay.* It is suggested that the authorities satisfy themselves that the temporary stay provisions in the FSLAB, including clause 166L of the FSLAB, are in accordance with the Key Attributes and international good practice, including with respect to a temporary stay on the exercise of contractual remedies relating to events of default in connection with ISDA contracts and other contracts relating to derivatives.

- *Bridge banks.* It is recommended that the SARB develop guidance on the circumstances in which a bridge bank would be used for resolution purposes, its regulatory requirements and capitalization sources. Since operating bridge banks can be very labor-intensive, these vehicles should only be considered as a resolution tool for systemically important banks when other options are not available or would fail to protect financial stability. Some jurisdictions allow bridge banks to operate without capital, but it is recommended that they do adhere to capital (and other prudential) requirements, albeit possibly with a transition period, to ensure resilience and to avoid unfair competition with other banks. When considering capitalization options, it is important to avoid reliance on the SARB; instead, any funding for capitalization purposes should be sourced from the government. Equally, it is important to structure the shareholding in a bridge bank so that the shares are held, directly or indirectly, by the government. Ownership of a bridge bank (or any other bank) by the SARB creates untenable conflicts of interest *vis-a-vis* its responsibilities for supervision and liquidity support.

- *Resolution funding*. As noted later in this technical note, the FSLAB contains no provisions for public funding of resolution. The mission understands that the authorities purposefully excluded such a mechanism from the FSLAB given the intention to design resolution arrangements that avoid reliance on public funding—hence the proposed loss-absorbing ("bail-in") instruments under the FSLAB (also referred to as "FLAC"). In principle, the mission supports this and can see logic in not incorporating into the FSLAB a public funding mechanism per se, given the moral hazard to which this could give rise. However, it needs to be recognized that there will likely be circumstances in which some public funding is unavoidable, such as where there are insufficient FLAC instruments for full recapitalization or where bail-in is thought likely to be destabilizing, or where government guarantees and indemnities might be required. This issue is discussed in more detail later in this note.

- *SARB funding in resolution*. Section 10 of the SARB Act makes provision for largely unfettered lending by the SARB to any entity, with no solvency requirement, provided that the entity has sufficient collateral available. Under the FSLAB, it is contemplated that the SARB may provide funding to a designated institution in resolution, presumably under Section 10 of the SARB Act. However, there are insufficient safeguards in place to ensure that SARB funding is not applied for solvency restoration, as opposed to the legitimate purpose of debt-financed funding for liquidity purposes. The SARB Act should be amended in due course to permit the SARB to lend to an institution in resolution only: (i) if the SARB is satisfied that the entity in question is adequately capitalized or will shortly be adequately capitalized as a result of solvency restoration resolution actions being taken that do not involve SARB funding; and (ii) for such time as the entity is unable to fund itself in the financial markets. If the entity in question has insufficient collateral to cover the SARB's credit and market risk exposures, the SARB should only lend under a government indemnity. More generally, the provision in the SARB Act empowering the SARB to inject share capital into a bank should be repealed. These issues are discussed in greater detail later in this technical note.

49. The FSLAB amends the creditor hierarchy via the introduction of insured depositor preference. The principal change is to establish a statutory depositor preference for covered deposits, in line with international best practice. The change will confer a priority on deposits protected under the proposed DIS relative to other unsecured senior (and obviously subordinated) liabilities, other than defined categories of preferred creditors, such as employee salaries payable. The current and proposed creditor hierarchy arrangements are set out below. This is a desirable change and will facilitate asset and liability transfers (i.e., by providing a clear legal ground for preferential treatment of insured deposits) and help to minimize losses for the DIS (thus reducing pass-through costs to other banks).

Table 2. South Africa: Proposed Revisions to the Creditor Hierarchy in Insolvency Under FSLAB

<table>
<tr><th>Current Creditor Hierarchy</th><th>Proposed Creditor Hierarchy</th></tr>
<tr><td>Secured creditors (up to value of security)</td><td>Secured creditors (up to value of security)</td></tr>
<tr><td rowspan="2">Preferred creditors</td><td>Preferred creditors</td></tr>
<tr><td>Covered deposits</td></tr>
<tr><td rowspan="3">Unsecured creditors</td><td>Unsecured creditors (including uncovered deposits and non-qualifying debt instruments)</td></tr>
<tr><td>FLAC instruments</td></tr>
<tr><td>Regulatory debt (in the order determined in the regulatory framework)</td></tr>
</table>

Source: SARB.

B. Resolution Planning Policy and Resolvability Assessments

50. The resolution planning mandate will be carried out by the RPD of the SARB. The division is currently part of the FSD, which reports to the deputy governor for Financial Stability. As such, it is operationally distinct from the PA, whose CEO is another deputy governor who is in charge of supervision of financial institutions. The resolution planning division includes a resolution unit and a crisis management unit, that also currently operate the project to establish the CODI. Excluding staff who will be transferred to the CODI, once it is established, the division employs a staff of four, and has three vacancies for recently approved positions.

51. As resolution authority, the SARB will be in charge of planning for resolution of individual institutions, assessing their resolvability, and carrying out resolution interventions. To deal with policy and planning issues and to assist the governor in his resolution responsibilities, the SARB has established an RPP, chaired by the deputy governor for Financial Stability. The RPP comprises senior management from the SARB (including the representatives of the RPD, National Payment System, Financial Markets, and Financial Stability departments) and representatives of the PA. The resolution unit acts as the secretariat to the RPP. The RPP reports to the SARB's FSC.

52. It will be necessary for the SARB to develop the policy and procedural arrangements for implementing different forms of resolution. This will be most important in the case of the SIFIs, but also for medium-sized banks. In particular, the SARB, in close liaison with the PA, NT, and FSCA, is encouraged to develop a resolution toolkit that sets out: (i) the resolution options at a generic level for SIFIs and, in due course, smaller banks respectively; (ii) the criteria for selecting particular options; (iii) the processes for determining non-viability; (iv) the processes for entry into resolution; and (v) the implementation steps for each option. The resolution options for the largest banks would include bail-in, bridge bank, Asset Management Company (AMC), business transfer, and various recapitalization options. The resolution options for small banks would typically include merger, purchase and assumption, and payout. The toolkit should also include guidance on the selection of resolution practitioners, including the skills, knowledge and experience needed for eligibility for appointment, together with the indicative terms of reference for the responsibilities of a resolution practitioner. The toolkit should also include cross-border coordination arrangements and communications strategies. The toolkit would need to identify the responsibilities of the SARB (lead agency), PA, NT, and FSCA, and the coordination arrangements required to ensure effective cross-agency coordination. The CODA will need to be incorporated into this cross-agency resolution planning process once the FSLAB has come into force.

53. **The development of a generic resolution toolkit is on the SARB's agenda and progress is being made in elements of its preparation.** This work is being advanced by the Resolution Policy Division, with informal liaison with staff from other agencies. The RPP is the main vehicle through which the policy development is being coordinated, under the oversight of the FSC. As noted earlier in the technical note, the mission sees a considerable benefit in establishing a more structured cross-agency coordination process to develop the generic resolution toolkit, given the important responsibilities that the various agencies have in resolution and financial crisis management. Accordingly, the mission recommends the formation of a resolution policy working group under the auspices of the FSOC, chaired by the SARB, and with representatives of the PA, NT, and FSCA involved (and CODI, once established). This working group should report regularly to the FSOC, as well as parallel reporting, as appropriate, within the SARB via the RPP and FSC.

54. **An important aspect of resolution policy under the FSLAB framework is the SARB's authority to designate institutions.** The governor of the SARB has the power to designate a financial institution to bring it under the resolution framework. This can be done at any time - ex ante or at the time of a crisis. However, the legal framework provides limited guidance as to the matters to which the SARB may have regard in making such designations. The decision will presumably rely to some degree on the criteria used for SIFI classification, and therefore have regard to size, connectedness, complexity, and substitutability. However, it will be important for the SARB to formalize its criteria and the factors and data to which it will have regard under these criteria, and to make the methodology transparent; considering that determinations may need to be promptly made at the point of failure, factoring in prevailing circumstances and, in particular, contagion risks at that point in time. In that regard, particular attention will need to be given to how systemic and economic importance will be assessed in the case of non-bank financial institutions, such as insurers and FMIs. Equally, it will be important to identify the criteria to be used in assessing contagion risk, particularly in periods of escalating financial system stress. It is therefore suggested that the SARB give appropriate priority to the development of a transparent assessment framework for designation.

55. **As part of the development of a resolution toolkit, careful consideration will need to be given to bail-in policy.** The authorities are proposing a bail-in structure which will largely rely on the issuance of a tranche of debt instruments with the contractual capacity for write-down or conversion to equity following the earlier bail-in of capital instruments in recovery mode. The resolution bail-in tranche is referred to as "FLAC", which is intended to be broadly similar to the Total Loss Absorbing Capacity standard for Global Systemically Important Banks.

56. **The details of the new FLAC requirements, which will be critical to the efficacy of the bail-in instrument, are currently under consideration.** The SARB engaged Pricewaterhouse Coopers (PwC) to undertake a study of the feasibility of the proposed bail-in arrangements, including issues relating to calibration of the amount of FLAC instruments that must be issued by a bank, the contractual features of these instruments, the types of persons and entities who would be

eligible to invest in these instruments, the transition period for implementation and the extent to which surplus capital can count toward FLAC. The SARB will need to consider and develop policy guidance on the extent to which, if at all, it would be prepared to apply statutory bail-in powers to other forms of unsecured debt, such as large-value bank deposits, including the attendant risks associated with doing so (such as the risk of triggering pre-emptive deposit runs and inter-bank contagion). A further issue is the need to ensure that FLAC instruments must be contractually bail-in upon a defined non-viability event and that this should occur either before resolution or upon entry into resolution. Where, for whatever reason, contractual bail-in of FLAC instruments has not occurred within a short period after the entry into resolution, it is essential that statutory bail-in can be applied immediately to those instruments.

57. In its consideration of FLAC instruments, the SARB recognizes the need for careful attention to the calibration of the level of FLAC. In this regard, there is a need to carefully consider the trade-off between the benefits and costs of building a substantial tranche of bail-in debt. The benefits of a relatively high calibration of FLAC include a reduced need for public funding. On the other hand, the costs associated with a high calibration of FLAC include increased funding costs, with likely pass-through to borrowers, and therefore impacts on financial system efficiency. Moreover, the higher the level of FLAC bail-in debt required to be held, the longer the transition period would need to be for banks to issue the FLAC instruments. In considering calibration issues, the authorities are advised to assess the systemic efficiency implications of different levels of bail-in debt, the likely transition period required for full implementation, and the extent to which banks should be able to count surplus capital (i.e., capital beyond a defined cushion above minimum capital ratio requirements) towards FLAC. In principle, FLAC calibration could vary from bank to bank depending on its risk profile, capital structure and resolvability.

58. The authorities also need to consider the implications of who holds the bail-in debt if the main holders of the debt are likely to be domestic institutional investors. Pension funds, investment funds and life insurers are the most obvious market for FLAC securities, but this raises the question of what the impact would be if bank losses were transmitted to such entities. If the losses sustained by banks were sufficient to cause a proportion of the FLAC instruments to be written down in value and the FLAC instruments are held by domestic institutional investors, this has the potential for contagion within the financial system. For example, it could potentially impose losses on life insurers or jeopardize the availability of retirement savings if pension funds are affected—which, in turn, could undermine the credibility of the bail-in instrument (e.g., if political and social pressure on SARB could result in a deferral of the use of bail-in powers). These risks can be reduced to some degree by encouraging banks, to the extent practicable, to issue a substantial proportion of FLAC instruments to foreign investors and to limit the amount of such instruments that can be held by domestic institutional investors, especially those with fixed-value financial commitments (such as life insurance companies and some pension funds). It would also be important to ensure that the eligibility for individual (natural person) investors to hold FLAC instruments is limited to those who meet a “professional investor” requirement and that the investment disclosures include investor attestations requiring investors to acknowledge that they understand and accept the risks entailed in investing in these instruments.

59. A comprehensive framework for undertaking resolvability assessments of, and developing resolution plans for, initially SIFIs and over in due course medium-sized banks needs to be developed by the SARB. This is on the SARB's agenda. The development of these frameworks should precede any bank-specific resolution planning, given the importance of taking a consistent approach to these matters across the relevant banks. Given the intensity of the work involved in preparing resolution plans and undertaking resolvability assessments, it is suggested that the SARB give priority to the largest banks, and then progressively extend the process to medium-sized banks. For small banks, a generic resolution plan that sets out potential merger options, "purchase and assumption" processes, and different payout options, with associated communications processes, should be sufficient.

60. The resolvability assessments would involve three main stages.[6] These comprise: an assessment of the feasibility of different resolution options for the bank in question; an assessment of the systemic impact of each resolution option; and an assessment of the actions needed to improve the resolvability of the bank under the preferred resolution options. Although the resolvability assessments should be led by the SARB, they also need to involve the NT (in relation to potential fiscal implications under some resolution options), the PA (in relation to viability assessments, entry into resolution and conversion of pre-resolution bail-in instruments), the FSCA (on market disclosure issues) and the CODA (in relation to the resolution of small banks and the basis of funding contribution to larger bank resolution processes). At least for the SIFIs, resolvability assessments should be undertaken annually, or otherwise following: (i) material changes in legal or business structures; and (ii) substantial amendments of the resolution regime.

61. As with resolvability assessments, resolution plans should be closely coordinated both domestically and (as far as practicable) with the relevant foreign authorities. At a domestic level, the SARB would lead the development and maintenance of resolution plans, with the other agencies being involved in the elements that relate to their respective functions. For banks that are subsidiaries of foreign banks, close coordination with the home authorities will be essential, particularly where the subsidiaries in South Africa are of systemic importance (even if not explicitly classified such). This is especially the case with respect to whether parent bank resolution plans cater for either or both Single Point of Entry (SPE) or Multiple Points of Entry (MPE) forms of resolution and the expected impact on the subsidiary in South Africa. For those banks domiciled in South Africa which have operations of systemic importance to host countries (such as in Eswatini, Lesotho, and Namibia, for example), there will need to be close coordination between the SARB and the host resolution authorities. This will be especially important with respect to the coordination of processes for: (i) viability assessment of home and host operations; (ii) entry into resolution; (iii) use of SPE versus MPE forms of resolution; (iv) possible burden-sharing arrangements (especially if SPE is used to recapitalize a cross-border banking group; (v) functionality support from the parent banks to their foreign subsidiaries; (vi) liquidity support in resolution; and (vii) communications.

[6] See FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions*, I Annex 3—Resolvability Assessments.

62. **For the SIFIs, resolution plans should cover the main forms of "open bank" resolution (i.e., forms of resolution which maintain continuity of critical functions and services in either the bank in resolution or in a successor entity).** These would typically include:

- Recapitalization of a bank via bail-in or issuance of shares to external parties;[7]
- Transfer of critical banking functions and services to another bank;
- Merger of the bank in question with another bank, e.g., by issuing a controlling shareholder position to another bank; and
- Establishment of a bridge bank and transfer of critical banking functions and services to the bridge bank or potentially the transfer of impaired assets and non-essential functionality to an AMC.

63. **The plans should be comprehensive and specific**. They need to specify in detail the particular business functions and services to be included in the resolution process, drawing on the identification of critical functions and services in banks' recovery plans. Pre-positioning requirements, such as requirements for the way banks need to be structured for specified resolutions, should be identified and implemented to ensure that the plan in question is feasible. Resolution implementation steps should be identified, and guidance developed to assist in the implementation process. The plan should also identify the likely areas where resolution funding, guarantees, or indemnities may be required.

64. **For the small banks, resolution plans will be much simpler and more standardized**. The plans would cater mainly for: purchase and assumption (with a pre-identification of the assets and liabilities eligible for transfer and the possible acquiring banks); merger (where potential merger banks should be pre-identified to the extent feasible); and closure and payout options. The resolution plans for small banks should be prepared jointly by the SARB and the CODI, given the latter's significant role in any resolution of a small bank.

65. **Resolution plans should be subject to regular review**. This is especially necessary where banks undergo significant structural changes or changes in the types of business being conducted. It is also important that the resolution plans be subject to periodic testing by the SARB, in liaison with the other authorities. This will help to identify the practical capacity of the authorities to implement the resolution plan and different options within it.

C. Insurance Resolution

66. **The insurance resolution framework in the Insurance Act 2018 empowers the PA to undertake a number of actions in the event of the failure of an insurer and/or its holding**

[7] Although bank resolution plans would not generally include the option of government-funded capital support, it is nonetheless important that the authorities maintain a contingency plan for how such support would most cost-effectively be provided should it prove to be necessary, together with the preconditions that would need to be satisfied in order to provide such support. The contingency plan should include an identification of the risk mitigation arrangements that would be appropriate if government funding of capitalization was provided.

company. These include placing an insurer into statutory management (Section 53), the appointment of a curator (Section 54), business rescue powers (Sections 55 and 56) and the winding up of an insurer (Sections 57 to 59).

67. The 2014 FSAP identified material gaps in the framework for winding up failed insurers, and these gaps remain. The Insurance Act resolution arrangements are substantially dependent on court processes and do not align closely to the KA. Policyholders do not have priority ranking in the event of the winding up of an insurer. This means that policyholders rank *pari passu* with other unsecured creditors, which is inconsistent with the IAIS Core Principles and prevailing best practice. There is no industry-funded policyholder protection scheme in place, other than on a limited scale for some categories of short-term insurance. Since the last FSAP, several insurers have faced stressed situations, although most cases have been addressed by transferring the business to other insurers. However, there are a few cases where stressed firms are in the process of liquidation.

68. The FSLAB will introduce changes to the resolution of insurers to the extent they have been designated by the SARB. These changes will enable the SARB to apply the same resolution powers to any such insurers as will be available in respect of banks. For insurers that are not designated institutions under the FSLAB framework, which will be most of them, the resolution arrangements under the Insurance Act (in conjunction with the Insolvency Act) will continue to apply. The mission recommends that the authorities undertake a review of the Insurance Act as soon as practicable to better align the resolution framework for insurers with that proposed for banks under the FSLAB, with appropriate modifications. The issues which should be addressed in that review include the need for effective law in relation to:

- The objectives for insurer resolution (focusing on policyholder protection, maintaining financial stability, minimizing disruption to the economy and avoiding where possible public funding of resolution);
- Entry into resolution (based on the concept of insurer non-viability);
- The provision of comprehensive powers for resolution, including to assume control of an insurer, facilitate business transfer, establish a bridge insurer, and facilitate recapitalization (potentially including through bail-in);
- Conferring priority on policyholder claims relative to other senior unsecured liabilities;
- Comprehensive moratorium and stay powers;
- NCWOL safeguards;
- Removing the involvement of the courts in the resolution process, other than conferring on the courts the power to consider ex post compensation to affected parties where they have been left worse off under the resolution than would have occurred under a conventional winding up under insolvency law;
- Legal protections for the resolution authority, its officers, staff and agents; and

- Funding structures for resolution.

69. Consideration should be given to the establishment of a policyholder compensation scheme. The absence of policyholder compensation creates a risk of government-funded bail-outs in large insurer failure situations, given the adversity that such failures can create for large numbers of policyholders. An industry-funded policyholder compensation scheme would help to reduce the risk of government bail-out and attendant moral hazard. It would also provide a funding mechanism to facilitate the transfer of policyholder liabilities (in the case of long-term insurance) to another insurer or to a bridge insurer. It is therefore suggested that, in parallel with the review of insurance resolution law, the authorities undertake a review of policyholder compensation options, having regard to international examples.

70. The authorities are also encouraged to review and strengthen internal guidance on insurance resolution policies and planning. The PA (or SARB if it becomes the resolution authority for insurers) should establish comprehensive policies and procedures for insurer resolution, including in relation to:

- The assessment of insurer viability;
- Identification of critical functions and systems (based on substitutability, interconnectedness and impact on the economy and financial system);
- Guidance on the selection of appropriate resolution options;
- Implementation guidance for business transfer, establishment of a bridge insurer (where appropriate), merger of multiple small insurers (where appropriate), and recapitalization options;
- Provision of prompt access to at least a proportion of policyholders' claims on a failed insurer, once the claims have been validated;
- Communications with stakeholders; and
- Cross-border cooperation and coordination.

D. FMI Resolution

71. An effective resolution regime for FMIs is an important adjunct to FMI regulation and supervision. The resolution of FMIs, which include securities exchanges, central securities depositories, clearing houses, central counterparties and trade repositories in the Financial Markets Act 2012 (FM Act), are provided for in Chapter XII of that Act. Section 96 of the FM Act provides that the FSCA may apply to the court under Section 81 of the Companies Act for the winding-up of the respondent or apply to the court under Section 131 of the Companies Act to begin business rescue proceedings in respect of the institution. The FM Act also sets out the provisions on winding-up or sequestration by the court (Section 100); the process for business rescue proceedings (Section 101) and the appointment of a curator (Section 102) in respect of regulated persons, such as licensed market infrastructures under the FM Act.

72. The resolution framework for FMIs would benefit from review. The current arrangements are significantly dependent on court processes and create risks of delayed or sub-optimal resolution arrangements being implemented. It is suggested that the authorities undertake a comprehensive review of the relevant laws over the medium-term, with a view to assessing the resolution framework against the relevant provisions of the KA. Particular focus for the review would include an assessment of the adequacy of the existing laws in relation to: resolution objectives; resolution authority; entry into resolution; ability to maintain continuity of critical functions and services in resolution; capacity to undertake comprehensive business transfers; ability to establish and capitalize a bridge FMI; and arrangements for the protection of client funds. The funding structure for FMI resolution should be assessed as part of the review.

73. The authorities are also encouraged to review and strengthen, as appropriate, the policies and processes for effective recovery and resolution FMI resolution. This should include an assessment of gaps and deficiencies in the authorities' policies, processes and procedures with respect to:

- The identification of critical functions and systems (based on substitutability, interconnectedness, and impact on the economy and financial system);
- The identification of recovery options and associated implementation considerations, including (but not limited to) rule-based approaches for allocating losses to participants and options for replenishing financial resources;
- The assessment of FMI viability (with particular reference to operational viability);
- Guidance on the selection of appropriate resolution options;
- Implementation guidance for business transfer, establishment of a bridge FMI (where appropriate), and recapitalization options; and
- Communications with stakeholders.

Recommendations

74. It is recommended that:

a. The authorities continue to evaluate the legal framework, with the aim to pursue, in due course, further amendments.

b. The SARB, in close liaison with the PA, NT and FSCA, develop comprehensive guidance on resolution policies, processes and procedures.

c. The SARB develop a framework for the consistent application of resolvability assessments and resolution plans, focusing initially on the six largest banks, then extending to medium-sized banks.

d. The SARB give consideration to the costs and benefits of different levels of FLAC calibration and the means by which contagion and other financial stability risks associated with institutional investment in FLAC instruments can be minimized.

e. The authorities review in the medium-term the resolution frameworks for insurers and FMIs, and associated policies, processes, and procedures, with a view to broad alignment with the KA.

f. The authorities consider the benefits and costs of an industry-funded policyholder compensation scheme.

E. Capacity Building

75. The SARB, NT and other authorities have made very considerable progress in developing the FSLAB and associated resolution policy in recent years. This has been done with a relatively small team of people in each agency. Much work lies ahead, particularly in the design of resolution policy, processes and procedures, and the implementation of resolution planning and resolvability assessments and in the implementation of the DIS. The current team in the SARB charged with leading this work is small, comprising just four staff. It is suggested to explore options for increasing staffing, possibly via secondments from other parts of the SARB or engagement of outside experts, to enable the work to be progressed comprehensively and in a timely manner. Moreover, further consideration should be given to staffing implications at other agencies—e.g., the PA (in view of supervisory reviews of recovery plans), the CODI (to help design, implement, and test the policies and systems needed for an effective DIS), and NT (to conduct further work on the use of public resources in resolution and support further legislative work).

76. A program of regular senior management workshops on strategic crisis management issues would be beneficial. This could usefully be done by holding one-day senior management workshops, at least annually, involving senior management from the SARB, NT, PA, FSCA, and (once established) the CODI, to discuss and agree on key strategies for dealing with major threats to the stability of the financial system. Themes for such dialogues could include: (i) the failure of a SIFI, with flow-on effects to other banks; (ii) a system-wide asset quality and liquidity shock; (iii) the threat to financial stability arising from a pandemic (as with the current Covid-19 situation); (iv) the failure of a major insurer; (v) the failure of a systemically important FMI; and (vi) the failure of multiple small banks. Such workshops could be aided by policy papers and guidance material, possibly scenario-based, with the aim of reaching agreement on key elements of cross-agency contingency plans for such scenarios.

77. Crisis simulations should be a key element of ongoing capacity building. Building on the crisis simulation exercises already held, it is suggested that the SARB, in close liaison with the other agencies, develop a program of regular crisis simulation exercises in which all relevant agencies participate. For maximum benefit, the chief executives of each agency (including the governor of the SARB) should participate in these exercises, as is done in many other countries. Exercises can be designed for different objectives and with different scale and scope, depending on the assessed needs at the time. Typically, crisis simulation exercises will test for such matters as: (i) intra-agency and interagency cooperation and coordination; (ii) crisis diagnostics; (iii) viability assessment;

(iv) systemic impact assessment; (v) process for entry into resolution (including payment system processes); (vi) selection of resolution option; (vii) wider support measures (such as liquidity support); and (viii) communications. Some exercises seek to test the capacity of authorities to implement a particular form of resolution, such as bail-in, bridge bank or merger.

78. It is recommended that the SARB, in liaison with the other authorities, aim to hold a cross-agency exercise at least every two years. Each agency would desirably also hold their own internal simulation exercises or other forms of testing in their respective functional areas. For example, the PA could test its capacity for early bank intervention and viability assessment. The SARB could test its capacity for systemic impact assessment, ELA and initiation of resolution procedures. The NT could test its capacity for fiscal support measures. And the FSCA could test its capacity for FMI resolution and market communications issues associated with bank resolution.

79. Cross-border exercises should also be held. This is especially important for the South African Development Community (SADC) authorities, given the prominence of South African banks in the region. Cross-border exercises can be used to test for various elements of resolution, including cooperation, coordination and communications on viability assessment, entry into resolution, selection of resolution option, implementation of SPE or MPE resolution, ELA and communications with stakeholders. Before these exercises are held, it is suggested that South African authorities first hold at least two domestic cross-agency crisis simulation exercises to strengthen domestic arrangements. It is also suggested that the proposed SADC work program on strengthening the resolution frameworks of other countries in the region be progressed, with technical assistance as necessary, with the aim of lifting all countries to a broadly common platform of resolution powers, policies and capacity. Once that has been done, occasional cross-border exercises would be a very useful way of further developing capacity in the region.

Recommendations

80. It is recommended that:

a. The SARB increase significantly its staffing in the resolution policy area, and the other agencies consider increasing staffing in their respective crisis management areas.

b. The SARB, in liaison with the NT, PA, and FSCA, hold regular senior management workshops on financial crisis management issues to firm up strategic policies and build capacity.

c. The authorities, led by the SARB, hold regular cross-agency crisis simulation exercises, and each agency undertake regular internal testing of their respective crisis management functions.

DEPOSIT GUARANTEE SCHEME AND RESOLUTION FUNDING

A. Deposit Guarantee Scheme

81. The FSLAB provides the legal basis for the new DIS. The legislation includes provisions for the establishment of the CODI that will be responsible for deposit insurance functions. The SARB has already undertaken considerable work to operationalize the DIS. The proposed arrangements for deposit insurance have been subject to international benchmarking; extensive consultation with the banking industry; a review by an international group of experts; with various modifications to the arrangements having been made in light of concerns raised by stakeholders. The deposit insurance framework appears to have fairly widely held support from the industry and other parties spoken to by the mission.

82. The DIS is broadly in line with sound international principles. The depositor protection objectives are clearly articulated in the FSLAB. The draft Bill provides for the establishment of the CODI as a subsidiary of the SARB, with its own statutory mandate, board of directors and senior management. Membership of the scheme will be compulsory for all banks (including commercial, mutual, and cooperative banks, and local branches of foreign banks). Cooperative Financial Institutions (CFIs), which form a small share of overall deposits in the banking sector, will be excluded from the scheme given their higher risk profile, less developed governance and risk management, and lower level of supervision. This is a sensible exclusion. The mission agrees with the authorities that cooperative financial institutions should be reconsidered for inclusion in the DIS or a modified version of it only once their governance and risk management arrangements have been considerably strengthened and they are subject to a more comprehensive form of prudential supervision. In the interim, a team from the CODI, together with the World Bank, has commenced work to get a better understanding of the CFIs, and suitable options for extending deposit insurance to this segment of the financial sector.

83. The proposed deposit insurance coverage is capped at ZAR100,000 per depositor per bank (i.e., approximately USD5,300 as at early April 2020). This is aimed at providing adequate protection for the large majority of retail depositors. Based on the authorities' 2014 survey of banks, 98 percent of retail depositors and 83 percent of small and medium-sized enterprises would have their deposits fully covered under the proposed regime. The level of protection is broadly in line with international norms (albeit lower than most G20 countries in terms of coverage relative to per capita GDP), and would protect the vast majority of small depositors, consistent with its objectives. It will be important for the authorities to keep the level of protection under review and to increase it periodically in line with the growth in nominal deposit balances so that it continues to protect a substantial majority of household and SME depositors for the full amount of their deposits.

84. The DIS will cover deposits booked locally in local currency (Rand) and foreign currency, with the covered amount (including accrued interest) being payable in Rand. Sensibly, the scheme will make provision for payout or deposit account transfer on a gross basis, rather than netting off any amounts owed by depositors to the failed bank. This will better facilitate prompt access to insured deposits and therefore enhance the effectiveness of the scheme.

85. The scheme will operate on the basis of banks being able to calculate eligible deposit balances on a "Single Customer View" (SCV). The SARB has published proposed requirements to prepare deposit data in a SCV format, and the planned framework will rely on SCV for the calculation of premiums paid by banks. It will take some time for all banks to be able to meet the SCV requirements, particularly those with IT systems that will need to be modified. For cases where a bank needs to undertake procedural, data or system changes, granular data reporting will be used as an interim solution. It is intended that the CODI will undertake regular testing of banks' capacity to generate, validate and report depositor data, and that the data will be subject to CEO attestation and external audit.

86. The envisaged funding structure has undergone significant change as proposals for the DIS were finalized. In initial consultation papers, the SARB proposed that the scheme would be funded to a level of approximately ZAR17 billion—equivalent to around 4 percent of covered deposits. This met with considerable resistance from the industry, given the size of the levies expected to achieve the target amount over the proposed transition period. As a result of further consultations),[8] the authorities proposed a three-tiered funding structure. Initial funding to meet the CODI's establishment costs and basic operational requirements will come from the SARB in the form of seed capital. In addition, banks will be required to pay regular premiums at 0.20 percent of covered deposits per annum to build a 'loss-absorbing capital' (equity) tranche; as well as an annual levy to meet the CODI's operational expenses, proposed to be set at 0.015 percent per annum in relation to a bank's covered deposits. Premiums will be calculated on a uniform level for banks, but with the possibility to transition to risk-based premiums in the future, considering both going-concern and gone-concern resolution strategies and resolvability. Banks will also fund a liquidity tranche by providing the CODI with interest-bearing deposits, equivalent to 3 percent of their covered deposits. The liquidity tranche is intended to be maintained at 3 percent of covered deposits on an ongoing basis, unless the level is adjusted by CODI.

87. The scheme will be supported by a liquidity facility from the SARB. This is intended to provide the CODI with rapid access to funding in a situation where existing funds are insufficient or where immediate liquidation of investments is costly for CODI. To date, the facility has not been formalized, given that the CODI's establishment is dependent on the enactment of the FSLAB. Repayments would be sourced from liquidation proceeds, with the SARB having a preferential claim against any realized recoveries.

88. Staff recommends that the funding structure of the DIS is further strengthened. The objective of this multi-tiered funding structure is to provide a substantive up-front industry-based funding, backstopped by the SARB. The proposed 3 percent deposit tranche has the merit of providing the scheme with up-front liquidity, but a specific target for the loss absorbing tranche has not been identified. Moreover, reliance on interest-earning deposits entails additional costs for the

[8] The SARB issued a Discussion Document in September 2020 for further consultation with interested parties, entitled: "*The deposit insurance funding model and the implications for banks.*"

CODI as compared to a more traditional scheme, whereby the DIS' resources are fully sourced from non-refundable premiums. In practice, the chosen structure may also prove procyclical, i.e., if banks would need to recognize losses following a sudden draw-down of the liquidity tranche, to enable the CODI to discharge its obligations vis-à-vis insured depositors. Given that deposit insurance payouts may materialize in periods of broader banking system stress, the imposition of losses on other banks via their deposits in the CODI could exacerbate their financial soundness and contribute to inter-bank contagion. The depositor preference framework in the FSLAB reduces these risks to some degree by giving the CODI a prioritized (subrogated) claim on the failed bank's assets, enabling it to replenish the deposits from realized recoveries. Nonetheless, further consideration should be given to the risks associated with the deposit-funded structure.

89. Although the authorities expect that the chosen structure will fit the needs of the CODI, staff recommends that further steps are taken to reinforce the funding model. Specifically, it is suggested that:

- The authorities formalize (and regularly reassess) an explicit target size for the scheme's loss-absorbing capital tranche, based on the expected level of payout for covered deposits, and specify a timeframe for achieving this—having regard to the probability of failure over the medium-term and the scheme's potential outlays of multiple small or medium-sized banks fail at the same time;

- The authorities make explicit provision for a replenishment of the deposit insurance fund, e.g., through annual recalibrations of the annual levy, after its resources have been utilized;

- The SARB and officials currently assigned to deposit insurance seek to establish the terms and conditions of a draft liquidity facility, with a view to this being formalized and implemented as soon as the CODI is legally established; and strengthening repayment sources (e.g., through the ability to impose extraordinary premiums); and

90. Consideration be given to providing the SARB with a government indemnity in respect of any funding it provides to the CODI under the liquidity facility, in recognition that, under good international practices, central banks do not generally bear the credit risk associated with funding provided to deposit insurance agencies – these risks are more appropriately borne by the government itself; **The DIS is being established as a "paybox plus" scheme.** As such, its funds will be able to be used for payout, transfer of deposit accounts via purchase and assumption, and contribution to another form of resolution. This is sensible and consistent with good international practice. It is essential to ensure that the DIS is not used for purposes beyond its statutory objectives. For example, the scheme should not be a source of funding for lending to a bank in resolution or for recapitalization of a struggling bank. It should only be used for the purpose of enabling, directly or indirectly, covered depositors to have access to their protected deposits, and only up to the estimated outlays of the CODI in a payout scenario on a "least cost" basis.

91. Work is under way in the SARB to operationalize the CODI. Some SARB staff are already dedicated to matters relating to the deposit insurance framework, including the implementation of SCV arrangements, payment processes and communications issues. These are very positive developments and will help to facilitate a timely implementation of deposit insurance arrangements once the law has been enacted. It will be important to ensure that the CODI is sufficiently staffed in its own right once it is formally established, together with robust governance, transparency and accountability arrangements. To that end, it is recommended that the SARB further progress the development of draft governance arrangements, pre-identify prospective directors for the board of the CODI, identify staffing needs, develop delegated authorities, and prepare the operational processes and procedures the CODI will need to commence operations once the law is in force. Included in these arrangements is a need for internal guidance, processes and procedures to be prepared on the following matters (which the mission understands are matters already under consideration by the SARB):

- Selection of payout options, having regard to technical feasibility, timeliness, capacity to maximize payout coverage, and cost. Payment options should include the capacity to make electronic payments to depositors' alternate bank accounts, the use of a paying agent (and the criteria for selecting paying agents in particular geographic areas), provision of cash to depositors, and the use of the failed bank's branch network and payment channels where it is operationally safe and feasible to do so.

- The use of purchase and assumption as a mechanism for making depositors' funds available to them through transferring covered deposit accounts to another bank or a bridge bank, including associated payments functionality (such as direct credits and debits linked to transaction accounts). The guidance in this respect would include identification of prospective recipient banks, the tender process to be applied in the selection of bank and the pre-positioning, and data requirements needed to implement the deposit account transfers.

- The operational framework for determining the least-cost form of providing depositors with access to their covered deposits, together with the framework for determining the maximum amount the CODI could contribute to a resolution option that does not involve depositor payout, based on a clearly described least-cost methodology.

- The framework for testing banks' capacity to calculate and report SCV amounts per depositor and associated depositor details to the CODI. The requirements for external audit of SCV and depositor data will also need to be developed, as will the requirements for CEO attestations as to compliance with the requirements.

- The investment criteria and procedures for investing funds held by the CODI, having regard to credit risk, market risk, concentration risk, country risk and liquidity.

- The cross-agency MOUs needed to be put in place, particularly between the CODI and the PA, and the CODI and the SARB. Cross-border MOUs may be needed in some cases to ensure that there is a clear allocation of responsibilities and agreed cooperation and coordination arrangements between the CODI and its foreign counterparts.

- The communications arrangements needed for effective deposit insurance. This will include the need for initiatives to raise public awareness of deposit insurance, disclosure arrangements and escalation procedures in a bank distress situation (including website and call center arrangements).

B. Resolution Funding

92. In the absence of sufficient loss-absorbing capacity or inability to allocate losses to the private sector, the resolution of a SIFI will inevitably require temporary public funding. Although losses should always first be applied to shareholders, other capital instrument holders and creditors subject to bail-in arrangements, funding is likely to be needed for several purposes, including: recapitalization (if bail-in is insufficient for that purpose); the transfer of liabilities to an existing bank or bridge bank; the transfer of impaired assets to an AMC; the guarantee of a bank's liabilities (e.g., derivatives and possibly new deposits); compensation to parties left worse off under a NCWOL framework; and the provision of an indemnity to the SARB for ELA or other forms of liquidity support to a bank in resolution. Some of the funding needed is likely to be sourced from the cashflows of the bank in resolution, but these amounts may be insufficient and otherwise 'front-loading' will be required. To some extent, such funding can be sourced from the DIS, subject to the conditions laid down in the FSLAB. However, it is likely that additional funding would need to be accessed for systemic failure situations, sourced either from the banking (e.g., levies) or public funding.

93. Currently, South Africa lacks a source of systemic resolution funding. The proposed DIS is not suited to this task, given that it is principally designed for the funding of payouts to insured depositors in small to medium-sized banks; it would be insufficient in size for a systemic resolution (as is generally the case globally). The FSLAB makes no provision for systemic funding, either by way of a pre-funded systemic resolution fund or through public funding with ex post industry levies.

94. While the absence of an explicit public funding mechanism reflects the desire to avoid moral hazard it is still important for the authorities to at least consider funding needs for systemic bank resolutions. It is therefore suggested that the NT and SARB work together on a contingency plan that sets out a draft Bill or other mechanism for public funding should it prove to be necessary. This would reduce the risk associated with pulling together emergency legislation in a crisis without the benefit of having carefully considered the issues beforehand. Accordingly, it is recommended that the authorities develop a draft resolution funding framework that could be implemented in law quickly if needed. This would include such matters as:

- A clear set of statutory purposes for the provision of any financial assistance, anchored to maintaining the stability of the financial system;
- A requirement that all estimated losses in the failed bank have been allocated to shareholders and subordinated creditors, and other senior unsecured creditors to the extent practicable, before external resolution funds are considered;
- Identification of the purposes for which public funding may be provided;
- Conditionality attaching to any such funding (including guarantees and indemnities);
- Powers to recover funding outlays (including any fees and interest costs) from the cash flows of the resolved bank and assets of the insolvency estate of the failed bank; and

- Powers to levy banks to recover the net present value of any funding outlays not recovered from the cash flows of the resolved bank and assets of the insolvency estate.

95. A broad provision in the Public Finance Management Act allowing for the provision of government guarantees, including potentially to financial institutions in stress, creates significant fiscal risks in its current form. This Act enables ministers (not confined to the MOF) to provide guarantees and indemnities to persons with relatively little safeguards for the protection of public funds. The Act does not stipulate the purposes for which guarantees may be provided or the preconditions which must be satisfied before a guarantee is given. It appears not to require the approval of Cabinet or any attestation process by the NT. There appear to be no statutory requirements on the terms and conditions applicable to government guarantees, or limits on the amount and duration of guarantees. This relatively unfettered ability to issue guarantees exposes the country to major fiscal risk, potentially exacerbating the already-high level of government debt. It is therefore suggested that the authorities review the Act as a matter of priority, with a view to promoting amendments that incorporate robust safeguards into the Act.

96. Similarly, the broad authority granted to the SARB in the SARB Act to provide liquidity to in a bank resolution creates significant risks to the SARB balance sheet in its current formulation. The SARB Act already enables for the SARB to lend to any party, provided it does so on a collateralized basis. This power is contained in Section 10 of the SARB Act. The Act does not require the SARB to satisfy itself as to the solvency of the entity to which it lends. The mission regards this as too wide a power and that, both for resolution-based lending and lending outside of resolution (including for ELA purposes), there should be more safeguards on the capacity of the SARB to lend. In that regard, it is suggested that the SARB Act be amended to require the SARB to lend only to an entity when it considers that lending is needed either for the maintenance of financial system stability or the implementation of recovery or resolution, and only if the SARB is satisfied either that the entity is adequately capitalized relative to its risks or is in the process of being adequately capitalized through recovery or resolution initiatives. The Act should require any lending by the SARB to be done on a fully collateralized basis. If the entity in question has insufficient collateral to cover the SARB's credit and market risk exposures, the SARB should only be empowered to lend under a government indemnity. The Act should only enable the SARB to lend where it is satisfied that the entity has exhausted all private sector sources of funding, and only continue lending until such time as the entity in question can meet its funding needs from private sector sources.

97. It is critical that the SARB is not used as funding source for solvency restoration or support. If public funding is to be provided for such purposes, these should be provided by the government, under the oversight of the MOF and NT, and not through the SARB. Consistent with well-established international principles and practices, central bank funding should only be used for liquidity support and not for solvency or risk absorption. Accordingly, it is recommended that the SARB Act be tightened to prevent the SARB from providing funding to a bank or any other party other than for liquidity purposes and through senior debt instruments. In that context, the existing provision in Section 13 of the SARB Act enabling the SARB to acquire shares in a bank (which, arguably, could be used to capitalize a bridge bank), with the approval of the MOF, should be repealed. In addition to making the proposed amendments to the SARB Act, the mission recommends that the SARB develop comprehensive internal policies, processes and procedures for lending in a bank resolution. These policies, processes and procedures could be developed in parallel to the development of associated frameworks for lending in other situations, including ELA. Matters to be addressed in the context of lending to a bank (or other designated institution) in recovery or resolution would include:

- The preconditions for lending;
- Processes for determining solvency and medium-term viability, including (as appropriate) the attestations and information that the SARB would require from the PA;
- The purposes for which lending would be provided;
- The eligible collateral, including potentially parent entity collateral;
- The terms and conditions of lending;
- Exit arrangements (including an assessment of the recipient's ability to repay and strengthen its liquidity position to minimize the probability of future support); and
- Disclosure and communications arrangements.

Recommendations

98. It is recommended that:

a. The SARB prepare a draft liquidity facility between the SARB and the CODI that can be formalized once the CODI is established.

b. The authorities formalize a target size for the loss-absorbing tranche of the DIS and keep this under review.

c. The operational requirements for deposit insurance continue are further progressed so that they are ready for implementation once the FSLAB has been brought into force.

d. The authorities develop clear policies on the purposes for which deposit insurance funding may be applied beyond the payout of covered deposits, including a least-cost methodology.

e. The SARB and the MOF jointly develop interim options for providing depositors with prompt access to their funds, prior to the full operationalization of the new DIS, with the necessary financing being sourced transparently from fiscal resources.

f. The authorities develop a (non-public) contingency plan, potentially in the form of a draft Bill, under which public funding may be used for resolution purposes.

g. The authorities review the Public Finance Management Act to strengthen the safeguards associated with the issuance of government guarantees and indemnities.

h. The SARB Act be amended to tighten the circumstances in which lending in recovery and resolution, and for broader purposes, may be provided by the SARB.

i. The SARB develop policies, processes, and procedures for lending in recovery and resolution, and for broader ELA purposes.

CONTINGENCY PLANNING AND CRISIS MANAGEMENT

A. Domestic Arrangements

99. As discussed earlier in this note, there are well-established mechanisms for domestic cooperation and coordination. However, the mission sees a need to refine these arrangements to sharpen the focus of the coordination bodies, particularly the FSOC, so that there is a more transparent and accountable cross-agency coordination of resolution and financial crisis management. It is suggested that the FSOC publish a charter that sets out its purposes and modus operandi generally, covering all of its statutory mandate, with particular focus on its role in overseeing resolution and financial crisis management. It is recommended that a FSOC working group be established, chaired by the SARB, to coordinate the development and implementation of resolution and financial crisis management matters. The working group would also appropriately be charged with the task of planning and facilitating cross-agency workshops on crisis management and crisis simulation exercises, under the direction of the FSOC. For these purposes, the mission suggests that the FSOC meet at least quarterly, with a working group on crisis management reporting to FSOC at each meeting.

100. Various MOUs and cooperative agreements have been entered into between the authorities, including between the SARB and the NT. These provide a sound basis for promoting a clear understanding of the authorities' respective functions and responsibilities, and the processes for cooperation and coordination. Building on these, it is suggested that the authorities develop a MOU between all four agencies (SARB, NT, PA, and FSCA), and with the CODI when it is established, to elaborate on the responsibilities of each agency and set out in more detail the processes to be followed for cooperation and coordination at each stage of crisis management, including viability assessment, systemic impact assessment, recovery processes, entry into resolution, selection of resolution options, implementation of resolution, resolution funding, communications and exit arrangements.

101. Contingency planning is a critical element of crisis management. It is therefore suggested that the authorities, led by the SARB, work together to develop contingency plans for dealing with crisis that pose a threat to financial system stability and the economy. These plans should be comprehensive and include an assessment of the key threats to financial and economic stability, including the failure or acute distress of a SIFI, a pandemic (with Covid-19 being the obvious current example), financial risk events, external threats (such as instability arising in another SADC country), and operational disruption events affecting FMIs and banks (such as electricity and telecommunication disruptions). The contingency plans should identify early alerts for each scenario, escalation procedures, crisis diagnostics, response options, assessment criteria, implementation guidance and communications. The responsibilities of each agency at each stage of a crisis should be clearly identified in the plan, together with specific coordination procedures. It would be desirable for the authorities to undertake periodic testing of selected contingency plans.

B. Cross-Border Cooperation

102. The PA has a number of MOUs for coordination of cross-border bank supervision with foreign authorities. These MOUs deal mainly with regular information exchange and supervisory cooperation, but do not cover in any specific way recovery or resolution issues. The FSLAB enables SARB to conclude MOUs relating to resolution with foreign authorities. The SARB anticipates entering into 13 such MOUs, which should be informed as much as possible by international guidance.[9]

103. The PA has set up supervisory colleges with some host supervisors of South African banks. SARB plans to establish Crisis Management Groups (CMGs) with resolution authorities and supervisory authorities in relevant countries (particularly those in the SADC region). This is encouraged, as it will assist in the development of more robust cross-border coordination arrangements. Especially for the South African SIFIs, firm-specific Cooperation Agreements (CoAgs) will be eventually be needed but negotiating these—aided by available international guidance—may be challenging given significant divergence across the region in legal frameworks and operational capacity. This is well recognized by the SARB and discussions have been held within the SADC to strengthen national resolution frameworks, with a view to aiming to achieve a broadly common platform across the region. Realistically, it will take a number of years to achieve this. In the meantime, SARB could usefully seek to increase information-sharing and deepen collaboration on issues pertaining to recovery planning—as a key step towards reducing the probability of banking failures. It is also recommended that the SARB engage with the home authorities of foreign banks with a significant presence in South Africa, with a view to strengthening cross-border cooperation and coordination on recovery and resolution.

104. An issue that the missions suggest for consideration by the authorities in the medium-term is establishing multilateral MOUs on financial crisis management. Under such an arrangement, the SARB, NT, PA, FSCA, and CODI would enter into one MOU jointly with their respective counterparts in another country, covering all elements of financial crisis management, including viability assessment, systemic impact assessment, viability assessment, early intervention, ELA, recovery, entry into resolution, implementation of resolution, exit arrangements and communications. Such an approach offers the potential to reduce the complexity associated with multiple bilateral MOUs between South Africa and a host/home country, while also providing a framework for coordinating all of the strands of different elements of crisis management. There is

[9] See, for example, section 7 of the KA.

precedent for such arrangements, including in northern Europe and between Australia and New Zealand.[10]

105. Before any cross-border arrangements are entered into, it is suggested that the South African authorities—in their capacity as home authority—first develop, jointly, their strategy for cross-border crisis management. This could be done within each agency and then coordinated by a working group under the auspices of the FSOC. The strategies would set out the objectives that South Africa has with respect to cross-border coordination on early intervention, ELA, recovery, resolution, and exit arrangements. It would also identify the matters on which it would seek cooperation from the home or host authorities in each situation and the matters on which it could be expected that the home or host authorities would seek cooperation from the South African authorities. The strategy could include an assessment of how either an SPE or MPE form of cross-border resolution might best be implemented, including as regards possible burden-sharing arrangements. The development of this thinking would lay the foundation for the eventual development of cross-border cooperation agreements. As a foundation for this work, it is recommended that the authorities satisfy themselves that the FSLAB provides the necessary legal powers and safeguards for effective cross-border cooperation and coordination, including an obligation on the SARB to seek to avoid adverse impacts on the financial systems and economies of other countries when resolving banks in South Africa and a robust legal basis for the confidential exchange of information.

Recommendations

106. It is recommended that:

a. The authorities establish a MOU between the SARB, NT, PA, FSCA, and CODI to set out the responsibilities of each agency and the processes for cooperation for all stages of crisis management.

b. The authorities develop a comprehensive contingency plan, under the auspices of the FSOC and led by the SARB, setting out the strategies for responding to a range of threats to the stability of the financial system.

c. The authorities seek to establish bilateral or multilateral MOUs with their counterparts in key home and host countries to facilitate cooperation and coordination on cross-border financial crisis management, with the SARB following this with bank-specific CMGs (or extended mandates for supervisory colleges).

d. As a precursor to establishing MOUs, the South African authorities—in their capacity as home supervisor—develop the key elements of a strategy for cross-border crisis management.

[10] See the Nordic-Baltic MOU on cooperation and coordination on cross-border financial stability and Memorandum of Cooperation on Trans-Tasman Bank Distress Management.

LEGAL PROTECTION, SAFEGUARDS, AND JUDICIAL REVIEW

Legal Protection

107. Effective legal protection is essential in resolution and crisis management situations. This recognizes that the authorities, their officers, staff and agents potentially face considerable legal risks in taking actions to address a bank stress, remedial or resolution event. The risks are most acute where actions are taken to remove members of a bank's board or management, to remove the control of shareholders, to change property rights or values, or to place a bank into liquidation. These risks arise not just in relation to bank resolution, but also for insurance and FMI resolution. If legal protection is not sufficiently robust, there is a risk that the authorities will not take the required actions or delay essential decisions to the detriment of meeting resolution objectives. It is for these reasons that the KA place emphasis on the need for robust legal protections for the relevant authorities, their officers, staff and agents, other than for acts taken in bad faith.

108. The existing legal protections are set out in various statutes. One of these is in the FSR Act, which provides broadly worded immunity[11] for, among others, the State and the MOF, as well as senior management and staff of the SARB, the PA and the FSCA. Legal protections are also contained in other laws, e.g., the Banks Act that protects the SARB and PA, their staff and duly appointed officials from any loss sustained by, or damage caused to, any person as a result of anything done or omitted in the bona fide performance of an official function. Legal protections are also provided under the Public Finance Management Act.

109. The existing legal protections are relatively robust. They are reinforced by risk management practices in each agency designed to ensure that all officers and staff follow the correct procedures and act within delegated authorities. It will be necessary to ensure that, upon the enactment of the FSLAB, legal protections are explicitly extended to cover the SARB's new resolution-related functions, as well as the activities of the CODI; and that both agencies establish appropriate delegations of authority, procedures, and risk management arrangements to minimize legal risks and reputation risks. In the context of ensuring that legal protections are robust, as regards resolution, it is suggested that the authorities review existing legal protections for the SARB and PA staff, and for other financial regulators, including the CODI, to ensure that the legal protections provide protection against acts taken other than in bad faith, as per internationally accepted standards and practices, and that such legal protections apply not just to management and employees of the agencies in question, but also to any parties engaged by them in the performance of resolution related functions. Further consideration could usefully be given to the adequacy of arrangements for the provision of legal assistance to staff, officers and agents of the SARB and other authorities in connection with defending against any legal actions. In accordance with KA 5.3, the authorities are encouraged to check to ensure that the law provides legal protection to directors and

[11] The relevant provision (section 285) offers protection against any loss or damage incurred by any person from a decision taken or action performed in good faith in the exercise of a function, power or duty under a financial sector law.

staff of an entity in resolution against liability that could arise as a result of their compliance with resolution directions.

Resolution Safeguards

110. Resolution safeguards are a critical element in the resolution framework. In particular, it is essential that there are well-defined statutory objectives, clearly specified triggers for resolution, protections against misuse of public funds and protection against abuse of property rights. The current resolution framework, as set out in the Banks Act, lacks a number of critical components of the KA, including clearly defined and appropriate resolution objectives, measures to protect public funds and measures to ensure that no parties are left worse off in a resolution than they would have been under a conventional liquidation process under insolvency law. The FSLAB substantially addresses these matters by establishing clear objectives, setting a point of entry for resolution, and establishing the NCWOL protection. When enacted, the FSLAB will require the SARB to exercise its resolution functions in a manner to impose losses on the failing institution's own creditors and shareholders before relying on public funds. It requires actions taken by the authorities to be subject to the creditor hierarchy and the NCWOL safeguard. It removes court-based resolution decision-making and eliminates the risk of courts suspending, reversing or amending resolution decisions.

111. In most respects these safeguards (in respect of entities covered by the FSLAB) are satisfactory and in line with the KA. However, the legal framework should be reviewed to ensure that the authorities can suspend temporarily market disclosures by a bank in distress, pending the implementation of a resolution. It is also suggested that the authorities review the Insurance Act and laws relating to FMIs in the medium-term to promote amendments that establish robust safeguards for resolution powers exercised under those laws.

Recommendations

112. It is recommended that:

a. The authorities seek to ensure that, via the FSLAB, robust legal protections are explicitly extended to cover SARB's new resolution-related functions, as well as the activities of the CODI; and that both agencies put in place the necessary operational arrangements to minimize legal risks.