

South African Reserve Bank

Financial Stability Department

Ending too big to fail:

South Africa's intended approach to bank resolution

Ending too big to fail: South Africa's intended approach to bank resolution

Contents

1.	Introduction	4
2.	The resolution framework.....	8
2.1	Objective.....	8
2.2	Scope	9
2.3	The process to enter resolution.....	10
2.4	Cooperation between the resolution authority and regulators.....	12
2.5	Resolution planning	13
2.6	Resolution powers	14
2.6.1	Statutory bail-in	14
2.6.2	Transfer and bridge institutions	18
2.6.3	General powers.....	18
2.7	Safeguards	19
2.8	Open and closed resolution strategies	20
2.9	Resolution phases	22
2.10	The role of a resolution controller.....	23
3.	Planning for an open-bank resolution.....	25
3.1	Introduction	25
3.2	Identifying banks subject to planning for an open-bank resolution.....	25
3.3	Key elements of open-bank resolution plans.....	27
3.4	Identification of resolution entities	27
3.5	Loss-absorbing and recapitalisation capacity	29
3.5.1	Regulatory capital and Flac instruments.....	29
3.5.2	Calibration of Flac requirements.....	31
3.5.3	Location of Flac instruments.....	34
3.6	Operational continuity in resolution	36
3.6.1	Identification of critical functions.....	37
3.6.2	Critical shared services	38
3.6.3	Operational continuity in resolution.....	38
3.6.4	Service agreements.....	40
3.7	Funding in resolution.....	41
3.7.1	Resolution funding requirements and private sources of funding	42

3.7.2	Funding support by the SARB	43
3.8	Continuity of access to critical financial market infrastructures.....	45
3.9	Valuation capabilities	46
3.10	Cross-border cooperation in resolution	47
3.11	Resolvability assessment and removal of barriers to resolution	49
3.12	Concluding remarks on resolution planning	50
4.	Conducting an open-bank resolution.....	51
4.1	Introduction	51
4.2	Entry into resolution	51
4.3	Stabilisation actions	53
4.3.1	Communication	53
4.3.2	Recapitalisation and valuation	54
4.3.3	Funding support	54
4.3.4	Appointing a resolution controller	55
4.3.5	Temporary stays.....	55
4.4	Restructuring	55
4.5	Exit from resolution	56
5.	Conclusion	56
	References	57
	Abbreviations	62

1. Introduction

Financial institutions are regarded as too big to fail (TBTF) if they are so systemically important that, if they fail, they cannot be closed or liquidated without a severe detrimental impact on the rest of the financial system, consumers and the real economy. To avoid such an outcome, governments have in the past been obliged to support failing financial institutions using taxpayers' funds. This led to a perverse situation in which shareholders and creditors of financial institutions benefited from profits and excessive risk-taking in good times, but taxpayers carried the cost of failure when such risk-taking led to failure. If the failing institution was also very large, the negative impact on government finances and the real economy could last for many years, even decades. More than ten years after the global financial crisis, the global economy is still struggling to recover.

One of the key regulatory reforms that the Group of Twenty (G20) introduced after the global financial crisis was to end the phenomenon of TBTF. The G20 required regulators to introduce additional regulatory requirements on systemically important financial institutions to reduce the probability that they may fail. In addition, the G20 asked the Financial Stability Board (FSB) to develop a set of international standards to make it possible for countries to resolve systemically important financial institutions, if they should fail, in a way that maintains financial stability, minimises the real economic impact and ends the reliance on government to bail out such institutions with taxpayers' money.

In 2011 (revised 2014), the FSB published the *Key Attributes for Effective Resolution Regimes (Key Attributes)* that members agreed to adopt in their jurisdictions in order to deal with the failure of systemically important financial institutions. The *Key Attributes* were formally adopted as an international standard in 2015, and all G20 member countries committed to their implementation. The FSB has subsequently also published detailed standards and guidance on the implementation of the *Key Attributes*. Collectively, these publications form the international standards that members have agreed to implement in their jurisdictions, as applicable.

In line with their commitment to implement the *Key Attributes* and end TBTF, the South African authorities reviewed the existing resolution framework and took steps to strengthen it where deficiencies were identified, and to introduce missing elements of the *Key Attributes*. In August 2015, the National Treasury and the South African Reserve Bank (SARB) jointly published a discussion paper titled 'Strengthening South Africa's

resolution framework for financial institutions' (the resolution paper).¹ After extensive consultation, the proposals set out in the resolution paper were incorporated into the Financial Sector Laws Amendment Bill, 2018 (FSLAB), which was published for comment on 25 September 2018. The FSLAB contains proposed amendments to the Financial Sector Regulation Act 9 of 2017 (FSRA), including the addition of a chapter with provisions for the orderly resolution of designated institutions, which will include all banks as well as non-bank systemically important financial institutions (SIFIs) and their holding companies.² The FSLAB also contains a chapter that will introduce an explicit deposit insurance scheme to provide protection to covered depositors in the event of a bank failure. The FSLAB amends a number of other acts that are required to make the resolution framework effective.

In terms of the FSLAB, the SARB will be designated as the resolution authority responsible for planning and managing the orderly resolution of designated institutions. The FSLAB provides the SARB with the necessary powers to fulfil this role. However, from the public consultation process on the FSLAB, it became clear that there was a need for the SARB to explain how it intends executing its resolution functions. A good understanding among all stakeholders of how they could be impacted by the proposed framework contributes to fair and effective market practices and financial stability. It is essential that the broader set of resolution powers should not only be contained in law, but should be supported by feasible resolution plans, standards to make institutions resolvable and the capacity to execute the plans, both in the SARB and in industry.

The purpose of this discussion paper is to provide an overview of how the SARB intends to perform its functions as the resolution authority, as well as some of the requirements that may be imposed on designated institutions after the promulgation of the FSLAB.³ The SARB and designated institutions will have to develop clearly defined strategies and take pre-emptive measures to make the legal provisions in the FSLAB effective, and to make the orderly resolution of large and complex financial institutions feasible. The comments received on the approach set out in this paper will be taken into account and

¹ For more information on elements of the envisaged resolution framework, in addition to the parts that are repeated in this paper, refer to the discussion paper on 'Strengthening South Africa's resolution framework for financial institutions', published by the National Treasury and the SARB on their respective websites on 25 August 2015.

² For a complete definition, refer to the definition of designated institutions in the FSLAB, available at <http://www.treasury.gov.za/twinpeaks/Financial%20Sector%20Laws%20Amendment%20Bill.pdf>

³ The FSLAB also provides for the establishment of the Corporation for Deposit Insurance and a Deposit Insurance Fund. However, the Deposit Insurance Scheme falls outside the scope of this discussion paper. More information on the intended Deposit Insurance Scheme is available on the SARB website at www.resbank.co.za.

will inform the process to develop resolution planning standards, to be issued once the FSLAB is promulgated.

The first chapter of the paper explains the overall framework, as contained in the FLSAB, as applied to all banks.⁴ Chapters 2 and 3 focus specifically on the development of resolution plans for an open-bank resolution strategy.

The paper is structured as follows:

Part 2 provides an overview on the elements of the resolution framework that will be introduced by the FSLAB, and how the powers assigned to the SARB may be applied in practice.

Part 3 sets out the key elements of planning for an open-bank resolution strategy, which will most likely be followed in the unlikely event of the failure of a bank that has been designated as a SIFI in terms of the FSRA. This part also includes an overview of the requirements that designated institutions may have to meet.

Part 4 describes the process that will most likely be followed leading up to and during a resolution.

This discussion paper should be seen as a first iteration, likely to be revised and expanded in future as experience is gained by both the SARB and the designated institutions, and as the focus expands to all designated institutions. The intention is also to publish more detailed guidance on certain aspects of resolution planning in future, as the work progresses.

Comments received on the discussion paper will assist the SARB in this process and inform the drafting of regulatory standards for resolution, once the FSLAB is promulgated.

The views expressed in this document are based on the assumption that the FSLAB will be passed by Parliament in its current form. To the extent that amendments are made to the FSLAB, the SARB will, where necessary, update the approach set out in the paper.

⁴ Although designated institutions include non-bank financial institutions that have been declared SIFIs, this paper focuses on banks.

Request for comments

Comments are invited on the discussion paper, as set out in this discussion paper, and must be sent to FST-RPD@resbank.co.za

The closing date for comments is 31 August 2019.

2. The resolution framework

2.1 Objective

The resolution objective in the FSLAB is to assist in maintaining financial stability by (i) making provision for the orderly resolution of designated institutions, and (ii) protecting depositors through the establishment of an explicit deposit insurance scheme. This objective is to be achieved with minimal cost to taxpayers. The powers and tools set out in the FSLAB may only be used to achieve this objective, and the paper should be read in this context.

The SARB believes that an orderly resolution will contribute to financial stability if the resolution:

- i. maintains the critical functions and critical shared services of the designated institution;
- ii. mitigates the risk of contagion that may arise due to the interconnectedness of the institution;
- iii. protects, in the case of a bank, the institution's covered depositors, either by maintaining access to deposits during the resolution period or through compensation paid from the deposit insurance fund; and
- iv. mitigates avoidable destruction of value and macroeconomic cost.

The FSLAB requires the SARB to consider the impact that a resolution action may have on the financial stability of another jurisdiction before taking such action and, where appropriate, consult with the resolution authority of that jurisdiction. To give effect to this requirement, the SARB will, in time, establish crisis management groups with relevant host authorities to discuss aspects of South African firm's institution-specific resolution strategies that may have an impact on their jurisdictions.

2.2 Scope

Prior to the FSLAB, the resolution tools for dealing with the failure of banks and non-bank SIFIs resided in different legislative frameworks under the control of the respective financial sector regulators. Because financial groups that include SIFIs are involved in various types of financial activities that fall under the authority of different regulators, the legislation dealing with the failure of such groups was fragmented. This fragmentation of tools and powers in the hands of different authorities increased the complexity of dealing with the failure of a SIFI, especially when these frameworks had inadequate powers to deal with the impact of such failures on financial stability.

The financial regulatory framework has undergone significant changes through the enactment of the FSRA and the creation of a Twin Peaks regulatory model. The FSRA also provides a framework for the management of systemic events, which may arise from, or be exacerbated by, the failure of a SIFI. It also brings together the fragmented provisions for failing financial institutions under one framework, thereby enhancing the ability of the SARB in its role as the authority responsible for financial stability to manage any adverse impact of the failure on the financial system.

Section 29(A)(1) of the FSLAB defines a designated institution as each of the following:⁵

- i. a bank;
- ii. a SIFI;
- iii. a payment system operator and participants of a systemically important payment system;
- iv. a company that is a holding company of a bank or a SIFI, or a payment system operator of a systemically important payment system; and
- v. subject to any determination in terms of subsection (2), if a bank or SIFI is a member of a financial conglomerate [...], each of the other members of the financial conglomerate.

The practical implication of the definition of designated institutions is that all banks, mutual banks and cooperative banks will fall under the provisions of the FSLAB from the day of promulgation. Non-bank financial institutions will only fall under the FSLAB if they had been formally designated as SIFIs (see Box 2 in section 2.8). Because no non-bank

⁵ Any reference to a bank throughout this document does not exclude other designated institutions. This paper focuses predominantly on the resolution of banks. The resolution of other types of designated institutions will be dealt with in due course.

financial institutions have as yet been designated, no such institutions will fall under the FSLAB on the day of promulgation. This is the main reason why this paper deals primarily with the SARB's intended approach to the resolution of banks.

2.3 The process to enter resolution

Banks are expected to have in place appropriate risk management systems, capital and liquidity buffers, risk management systems and governance arrangements to ensure that they operate as viable businesses in normal times and can withstand stress in difficult times. South African banks are generally sound, and subject to robust regulation and supervision. As a result, bank failures are rare events in South Africa. However, it can and does happen from time to time that a bank goes through a period of stress that threatens its viability, either as a result of failure in its own management processes or as a result of external events. In addition, a credible resolution framework increases market discipline, and as a result improves risk management practices in the financial sector.

Banks would almost never enter resolution without warning signs of building pressure or without management, sometimes under instruction from the regulators, implementing corrective action. Banks are expected to have their own measures in place to help them recover from stress scenarios. The financial sector regulators also have powers to apply stricter requirements on banks and so avert further deterioration.

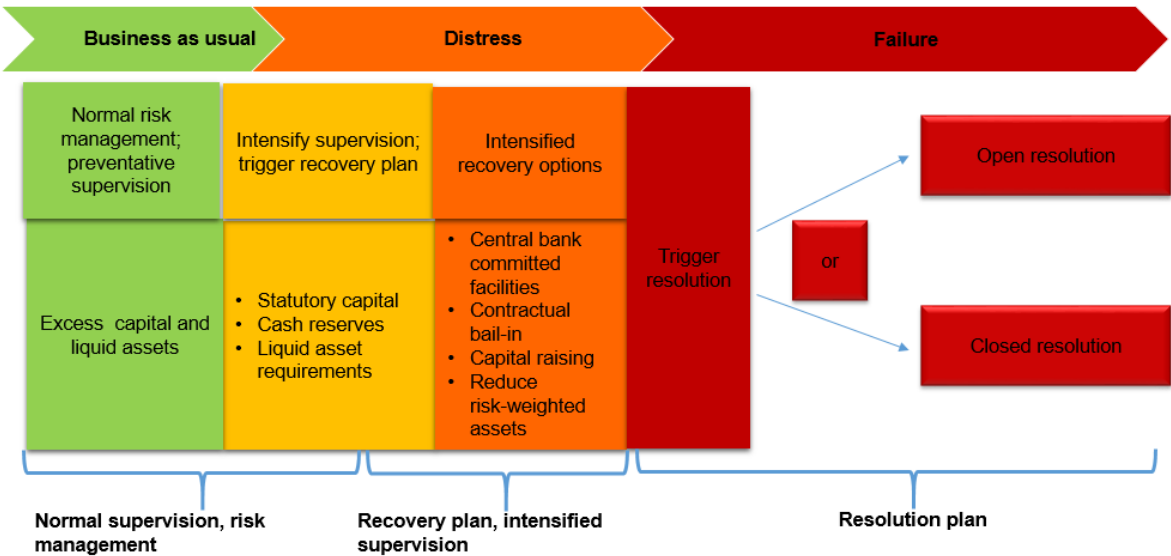
The Prudential Authority (PA) requires all banks to develop recovery plans to ensure that they would be able to deal with events or periods of severe stress and take sufficient pre-emptive steps to avoid failure and resolution. The PA sets minimum standards for recovery plans, to ensure that these plans include credible options, tailored for each institution, to cope with a wide range of stress events and scenarios. Recovery plans are developed by banks themselves and approved at the highest level of governance by their boards of directors. As an institution enters a period of stress, it is the responsibility of the bank's management to trigger and implement the appropriate aspects of its recovery plan.

Recovery plans cannot assume the availability of any recovery actions that are not under the control of the bank's management. Examples where interventions fall outside the control of banks, and therefore beyond the recovery phase, are where statutory resolution powers are required or where banks need financial support by the authorities.

Despite the distinction drawn above, recovery and resolution are interrelated insofar as both rely on capabilities in firms to measure and model capital and liquidity needs in stress situations, and on the actions that firms might take in response to stress to restructure business lines or to dispose of assets.

Figure 1 shows the theoretical process of how a bank could move from business-as-usual into resolution.

Figure 1: Theoretical path from normality to failure



It should be emphasised that the path shown in Figure 1 is theoretical, and in reality this path to failure may differ. Past experience has shown that the nature of a bank’s business, and the degree to which it relies on the confidence of its depositors and creditors, could turn a stress scenario into a possible failure in a very short time, often affecting liquidity long before solvency comes under threat. Therefore, it is important to note that resolution could be triggered before all recovery actions have been depleted, if the SARB regards the recovery options at the bank’s disposal as insufficient to deal with the event, or if a bank can only be resolved with the use of statutory resolution powers.

The trigger for placing a designated institution in resolution builds on the existing triggers for statutory management processes, such as curatorship under the Banks Act 94 of 1990. The FSLAB creates a point of resolution (POR), which is deemed to be the point where (i) a designated institution is or will probably be unable to meet its obligations (including its regulatory requirements), and (ii) it is necessary to trigger resolution to

protect or maintain financial stability. A bank may enter resolution at any point in Figure 1 if the triggers for resolution have been breached and the SARB believes that recovery actions have failed or will not be successful. At this point, the SARB will recommend to the Minister of Finance (Minister) that the bank be put in resolution and, if the Minister agrees, the resolution process and resolution powers in the FSLAB will be invoked.

2.4 Cooperation between the resolution authority and regulators

The separation of functions between the PA, Financial Sector Conduct Authority (FSCA) and the SARB (resolution authority) in the FSRA is intended to ensure the accountability of the different authorities for their respective roles and responsibilities in the interest of financial stability. However, the separation of these functions increases the need for inter-agency cooperation. The FSRA sets out provisions that aim to promote cooperation between the authorities, including:

- i. obligations on the PA and the FSCA to cooperate with the SARB to promote financial stability; and
- ii. requirements for the financial sector regulatory authorities and the SARB to enter into memorandums of understanding (MoUs) that set out how they will cooperate to fulfil their obligations in terms of the FSRA.

The MoUs between the SARB and the regulatory authorities have been finalised and are available on the SARB website. Once the FSRA has been amended by the FSLAB, the MoUs will be updated to reflect the cooperation arrangements in respect of the resolution framework and resolution-related activities. Having both the resolution authority function and the PA in one organisation assists with the coordination of resolution actions.

The SARB will, among other things, require the cooperation of the financial sector regulators to:

- i. issue standards for resolvability;
- ii. contribute to the development of resolution plans;
- iii. assist with resolvability assessments; and
- iv. make determinations, including on whether the designated institution has reached the POR.

To the extent possible, the SARB aims to rely on the systems and processes of the financial sector regulators to obtain resolution-related information. However, because the SARB's objectives and functions as a resolution authority will differ from the objectives and functions of the financial sector regulators, there may be a need for additional information and requirements. In these circumstances, either existing systems and processes of the financial sector regulators will be enhanced to ensure that the resolution information needs of the SARB can be met, or the SARB will establish direct arrangements with firms for this purpose.

2.5 Resolution planning

The resolution powers assigned to the SARB in the FSLAB can be divided into powers used to plan and prepare for the failure of a designated institution, and powers used during a resolution.

The FSLAB assigns an obligation on the SARB to develop resolution plans for all designated institutions, and also provides the SARB with legal powers to assess their resolvability and take action to remove barriers to resolvability. Resolution planning should ensure that both the SARB and the firm in resolution are equipped to deal with an actual failure, if it occurs. Without effective resolution planning, resolvability assessments and the removal of barriers to resolvability, the SARB will not achieve the resolution objectives in the FSLAB.

Through the resolution planning process, the SARB should gain in-depth resolution-related information about each designated institution, develop feasible resolution strategies tailored to each institution, put in place the capacity to execute these plans, conduct resolvability assessments and remove barriers to resolvability.

Resolution planning should not be seen as planning for specific scenarios of failure or as a path of action to which the resolution authority commits itself. Rather, it aims to make an institution resolvable by pre-emptively putting in place recapitalisation capacity, the availability of resolution-related information and arrangements to ensure the continuity of critical functions and continued access to financial market infrastructures when a bank enters resolution, as well as funding arrangements and agreements with host authorities on the key elements of cooperation in cross-border resolution arrangements, among other things.

Resolution plans should be neutral to the cause of failure and should not be seen as an indication of a firm's probability of failure. Rather, effective resolution planning should be seen as an integral part of financial regulation on a going-concern basis.

Because resolution planning is such an important element of ending TBTF, it is discussed as a separate process in Part 3 of this document.

2.6 Resolution powers

No framework can completely remove the possibility that public funds may be required to stabilise a failing institution, especially if it is a SIFI. However, the provisions in the FSLAB require the SARB to impose losses on the failing institution's own creditors and shareholders before relying on public funds, and to enable the recapitalisation of a firm in resolution from its own balance sheet.

The main new powers for executing a resolution that are introduced by the FSLAB are the power of statutory bail-in and the power to establish a bridge institution and transfer all or part of a bank's assets and liabilities to such an institution. In addition, the FSLAB provides for a number of general powers to support an orderly resolution.

2.6.1 Statutory bail-in

Clauses 166R and 166S of the FSLAB enable the SARB to take the following actions in relation to a designated institution in resolution:

- i. write-down the shares of the designated institution;
- ii. issue new shares in the designated institution;
- iii. write-down, subject to exclusions, the liabilities of the designated institution; and/or
- iv. convert debt instruments to equity.

Collectively, these actions are referred to as statutory bail-in. Bail-in will enable the SARB to recapitalise a designated institution at the point of entry into resolution. Requiring banks to maintain a specified level of liabilities that are designated for bail-in in resolution, where creditors are aware of and compensated for the inherent risks, makes it possible for the SARB to first assign losses to shareholders and creditors with sufficient capacity to also restore the capital of a bank in resolution. The FSLAB introduced a new tranche of loss-absorbing instruments, referred to as 'Flac'

instruments, which will be subordinated to other unsecured liabilities and be clearly intended for bail-in in resolution.

Parts 3 and 4 of this document contain more detail on how the SARB intends to apply the bail-in power to recapitalise a bank in resolution. Box 1 below provides some background on the SARB's views regarding the interaction between regulatory and statutory bail-in powers.

Box 1: Regulatory and statutory bail-in

The regulatory framework for banks provides the Prudential Authority (PA) with the power to trigger the contractual write-down or conversion clauses embedded in additional tier 1 (AT1) and tier 2 (T2) regulatory capital instruments at either the point where the PA determines it necessary to prevent the firm from becoming non-viable, or when public sector support is required to prevent the bank from failing. The co-existence of these regulatory bail-in powers and the statutory bail-in powers introduced by the FSLAB requires coordination between the two authorities. To formalise such coordination, the FSLAB amended section 31 of the Financial Sector Regulation Act 9 of 2017 (FSRA) to require the PA to obtain the concurrence of the SARB before taking any action to write-down or convert the liabilities of a designated institution.

Regulatory bail-in can occur before and outside of resolution as a recovery option, and can be applied only to AT1 and T2 debt instruments, without any realised losses (apart from dilution) imposed on common equity tier 1 (CET1). Regulatory bail-in does not follow the statutory creditor hierarchy, but imposes losses on creditors who have contractually agreed to it. Statutory bail-in can only be applied in resolution, and has to strictly follow the statutory creditor hierarchy and safeguards in the FSLAB. As a general rule, each tranche of either equity or debt has to be depleted before losses can be imposed on a more senior tranche. The implication of the differences between these two frameworks is that the creditor hierarchy and loss given default for investors can differ, depending on whether the regulatory, statutory or both bail-in powers are applied, and the sequence in which they are applied.

There are a number of reasons why regulatory bail-in outside of resolution is unlikely to be a successful recovery option for a systemically significant bank:

- i. Regulatory capital changes the composition of capital from debt instruments to equity, but does not increase the total amount of capital. Therefore, it will only be a successful recovery option if a bank only breaches its CET1 capital requirement but still has a large surplus of AT1 and T2 capital instruments available. Regulatory bail-in can restore compliance with the CET1 capital requirement, but not the total capital requirement. By contrast, statutory bail-in converts previously non-qualifying debt instruments to regulatory capital instruments, thereby increasing the absolute amount of capital.

- ii. Any bail-in action, whether regulatory or statutory, will result in a market reaction that could potentially freeze access to funding for the bank involved. It will also be very expensive, if not impossible, for the bank to issue new qualifying T2 instruments for an extended time. This is why bail-in for a SIFI bank, in particular, should be accompanied by a comprehensive resolution strategy, including the possibility of official liquidity support until it can access private markets again and evaluate the recapitalisation capacity from its own resources.
- iii. Bailing in the AT1 and T2 instruments of one bank is likely to have a systemic impact, in particular if it is a SIFI bank. Investors will be reluctant to immediately invest in similar instruments of similar institutions, which may affect the pricing of bank funding in general. This may require support and interventions by the SARB and possibly the National Treasury.
- iv. Because the SARB will be uncertain about the amount of AT1 and T2 that could be depleted through regulatory bail-in in the recovery phase of bank distress, it may have to require banks to hold higher levels of recapitalisation capacity for resolution purposes, with higher costs.
- v. Two frameworks for bail-in increases uncertainty for investors about their credit risk and relative position in the creditor hierarchy under different scenarios. Such uncertainty could reduce investor demand and/or cause the higher pricing of loss-absorbing instruments (both for regulatory and resolution purposes).

In light of the above factors, it is the view of the SARB that statutory bail-in will be appropriate for banks with an open-bank resolution plan, as described in paragraph 2.8, where recapitalisation through statutory bail-in is the key element of the resolution strategy. These banks are most likely to be the banks that will be declared SIFIs in terms of the FSRA. These are also the banks that will be required to hold a specified level of Flac instruments for resolution.

Banks not subject to open-bank resolution planning will not be required to hold a specified amount of Flac instruments. For these banks, regulatory bail-in can still play a useful role in recovery.

2.6.2 Transfer and bridge institutions

The SARB will have the ability to restructure a designated institution in resolution. To this end, clause 166R empowers the SARB to take the following actions:

- i. transfer any or all of the assets and/or liabilities; and/or
- ii. conduct a sale, merger or similar arrangement.

These powers can also be used in combination with the power to create a bridge institution, in which case it enables the SARB to, for example, transfer the critical functions and critical shared services of the failed designated institution to the new entity by transferring the underlying assets and liabilities. The SARB could also do a partial transfer by separating the failed or failing parts of the designated institution from those that are needed for the continuation of the critical functions and critical shared services.

Where either bail-in or transfers result in losses to shareholders or creditors, they will have to meet the safeguards specified in the FSLAB, as discussed in paragraph 2.7.

2.6.3 General powers

2.6.3.1 *Stays on early termination rights*

In terms of the FSLAB provisions, placing a designated institution in resolution may not be considered a default event. The intention of these provisions is to ensure that counterparties may not consider resolution as an early default event that might give rise to early termination rights. These provisions will also ensure that cross-default clauses in agreements may not apply to a resolution.

The SARB may also issue moratoriums, including for the suspension of the designated institution's obligations in terms of the agreements it entered into before it was placed in resolution. Moratoriums will be for a limited period, which will be prescribed in a prudential standard, and will only be used in exceptional circumstances to mitigate the impact on financial stability.

2.6.3.2 *Control and management*

After the Minister makes a determination to place a designated institution in resolution, the control and management of the designated institution will vest in the SARB. The SARB will be responsible for the day-to-day management of the designated institution, which it may direct the resolution controller to execute on its behalf. (The role of the resolution controller is discussed in section 2.10.)

2.6.3.3 Liquidation

The SARB may, if a designated institution is or becomes insolvent, apply to the court to place the designated institution in liquidation. No other person than the person nominated by the SARB may be appointed as liquidator of the designated institution's estate.

2.7 Safeguards

Resolution empowers the SARB to act to protect financial stability. However, in doing so it needs to deliver an outcome that is broadly consistent with how losses would have been distributed in an insolvency and that leaves no creditor worse off than they would have been in liquidation (the NCWOL rule). When conducting a resolution, the SARB cannot act in disregard of the private interest of creditors and shareholders. The SARB's actions must not only be subject to the objectives of the FSLAB, but also to its safeguards, which are the following:

- i. The SARB's actions are subject to the rule that no creditor should be worse off as a result of resolution actions than would have been the case in liquidation. This rule prevents the SARB from taking an action that will result in creditors or shareholders bearing losses greater than the losses they would have suffered in liquidation.
- ii. When assigning losses in resolution, the SARB must respect the creditor hierarchy in the Insolvency Act 24 of 1936. The SARB must also ensure the *pari passu* treatment of creditors in the same class, unless a deviation is required to ensure that it conducts an orderly resolution and for financial stability to be maintained. However, deviation from *pari passu* treatment will be exceptional and only applied when there is a clear and convincing rationale for doing so. The baseline approach is to strictly follow the creditor hierarchy.

The FSLAB includes amendments to the Insolvency Act, including changes to the creditor hierarchy. These changes are presented in Figure 2 below. Losses in resolution will be assigned according to the amended hierarchy.

Figure 2: Creditor hierarchy in insolvency

Current	Amended
Secured creditors (up to value of security)	Secured creditors (up to value of security)
Preferred creditors	Preferred creditors
	Covered deposits
	Unsecured creditors (including uncovered deposits and non-qualifying debt instruments)
	Flac instruments
Unsecured creditors	Regulatory debt instruments (in the order as determined by the regulatory framework)

2.8 Open and closed resolution strategies

There are two generic approaches to resolution, namely open-bank resolution and closed-bank resolution. A simple distinction between the two is that, in the case of a closed-bank resolution, the bank ceases to exist in its current form under its own licence, while in an open-bank resolution, the bank continues to function in its existing form under its own licence.

The framework for closed-bank resolution remains largely unchanged, with some enhancements, such as a more refined creditor hierarchy and the introduction of explicit deposit insurance to compensate covered depositors up to the cover limit.

Strategies for closed-bank resolution are only feasible for smaller and less complex financial institutions, and focus mainly on ways to limit losses to creditors and depositors as well as contagion effects on the rest of the financial sector. Closed-bank resolution strategies include selling parts or all of the bank to private sector buyers, winding-down activities, transferring parts of the bank to another bank or bridge entity and funding such

transfers from the deposit insurance fund, or liquidating the bank and compensating depositors from the deposit insurance fund.

Liquidation should not be the default outcome for smaller banks that fail. Factors that will play a role in the choice of closed-bank resolution strategies include the reasons for failure, whether the bank has a viable business model, the probability that it can be restored to a viable entity, sources of financial support other than from government, and the possibility of a private sector solution. Only if these factors are largely absent or negative will liquidation be considered.

An open-bank resolution strategy is appropriate for banks that are too big and systemically important for any closed-bank resolution to be practically feasible, and will have severe negative consequences for financial stability and the real economy. The aim of an open-bank resolution strategy is to resolve a failing bank in such a way that the provision of critical functions and critical shared services⁶ continues without interruption. The bank stays open for business and is preserved in its existing form, at least initially, although it could be restructured over time if necessary to address the causes for failure and restore viability.

Open resolution strategies will be, at the minimum, developed for institutions that are designated as SIFIs because of their size, complexity, interlinkages with the rest of the financial system, cross-border activities and non-substitutability of critical functions. Box 2 sets out the process and criteria applied to designate SIFIs in terms of the FSRA.

Planning for and executing an open-bank resolution is discussed in more detail in parts 3 and 4 of this document.

⁶ Critical functions and shared services are discussed in paragraph 3.6.

Box 2: Systemically important financial institutions (SIFIs)

In terms of section 29 of the Financial Sector Regulation Act 9 of 2017 (FSRA), the Governor may, by written notice to a financial institution, designate the institution as a systemically important financial institution (SIFI). These SIFIs will have additional regulatory and resolution requirements in order to reduce the probability of their failure and to limit the impact of their failure on financial stability, should it occur. In accordance with the FSRA, the designation of a financial institution as a SIFI, or the revocation thereof, must be published. When making a determination to designate a SIFI, the FSRA prescribes that the Governor must take the following indicators into account:

- i. size of the financial institution;
- ii. complexity of the financial institution and its business affairs;
- iii. interconnectedness of the financial institution with other financial institutions;
- iv. whether there are readily available substitutes for the financial services and financial products that the financial institution provides;
- v. recommendations made by the Financial Sector Oversight Committee;
- vi. submissions made by or for the financial institution concerned; and
- vii. any other matter prescribed by the FSRA Regulations.

The SARB has developed a methodology to assist the Governor in identifying banks that should be designated as SIFIs and to ensure consistency in the designation. The SARB is currently in the process of designating the first set of banks as SIFIs.

2.9 Resolution phases

An open-bank resolution strategy will typically have two phases. The first phase is to stabilise the institution. The first stage comprises the immediate measures that the SARB has to take when an institution enters resolution in order to maintain financial stability. This phase focuses on all the actions necessary at the point of resolution to ensure that its critical functions continue without interruption, that it does not default on contractual obligations, and that contagion and the impact on the rest of the financial sector is contained. The key actions necessary at the point of entry into resolution are recapitalisation; reassuring the market through effective communication of a resolution plan and public support, where relevant; maintaining access to financial market

infrastructures; and ensuring that the bank has adequate funding and liquidity available to continue operating.

Entry into resolution will not itself address the cause of failure, and the stabilisation phase only provides the SARB with time for an orderly restructuring to address any problems in the balance sheet and to restore viability.

The second phase of an open-bank resolution consists of interventions over time to restore the bank's viability and to allow it to exit resolution as a going concern. When following an open-bank resolution strategy, the ultimate aim is not necessarily to preserve the entire legal entity in its existing form over the long term, but to preserve those parts of the institution that are necessary for the continuation of its critical functions and critical shared services, and for it to be a viable business. However, the entity exiting resolution may well be smaller and simpler than when it entered resolution.

2.10 The role of a resolution controller

The FSLAB requires the SARB to appoint a resolution controller when a designated institution is placed in resolution to assist the SARB in performing its resolution functions. The role of a resolution controller will be different from that of a curator and other similar functionaries provided for in the current frameworks dealing with the failure of financial institutions. In terms of the current provisions in the Banks Act 94 of 1990, a number of legal powers are assigned by the regulator to the curator. In terms of the FSLAB, all legal powers will continue to vest with the SARB, and the SARB will remain the authority responsible for exercising these powers and for taking the necessary resolution actions. The role of the controller will be to assist the SARB in the execution of the resolution strategy by performing the following functions:

- i. execute the day-to-day management of the designated institution on behalf of the SARB;
- ii. conduct meetings with creditors and other stakeholders;
- iii. ensure that the actions of the designated institution are in line with the resolution strategy set by the SARB; and
- iv. provide information for assessments and valuations.

Part 2 of this document highlighted the main elements of the resolution framework, as contained in the FSLAB. Because planning for and executing an open-bank resolution is more

complex than a closed-bank resolution, in particular if it involves a SIFI, Part 3 focuses specifically on planning for an open-bank resolution.

3. Planning for an open-bank resolution

3.1 Introduction

With the promulgation of the FSLAB, the SARB will take on additional legal responsibilities in terms of the resolution of designated financial institutions. With these responsibilities also come additional powers, as described in Part 2 of this document. However, the existence of additional legal powers will only address TBTF and enable the orderly resolution of a SIFI if they are supported by feasible resolution strategies and plans, resolvable institutions, and the capacity to execute resolution strategies, both in the SARB and in the banks involved. Resolution strategies and plans should facilitate the effective use of resolution powers to make the resolution of any bank feasible, without severe systemic disruption and without taxpayer solvency support.

Because resolution planning for an open-bank resolution is more complex, this part of the document focuses on resolution planning for an open-bank resolution. Planning for a closed-bank resolution could involve some of these elements, but not all, and would be scaled according to the size and complexity of the bank concerned.

3.2 Identifying banks subject to planning for an open-bank resolution

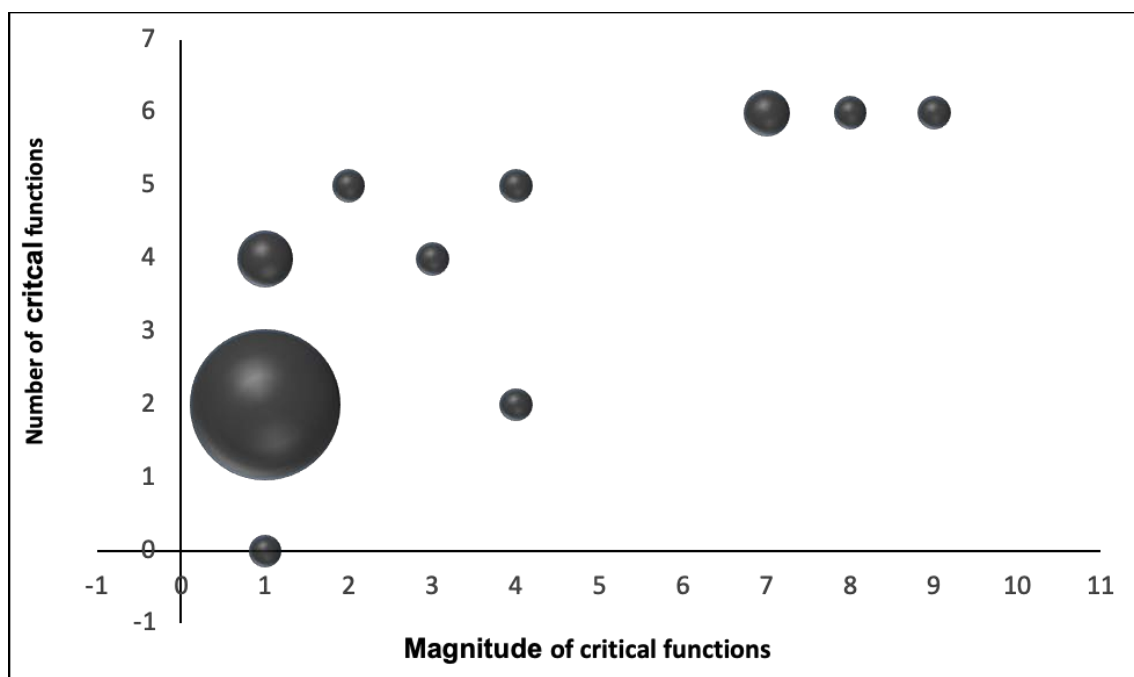
Resolution planning will be conducted proportional to the systemic importance of individual designated institutions. As discussed in paragraph 2.8, the first decision that the SARB will have to take with regard to resolution planning is, for which banks it will be practically possible to transfer, sell, wind down or liquidate, and for which banks there will be no option but to keep them open for business in resolution, in the interest of financial stability. The latter category is likely to be banks that have been designated as SIFIs. These banks are too big, too interconnected and too complex to put into liquidation without severe systemic effects and/or provide too many critical functions at such a scale that they cannot practically be transferred to another institution at the point of failure.

Figure 3 shows the distribution of South African banks on a matrix in which the y-axis shows the number of the critical services provided by a bank⁷ and the x-axis the scale

⁷ The number of critical services has been based on the Financial Stability Board's generic categories of critical services, as discussed in paragraph 3.6.1, and is therefore not an exact number based on individual bank assessments.

at which such services are provided relative to the total market, which is closely related to the size and systemic importance of the bank itself. The size of each bubble represents the number of banks that fall into a particular area of the matrix. This is not an exact distribution and will be refined in the process of actual resolution planning per bank. The underlying data are proxies and not a complete set of indicators. The figure does, however, illustrate the concentrated nature of the South African banking sector.

Figure 3: Distribution of South African banks



The largest bubble lies in the bottom left-hand corner, showing that most banks provide less than three of the generic critical functions that were used for the classification. These banks generally also provide the services on a relatively small scale. In most cases, these are small banks that provide deposit-taking and transactional services on a scale that these services could possibly be transferred or sold to another bank, and funded or paid out by the deposit insurance fund. Some foreign entities that have mainly trading activities also fall in this category. Resolution options for these banks should, to a large extent, already be contained in their recovery plans, only to be augmented by the ways in which the PA or the SARB could provide support to such recovery options.

A few banks lie in the middle area of the matrix. They provide a number of critical functions and are of a magnitude where it may become challenging, but not necessarily impossible, to wind them down, transfer or sell off parts of the business or liquidate a portion of the bank, and still be able to provide support or compensation from the deposit insurance fund. For these banks, the choice of a resolution strategy is not as

straightforward. They will have to be assessed on an individual basis to determine exactly which critical functions they provide, which obstacles to resolution exist and whether these could be overcome, and therefore whether they would fall in the category of open or closed banks for resolution planning purposes.

At least four banks definitely fall in the open-bank resolution category, and will require the development of comprehensive open-bank resolution plans and the capacity to execute these plans. These banks also typically form part of larger financial groups and have foreign operations, which will also have to be considered in their resolution plans.

From the distribution in Figure 2, it is expected that the SARB will have to develop, in cooperation with the banks involved, comprehensive open-bank resolution plans for between four and eight banks, with alternative strategies considered for the remaining ones.

3.3 Key elements of open-bank resolution plans

Resolution planning for an open-bank resolution should address a number of key elements, each of which are discussed in the subsequent paragraphs. The main elements in an open-bank resolution plan are the following:

- i. the identification of resolution entities in a financial group;
- ii. ensuring adequate loss-absorbing and recapitalisation capacity;
- iii. the identification of critical functions and shared services, and how to ensure operational continuity in resolution;
- iv. the quantification of funding needs and sources of funding available in resolution;
- v. continuity of access to financial market infrastructures;
- vi. strategies to wind down non-material activities and entities (including trading and derivatives);
- vii. cross-border cooperation in resolution;
- viii. the identification of barriers to resolution through resolvability assessments and how these are to be addressed; and
- ix. the restructuring plan.

3.4 Identification of resolution entities

The FSLAB requires that the SARB develop resolution planning for all designated institutions. In the case where a bank forms part of a financial group or conglomerate, all entities in a financial group will be designated institutions, unless, in accordance with subsection (2), the Governor specifically excludes certain entities from the definition by written notice. To avoid a situation where the SARB will have to include a multitude of entities in the resolution plan for a financial group, the SARB will, upfront, identify the entities in financial groups that will be excluded from the definition of designated institutions. All remaining entities will, by default, be designated institutions and form part of the group's resolution plan.

An important reason why it is important to identify which entities in a financial group should remain designated institutions is that, in terms of the FSLAB, resolution powers can only be applied to entities that have been placed in resolution, which can only be designated institutions. Resolution planning should provide for the application of resolution actions to particular entities in a group.

However, not all designated institutions in a financial group have to be put in resolution in the event of the failure of a SIFI in the group. On the contrary, the SARB would prefer to put as few as possible entities in resolution and to allow most entities in the group to continue with their operations without avoidable interference. As a general approach, entities in a financial group will only be put in resolution if it is necessary to take resolution actions for the recapitalisation and continued operation of the failed bank. The entities in a financial group that the SARB intends to put in resolution in order to apply resolution actions to them are referred to in this document as 'resolution entities' (REs).

REs can be identified for different purposes in resolution planning. Some REs will play a key role in the recapitalisation of the SIFI, in which case the bail-in power will be applied to these REs. Other REs may not be subject to any bail-in powers, but may require other resolution actions (such as restructuring and bridge bank arrangements) to be applied in order to achieve an orderly resolution of the SIFI. Some REs may be put in resolution for more than one purpose, for example for recapitalisation as well as restructuring and taking over management and control.

Exclusion from the definition of a designated institution does not necessarily mean that an entity is absolved from any obligations with regard to the resolution of the bank in the financial group. It is likely that some excluded entities in a financial conglomerate will play an important role in supporting an orderly resolution of the designated institution(s)

in the conglomerate. Although these entities can be excluded from being designated institutions, the supporting functions and services that they provide should still be included in the bank's resolution plan. The entities in a financial group that are excluded from being designated institutions, but still have to be included in the resolution planning for the designated institutions for the supporting functions that they will have to perform in resolution, are referred to as 'resolution support entities' (RSEs).

An important element of resolution planning for the SARB and the designated institutions will be to identify the RSEs in the financial conglomerate to which the designated institutions belong. RSEs will not be subject to the use of direct resolution powers, but will be required to support the resolution of the designated institution by, among other things, continuing to provide critical services, adhering to agreements or providing financial services and/or liquidity.

3.5 Loss-absorbing and recapitalisation capacity

A key element of open-bank resolution planning is to determine the appropriate amount and location of loss-absorbing and recapitalisation instruments in a financial group that would facilitate an orderly resolution. Without such resources, bail-in is not a viable option and the only remaining option is a bail-out by government. This section motivates the need for loss-absorbing and recapitalisation instruments, and highlights the factors that may affect the required amounts and location of such instruments.

3.5.1 Regulatory capital and Flac instruments

A prerequisite for an open-bank resolution is the availability of adequate resources to absorb going-concern losses and to recapitalise the firm in resolution to a minimum required level, through bail-in. Loss-absorbing capacity (LAC) refers to the amount of equity and debt instruments available on a bank's balance sheet that can be readily bailed in, first, to absorb any further losses that transpire at the POR and, second, to recapitalise the institution to a level that will allow it to meet the minimum requirements set by the PA for it to remain a licensed bank.

The FSLAB allows for all liabilities, except those stipulated in clause 166R, to be subject to bail-in in order to absorb losses. Although legally possible, there are practical impediments to bailing in many of these liabilities. For example, the unexpected bail in of, for example, deposits that are not covered by the Deposit Insurance Scheme may

well exacerbate the financial stability risks of such a decision. Furthermore, there may be time-consuming operational challenges associated with identifying and locating liability holders as well as with the valuation of certain liabilities subject to the bail-in.

To overcome these complexities and possible adverse consequences, the FSLAB allows the SARB to require the issuance of Flac instruments, which will form a pre-identified, transparent tranche of funding instruments available for bail-in at the POR. The holders of these instruments should be informed investors who are aware of the risks associated with their investments, able to assess these risks and be accordingly compensated through the returns they receive. In terms of the creditor hierarchy (read with the provisions of the FSLAB), Flac instruments will be subordinated to unsecured liabilities but will rank senior to regulatory capital instruments.

The requirements of Flac instruments should be designed in such a way that it limits the contagion impact of bailing in these instruments. Box 3 sets out some of the proposed characteristics of funding instruments to qualify as Flac instruments.

Box 3: Proposed characteristics of Flac instruments

The proposed requirements that instruments will have to meet in order to qualify as Flac instruments include the following:

Approval

The designated institution needs to obtain the prior written approval of the Prudential Authority before issuing the instrument.

Fully paid

The instrument must be issued and fully paid by the investor.

Unsecured

The instrument must not be secured nor covered by any form of guarantee or collateral or any other arrangement that could change the subordination of the instrument.

Not subject to set-off

The agreement must not be subject to any set-off obligation or requirement.

Minimum remaining maturity of 12 months

The instrument must have a minimum remaining maturity of 12 months.

Contractual subordination

The agreement must state that the instrument is subordinated to other unsecured liabilities, excluding instruments that count towards the designated institution meeting its regulatory capital requirements.

Derivative features

The instrument must not have any derivative or derivative-linked features.

Non-redeemable

The instrument may not be callable or redeemable prior to its maturity.

Funding

The instrument must not be funded, directly or indirectly, by the designated institution or its holding company.

Trading

The designated institution must not be a market maker for the instrument in the secondary market.

Issuer

The instrument must be issued by the designated institution in its own name and not by a special purpose vehicle or other related party.

Holder

Instruments held by another designated institution will not qualify as a Flac instrument.

Acceleration

The instrument must not contain any right to accelerate repayment prior to maturity.

Applicable law

The agreement must state that it is be subject to South African law.

Minimum denomination

The instruments must be issued in minimum denominations of at least R1 million.

3.5.2 Calibration of Flac requirements

The regulatory capital of a bank is designed and calibrated to absorb losses on a going-concern basis, in line with the business model and risk profile of the bank concerned. Although resolution should be triggered proactively to ensure that a certain amount of value is protected, it can be assumed that a certain level of regulatory capital would have been depleted at the POR. It is also possible, even likely, that not all losses may be

reflected in the bank's financial statements and regulatory returns at the POR. The resolution valuations could reveal losses not previously stated, resulting in the further erosion of regulatory capital. In addition, there will be costs involved for the resolution actions and to restore the underlying causes of failure, which have to be provided for. All these losses and costs are likely to further erode any remaining regulatory capital.

The resolution authority will be responsible for ensuring that there is a sufficient amount of Flac instruments available to be bailed in at the POR in order to recapitalise the bank. Various jurisdictions have set their total loss-absorbing capacity (TLAC) at double the regulatory capital requirement, excluding buffers. It is premature for the SARB to adopt the same approach without the necessary consultation with the regulators, the market and individual banks. In order to contribute to an informed decision on the calibration of Flac instrument requirements, a comprehensive impact study has been commissioned with the support of the World Bank. The study will be conducted between July and December 2019. PwC has been selected as the service provider. The objective and expected outputs of the study, as extracted from the terms of reference, is set out in Box 4.

Taking into account the findings of the study, the following considerations will also inform the SARB's decision on Flac requirements:

- i. The SARB's assumptions about the residual levels and composition of regulatory capital the institution may have at the POR. This may also include assumptions on the designated institution's own funds that do not qualify as regulatory capital, for example preference shares.
- ii. The level and composition of regulatory capital that will be required for the bank to maintain its authorisation in the interval between entering and exiting resolution. These requirements will be determined in consultation with the PA. The PA will also have to indicate whether the institution will be required to meet all the capital buffer requirements and/or requirements for both Pillar 1 and Pillar 2 capital.
- iii. An estimate of the level of capitalisation that will be required to restore market confidence.

Box 4: Feasibility and cost-benefit analysis of using bail-in as a recapitalisation mechanism in South Africa

The purpose of the project is to obtain market information required for the formulation of an optimal set of characteristics for Flac instruments and the calibration of Flac requirements for South African banks. The outcome of the project should be a comprehensive analysis that will form the basis for consultation with key decision makers and industry in the process of establishing appropriate Flac requirements for South African banks with open-bank resolution plans. The information to be obtained should include the following:

- a. comparative information about the impact of the minimum requirement for own funds and eligible liabilities (MREL), total loss-absorbing capacity (TLAC) and similar requirements in other G20 countries on the costs of these instruments and on the overall cost of bank funding;
- b. the potential supply and appetite among domestic and foreign investors (in terms of size, location and composition) for Flac instruments issued by South African banks that have been declared as SIFIs;
- c. factors that would affect the appropriate calibration of a Flac requirement, such as the minimum level and composition of regulatory capital that a bank should have when exiting resolution in order to participate in financial markets as a credible counterparty;
- d. a feasible level of Flac requirements as well as an appropriate time frame over which to phase in such requirements;
- e. a minimum set of characteristics for Flac instruments that will ensure a balance between a credible bail-in capacity and an adequate market breadth and depth for these instruments – the project should indicate which characteristics are essential for credibility, which are optional, and which will be too problematic to require in the South African context;
- f. the expected impact of Flac requirements on the cost of Flac instruments issued by South African banks with open-bank resolution plans, as well as on banks' average cost of funding – this cost is likely to differ among the individual banks involved;
- g. the potential reduction in the cost of funding of tranches senior to Flac instruments;
- h. the expected impact of requiring banks to issue Flac instruments from their holding companies rather than from the operating entities, and the time frame over which such a requirement could feasibly be phased in;
- i. investor preferences with regard to different bail-in mechanisms (i.e. write-off, conversion or a combination); and
- j. the estimated net cost or benefit of imposing Flac requirements for banks and for the financial system.

3.5.3 Location of Flac instruments

Flac instruments could potentially be issued by the holding company of a bank or by the bank itself. The location of Flac instruments issued to external creditors will be one factor in determining whether an RE will be put in resolution in order to execute bail-in. If most of the Flac instruments are located in the bank, the bank itself will have to be put into resolution in order to use the bail-in power. If all Flac instruments are issued by the holding company, it may be possible to put only the holding company in resolution, provided that there are intragroup matching internal recapitalisation mechanisms in place to facilitate a smooth and certain downstreaming of capital to the operating bank, and that no other resolution powers are required to be executed on the operating bank.

There are clear benefits associated with recapitalising at the holding company, thereby maintaining the structural subordination of Flac holders at the holding company. The benefit of this approach is that (i) the ownership structure of the operating company remains unchanged, and (ii) it simplifies the recapitalisation through the internal upstreaming of losses to the holding company.

Although issuing the Flac instruments from the holding company would be the ultimate preferred strategy of the SARB, this may be difficult to achieve in the interim due to the prevailing funding structure of banking groups.

The FSLAB provides the SARB with flexibility regarding the location of Flac instruments. Once the findings of the feasibility study referred to above are available, and pending the outcome of industry consultation and bank-specific discussions on the issue, more guidance on the location of Flac instruments will be included in a regulatory standard. This guidance should provide adequate certainty to investors regarding the location of Flac instruments and the mechanisms that will be applied to recapitalise the bank. In all circumstances, the creditor hierarchy and safeguards in the FSLAB should be respected.

The need to place REs in resolution will be dependent on the structure of the conglomerate as well as on the cause and nature of the failure of the SIFI, as explained in elementary examples below:

Example 1:

A bank suffers losses that result in a need for recapitalisation, but that do not require any other resolution actions to be applied to the bank to restore viability. If adequate loss-absorbing capacity is situated in the holding company, only the holding company can be placed in resolution to bail in external holders of Flac instruments in the holding company and recapitalise the SIFI through internal transactions. In this example, both the SIFI and its holding company will be designated institutions and REs, but the scenario will require only the holding company to actually be put in resolution.

Example 2:

If, in addition to the recapitalisation in Example 1, the bank needs to be restructured or any other actions have to be taken at the level of the bank or another RE in the group, those entities will also have to be placed in resolution. It may still be that in this case the bail-in of external creditors is only done at the level of the holding company, but the other REs may have to be put in resolution in order to apply other resolution actions to them.

Example 3:

If recapitalisation of the bank is required and Flac instruments are held by both the holding company and the operating bank, both the holding company and the bank will have to be put in resolution in order to apply bail-in at both levels.

It is generally clearer to the market if bail-in occurs at one place in a financial group, and it is the preference of the SARB that it should eventually be possible to apply bail-in only at the level of the holding company. The extent to which this can be achieved will depend as much on the industry itself as on the banks. Policy decisions about the extent to which this approach will or can be enforced over time will be taken in due course, depending on the outcome of the feasibility study on Flac instruments and resolution planning engagements with individual banks.

In the public consultation on the FLSAB, questions about whether the SARB will use a single point of entry (SPE) or multiple point of entry (MPE) approach to resolution were raised. Box 5 puts these concepts into context. It is the SARB's view that clear communication regarding which entities in a financial group will be subject to bail-in in resolution is more important than categorising its strategies as either MPE or SPE.

Box 5: Some context on single point of entry and multiple point of entry

In a consultative document issued by the Financial Stability Board in 2012 titled *Making the Key Attributes requirements operational*, the concepts of single point of entry (SPE) and multiple point of entry (MPE) into resolution were introduced. These concepts were introduced in the context of cross-border cooperation in resolution planning and firm-specific cooperation agreements between home and host authorities at the time applicable, mainly to globally systemically important banks with extensive operations across many jurisdictions.

The consultative document sets out the factors that will determine whether either an SPE or MPE strategy will be more appropriate, and the preconditions for either of the strategies to be successful. The concepts of SPE and MPE were further entrenched in a cross-border resolution context in the 'Total loss-absorbing capacity (TLAC) term sheet' that was issued by the Financial Stability Board in 2015.

Although the concepts of SPE and MPE could be applied to the distribution and location of the loss-absorbing capacity within a domestic financial group (i.e. between the holding company and the operating bank), it should be kept in mind that its original intention was to describe the distribution and pre-location of loss-absorbing capacity across borders, in different jurisdictions. In this context, South Africa intends following an SPE approach. Because South African banks' foreign operations are relatively small compared to the group, recapitalisation will occur at the parent company and downstreamed to foreign operations through internal arrangements, if necessary.

The SARB will refrain from using the SPE and MPE terms because of the varying meanings attached to it. The important considerations in South Africa's approach are:

- i. whether Flac instruments are, or should be, issued by a holding company or its operating company; and
- ii. which entities in a group are placed in resolution, either for recapitalisation or restructuring.

3.6 Operational continuity in resolution

3.6.1 Identification of critical functions

In an open-bank resolution, the uninterrupted continuation of critical functions, and of the critical shared services that support these functions, is an essential element of an orderly resolution in the interest of financial stability. To achieve this, resolution plans should strategically identify all the critical functions that should be preserved in resolution.

The FSB⁸ defines critical functions as “activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability due to the banking group’s size or market share, external and internal interconnectedness, complexity and cross-border activities”.

The FSB guidance recommends a three-step approach to the identification of critical functions, namely:

- i. Assessing the impact of the failure or discontinuation of a function on third parties, both directly and through interlinkages. This step is not firm-specific, but focuses on the nature of the function itself.
- ii. A supply-side analysis of potential providers of these functions, and whether it could potentially be provided by other firms.
- iii. An assessment of the criticality of a function for a specific bank. Even if, from an assessment in step (i), a function is critical, it may not be critical for a specific firm, for example, if it is not performed at a material scale or can easily be substituted by other firms.

The SARB will, in cooperation with banks, identify which critical functions are performed. The resolution plan should address all measures necessary to ensure that these services can continue uninterrupted in resolution. This will require an assessment by each designated institution according to the detailed guidance provided by the FSB.

In its guidance the FSB identifies the following broad categories of functions and services that could involve critical functions, provided that the criteria of materiality, substitutability and impact on customers are met:

⁸ Financial Stability Board, ‘Recovery and resolution planning for systemically important financial institutions: guidance on identification of critical functions and critical shared services’, 16 July 2013.

- i. deposit taking;
- ii. lending and loan servicing;
- iii. capital market participation and investment activities;
- iv. participation in wholesale funding markets;
- v. payment, clearing and settlement services; and
- vi. custody services.

3.6.2 Critical shared services

In addition to identifying critical functions, designated institutions will also need to do an assessment and map their critical shared services for purposes of resolution planning. These are services provided by the SIFI itself or outsourced to third parties that are necessary to support the continued provision of critical functions. If these services become unavailable, it would lead to an inability to perform the critical functions.

The FSB provides examples of different categories of shared services that could be important for operational continuity in resolution. The following is a summary of some of these services:

- i. Finance-related shared services: Treasury functions, accounting, statutory and regulatory reporting, collateral management, trading and asset management, risk management, cash handling and distribution, etc.
- ii. Operational shared services: Human resource services, the availability of information technology services and support, the ability to process transactions, facilities management, legal services, etc.

3.6.3 Operational continuity in resolution

The SARB approach will incorporate the guidance provided by the FSB. These documents assisted the SARB in identifying appropriate criteria to assist in ensuring operational continuity in resolution (OCIR). The SARB has also considered how the FSB guidance has been adopted by the authorities in member jurisdictions, including the Bank of England, the United Kingdom Prudential Regulatory Authority, the European Banking Authority and the European Single Resolution Board.

OCIR refers to the capability of a bank in resolution to continue with its critical functions and the operations that support these functions. An important element of resolution planning is to put mechanisms in place to ensure that services continue to be provided

to a bank in resolution, for example through contractual arrangements between the designated institution and service providers.

There are two areas where resolution planning will need to ensure that OCIR has been addressed, namely:

- i. outsourcing arrangements and agreements with third parties; and
- ii. insourcing arrangements within the group.

The aim of OCIR is to improve the governance of critical functions and services to ensure that they can continue without interruption during all the phases of a resolution. Services should be clearly documented, contractually protected and have adequate liquidity to continue in resolution. To achieve these goals and to ensure operational continuity, the SIFI will have to confirm that the following is in place:

- i. Adequate liquidity should be available to ensure that the critical functions can continue to be delivered, even during resolution.
- ii. Contractual provisions, including service level agreements and transitional service agreements, should be in place to ensure that the firm providing the function or services is obliged to continue the service and that this obligation cannot be altered in any way even when the institution is in resolution.
- iii. The management information systems should be able to identify critical shared services on a legal-entity and line-of-business basis.
- iv. The management information systems should also be able to provide information about ownership of assets and outsourcing arrangements.
- v. Access to operational assets by the critical shared service providers should not be disrupted by the failure or resolution of any particular group or entity. In some cases, this may require that operational assets essential to the provision of critical shared services are owned or leased by the same legal entity providing those critical shared services. In other circumstances, where ownership is not possible, contractual provisions should be put in place to ensure that rights of access will be maintained.
- vi. The firm should have formalised processes and procedures in place to identify and retain personnel required for the provision of critical functions.
- vii. A record of the operational, legal and governance structure of the service provider, which includes the jurisdiction where the services are centralised, as well as pricing arrangements and the location of operational assets, should be in place.
- viii. Where the critical services are provided by an intragroup company, an analysis

must be performed to assess the ability of the institution to provide such services in resolution.

The SARB will expect a bank to be able to demonstrate (within a reasonable time frame) how its operational arrangements will be able to support OCIR in the interest of an orderly resolution.

3.6.4 Service agreements

The SIFI should ensure that agreements are updated to require its counterparties to continue providing services during a resolution and to support the actions that the SARB may take. The requirements that banks will have to meet are set out in Box 6.

Box 6: Service agreements and governance arrangements

- i. The agreements governing the provision of critical functions should be sufficiently documented, at least including the following:
 - the provider and recipient of the service;
 - nature of the service;
 - a transparent pricing structure;
 - measures that can be used to evaluate the service provided;
 - continued provision of services during a resolution;
 - exclusion of resolution from being considered as a default event;
 - substitution clauses to provide for the continuation of critical functions and critical shared services;
 - ensuring that the contract makes provision for the cost of the services to remain at arm's length, even in resolution; and
 - ensuring that the designated institution's provider of critical functions continues to provide the said functions, as per normal, even in the event where another group member shows signs of financial difficulty.
- ii. SIFIs should be able to demonstrate how access to services supporting critical functions will be maintained during resolution. Where this cannot adequately be demonstrated, the SARB might require these services to be owned or leased by the institution that receives the services supporting a critical function.
- iii. The institution should be able to describe how critical services will be influenced

if it enters resolution. This includes the following:

- How the operational arrangements make provision for separability and restructuring. This is especially relevant in a situation where a resolution action could include the disposal of certain entities or business units that provide critical functions.
 - How the operational arrangements allow certain identified entities to be ring-fenced from the wider group.
- iv. The outsourcing of functions does not eliminate the responsibility of the systemically important financial institution (SIFI) to manage and mitigate risk tolerance levels, and any amendments to agreements have to comply with regulatory requirements, in particular directive 8/2016. In the case where the critical function is provided within the group, the SIFI should ensure that the service provider has the necessary governance arrangement in place to meet regulatory requirements. When critical services are provided by external parties, it is expected that the designated institution can prove that the necessary governance and oversight arrangements are in place.
- v. Staffing arrangements of critical service providers should allow for operational continuity in resolution, for example by ensuring that:
- critical staff of the entity who provide the critical service do not perform significant duties for other entities within the group and, in such cases where other duties are performed, the duties related to the entity that provides critical services take priority during a resolution;
 - critical staff members receive the majority of their remuneration package from the entity providing the service; and
 - the critical service provider has sufficient senior management available to ensure the continuation of services in a resolution.

3.7 Funding in resolution

An open resolution strategy requires the designated institution to continue with its operations. For this purpose, the institution will need to have sufficient funding available in resolution. An important element of a credible resolution plan is to assess the likely funding needs and identify potential sources of funding in resolution. This section

focuses on the requirements that designated institutions have to meet for funding in resolution.

3.7.1 Resolution funding requirements and private sources of funding

Banks will be required to determine their funding needs as part of resolution planning, and to ensure that their management information systems enable them to monitor and report on their possible funding needs during a resolution.

Guidance by the FSB states that banks should have the capabilities in place to monitor, report and estimate funding needs in resolution (*Funding strategy elements of an implementable resolution plan, 2018*). This entails that the bank should be able to measure sources and the positioning of liquidity, estimate funding needs in resolution, report liquidity information on a regular basis and in a timely manner, and identify and rapidly mobilise assets that could be used as collateral. Any operational, legal and regulatory impediments to accessing and mobilising liquidity, including on a cross-border intragroup basis, should be identified and removed, to the extent possible, as part of resolution planning.

Funding in resolution should be sufficient to ensure the continuity of critical services in a resolution. Banks will also have to largely meet their regulatory liquidity requirements. Determining liquidity needs in resolution should include a viable path for the bank to restore its compliance with regulatory requirements, such as the liquidity coverage ratio (LCR), to sufficient levels that will allow the regulators to maintain its authorisation as a bank, and for it to have continued access to the ordinary monetary operations of the SARB.

To help ensure sufficient funding in resolution, a designated institution should put measures in place that will enable it to estimate its liquidity and obligations in resolution. These measures may include measures to:

- i. understand the legal, regulatory or operational obstacles to transferring funds between entities;
- ii. estimate the aggregate amount of liquidity needed to ensure that material operating entities can be stabilised and continue to operate without disruption in resolution or to allow them to be wound-down in an orderly manner;

- iii. estimate the liquidity required to meet all obligations related to their payment, clearing and settlement activities, including any change in demand for and sources of liquidity needed to meet such obligations;
- iv. estimate the potential liquidity effects of adverse actions by market infrastructures;
- v. model expected counterparty behaviour and include relevant counterparty requirements, such as increased initial or variation margin requirements, during resolution;
- vi. identify and measure, for each material operating entity, intraday liquidity needs, operating expenses and working capital needs.

With regard to the sources of funding, the guiding principle is that a bank's internal liquidity sources and access to private financial markets should be the preferred source of funding in resolution. To this end, the resolution funding plan should:

- i. identify firm assets and private sources of funding that may be available in resolution, and the time frames within which such funding should become available;
- ii. the extent to which those sources of funding can meet the funding needs of the bank in resolution in different stress scenarios; and
- iii. identify the process to use such sources of funding, including the mobilisation of unencumbered assets as collateral and the distribution of funding throughout the group. (FSB Guidance, 2018.)

The sources of funding in a bank's recovery plan and any contingency funding arrangements available, if done properly, will provide a good basis for the assessment of private sources of funding.

3.7.2 Funding support by the SARB

Although access to private funding is the preferred option in resolution, the bank may need additional liquidity from the SARB if it cannot source adequate funding on its own. In South Africa's concentrated financial market, it is expected that entry into resolution will close certain sources of funding and liquidity that the bank had previously counted on.

In addition to the normal liquidity facilities provided by the SARB, section 10 of the South African Reserve Bank Act 90 of 1989, as amended (SARB Act) provides the SARB with the power to provide emergency lending assistance (ELA), without limiting the types of

institution that could be a recipient of ELA. The only condition is that any lending by the SARB, including ELA, should be collateralised. This implies that the bank should have suitable collateral available for ELA. Resolution planning should focus on the identification of acceptable pools of collateral for ELA, getting draft contracts in place, and making it operationally quick to mobilise this collateral.

The SARB Act is interpreted in terms of the mandate of the SARB, which implies that ELA should also contribute to financial stability. Not all the conventional Bagehot criteria for providing ELA may be suitable in a situation of an open-bank resolution:

- i. The first criterion is that a bank should be solvent. There may be significant doubt about the solvency of an entity at the POR. However, solvency should be restored by the recapitalisation process.
- ii. The second criterion is that ELA should be provided at a penalty rate. The historic purpose of this requirement was to discourage banks from relying on ELA as a source of funding unless there is no other option. In resolution, a bank will already be under strain, facing significantly higher costs of private sector funding and recapitalisation needs, and will have limited other options to access liquidity. Although ELA should not be free, making the cost and conditions for ELA too punitive will only increase the burden on the bank and reduce the viability of the resolution. In addition, moral hazard will be addressed by writing down or converting shareholders and subordinated creditors.
- iii. The third criterion is that ELA lending should be against good collateral. In this regard, much can be achieved in resolution planning if the SARB and the banks identify, package and mobilise pools of good collateral in good times, to be available for ELA in the event of a resolution.

South African banks are allowed to apply for a committed liquidity facility (CLF) with the SARB, which is a going-concern facility provided at a fee against pre-approved sets of high-quality collateral. The CLF was initiated as an alternative approach under the Basel III liquidity framework for banks to meet their LCR. The benefits of agreeing on a committed facility are the speed and ease with which liquidity can be provided when legal agreements and collateral arrangements are pre-established.

The CLF is in the process of being phased out as a regulatory instrument that counts towards the LCR. In order to maintain the benefits associated with the current CLF, the SARB is considering alternatives to possibly replace the CLF as a regulatory instrument with a facility specifically designed for recovery and/or resolution purposes. This will

also entail a review of the entire approach to ELA, including the SARB's approach to the transparency of ELA and the pre-positioning of collateral.

3.8 Continuity of access to critical financial market infrastructures

The SARB's approach to ensuring access to critical infrastructures will be informed by the standards and guidance issued by the FSB, including the FSB's *Guidance on Continuity of Access to Financial Market Infrastructures for a Firm in Resolution*, published in July 2017.

Maintaining access to critical financial market infrastructures (FMIs) is essential to ensure that a bank's critical functions can be maintained during resolution. The SARB, financial sector regulators, designated institutions and FMIs will need to work together to develop measures to ensure the continued access of designated institutions to critical FMI services during resolution. The SARB will need to engage, cooperate and have appropriate ex ante information-sharing arrangements in place with financial sector regulators and FMIs.

Designated institutions will need to assess their FMI services, map their activities and instruments to different FMIs, and put in place arrangements with the operators of these infrastructures to ensure they continue to meet the requirements during resolution. Box 7 sets out possible requirements that will contribute to ensuring that access to FMIs is maintained during a resolution.

Box 7: Requirements for access to market infrastructures

Arrangements by providers of market infrastructure services

To give effect to the provisions of the resolution framework, a financial market infrastructure (FMI) should have the following arrangements in place:

- i. make provision in its rule book (or similar instruments) to enable continued access to critical market infrastructure services by a designated institution;
- ii. identify and communicate the range of possible actions and requirements it may impose on a designated institution in resolution; and
- iii. identify operational and other implications of a transfer of operations or positions of a designated institution in resolution to a successor entity.

Arrangements by banks that use the services of market infrastructures

Designated institutions need to assess their participation in FMIs and put in place arrangements with the FMI operators to ensure continued access to services. These include:

- i. arrangements to provide information regarding a designated institution's reliance on critical market infrastructures services;
- ii. contingency plans and arrangements detailing how the designated institution would ensure that it continues to meet its obligations (including risk management and participation requirements) to the relevant market infrastructures during resolution;
- iii. contingency arrangements for the continuation of critical functions should its access to a market infrastructure be terminated or suspended; and
- iv. arrangements to ensure that it is able to provide necessary information to the authorities during resolution.

3.9 Valuation capabilities

The FSB document titled 'FSB consults on making the Key Attributes requirements operational' provides guidance regarding valuation requirements. These requirements include:

- i. which valuations are required and the valuation principles that would be applied (e.g. going concern or gone concern);
- ii. the information that will be required for that valuation;
- iii. the point in time at which the valuation is to take place;
- iv. any need to appoint an independent valuer; and
- v. timelines for each of these aspects.

The FSB guidance makes it clear that home and host authorities should aim to address difficulties in ascertaining the value of assets and liabilities in the resolution planning process. Due to the time constraints in resolution, authorities may have to rely on preliminary assessments or estimates. Therefore, making decisions on the basis of valuations that are not final should be allowed.

The FSB also published its *Principles on Bail-in Execution* in 2017, which provides authorities with guiding principles on valuation in order to plan and execute a bail-in. These guiding principles state that valuations should enable the following:

- i. determine whether the conditions for resolution or the conditions for the contractual write-down and/or conversion into equity of regulatory capital instruments have been met;
- ii. estimate losses, which may inform the resolution strategy;
- iii. determine the write-down and conversion rates, for example the value of the securities that creditors will receive in exchange for their claims; and
- iv. assess whether the NCWOL safeguard has been met.

Valuation is a complex component of resolution that has to be performed at a sufficient standard to ensure that resolution actions are properly executed. In addition, valuation also has to be performed under time constraints to avoid further erosion of value and provide the best probability of an orderly resolution.

Especially due to the time constraint, South Africa plans to perform one internal valuation and two independent valuations. The internal valuation will be used to meet the requirements in (i) above. The two independent valuations will be conducted to address (ii) to (iv).

The SARB will develop standards and guidance notes to assist in achieving the above requirements by:

- i. setting the minimum requirements that designated institutions have to comply with to ensure that their management information systems are able to provide the relevant information and execute the required valuation capabilities to allow the SARB to plan for resolution. Banks' management information systems should be able to provide the independent valuer with the relevant information within the required time frame to execute the independent valuations;
- ii. providing the minimum requirements that an independent valuer should meet in order to perform such a valuation; and
- iii. providing the criteria and assumptions that should be utilised when performing a valuation.

3.10 Cross-border cooperation in resolution

The *Key Attributes* contain a number of provisions that support cross-border cooperation and information-sharing, which includes removing obstacles that prevent information-sharing and the establishment of crises management groups (CMGs).

In the FSB's document *Making the Key Attributes Requirements Operational*, it is stated that firm-specific cross-border cooperation agreements (CoAGs) should be put in place to guide the activities of CMGs in planning, coordinating and implementing resolutions. In addition to providing a general framework for sharing information in CMGs, CoAGs need to relate directly to the resolution strategies and plans, incorporating commitments of home and key host authorities to cooperate and implement a resolution strategy, and setting out the process for taking decisions in a timely manner. Authorities may enter into bilateral agreements that may complement firm-specific CoAGs. Institution-specific CoAGs should:

- i. establish the objectives and processes for cooperation through CMGs;
- ii. define the roles and responsibilities of the authorities before and during a crisis;
- iii. set out the process for information-sharing before and during a crisis, including sharing with any host authorities that are not represented in the CMG;
- iv. set out the processes for coordination in the development of the resolution plans;
- v. set out the processes for coordination among home and host authorities in the conduct of resolvability assessments;
- vi. include agreed procedures for the home authority to inform and consult with host authorities in a timely manner when there are material adverse developments affecting the firm and before taking any significant action or crisis measures;
- vii. include agreed procedures for the host authority to inform and consult with the home authority in a timely manner when there are material adverse developments affecting the firm and before taking any discretionary action or crisis measure;
- viii. provide an appropriate level of detail with regard to the cross-border implementation of specific resolution measures, including with respect to the use of bridge institutions and bail-in powers;
- ix. provide for meetings to be held at least annually; and
- x. provide for regular (at least annual) reviews by appropriate senior officials of the operational plans implementing the resolution strategies.

Resolution strategies, operational plans and CoAGs will need to be maintained as living documents which are to be improved and updated over time. In particular, they will need to be developed and amended to take account of changing circumstances, including

changes in the macro environment, the bank's organisation and structures, and the national resolution powers and funding arrangements in home and host authorities.

From a SARB perspective, MoUs should be in place with central banks of host jurisdictions in which South African banks have operations that are either significant to the financial group or significant to the host jurisdiction. Currently, the PA has MoUs in place with all host jurisdictions in which South African banking groups have operations for the purpose of sharing regulatory information. These MoUs will have to be reviewed and expanded on to ensure that they adequately take into account resolution-related information requirements. The SARB will also put in place institution-specific CoAGs to supplement the MoUs. In instances where the resolution authorities in host jurisdictions are entities other than the regulators, for example deposit insurance agencies, these CoAGs will also have to include these entities.

Arrangements for resolution purposes will reflect the division of responsibilities between home and host country authorities. The SARB will aim to develop its resolution strategies in a way that limits adverse effects on host jurisdictions.

3.11 **Resolvability assessment and removal of barriers to resolution**

The identification of barriers to resolution through resolvability assessments and interventions to remove or reduce such barriers are critical requirements to ensure that the SARB is able to conduct an orderly resolution. Resolvability assessments form part of resolution planning and will be conducted as a joint effort between the SARB and the banks, during which all elements of the resolution plan will be covered. Banks will be required to undertake certain actions to ensure that they are structured in a manner that supports the execution of the resolution strategy.

The SARB's approach in conducting resolvability assessments will follow the guidance issued by the FSB. The FSRA enables the SARB to direct the PA to impose certain requirements on designated institutions. The scope of the directives will be expanded by the FSLAB to include the actions necessary to achieve the resolution objectives.

While a final assessment of resolvability as part of resolution planning will be the responsibility of the resolution authority, designated institutions will be required to undertake self-assessments to inform this decision. These assessments may include:

- i. identification of barriers related to its group structure;

- ii. availability and adequacy of the loss-absorbing capacity;
- iii. adequacy of the designated institution's arrangements to ensure operational continuity in resolution;
- iv. adequacy of arrangements to facilitate the designated institution's continued access to market infrastructures during resolution; and
- v. the designated institution's arrangements to facilitate effective internal and external (including with authorities) communication as well as continued access to market infrastructures.

3.12 Concluding remarks on resolution planning

In terms of the FSLAB, resolution planning will be a process that is performed on an ongoing basis, alongside regulation and supervision. Planning for failure will no longer be an activity that only takes place when a bank faces difficulties or approaches a point of non-viability. Resolution plans have to be developed irrespective of a bank's probability of failure. Some of the lessons of the global financial crisis that led to the requirement for resolution planning were that (i) big banks can also fail, and (ii) even healthy banks can fail if the external environment deteriorates sufficiently and rapidly.

Resolution planning does more than prepare for resolution: the planning process in itself often leads to more resilient institutions by looking at the structure and operations of a bank through a different lens. Banks that are structured for an orderly failure understand their own businesses better, have more insight into their own vulnerabilities and take efforts to strengthen these.

Resolution planning also improves market discipline. If investors are convinced that resolution plans are feasible, market pricing starts to reflect the true underlying risks of individual banks, and investors start to reward well-managed banks relative to badly managed banks. As long as investors believe that big banks will be bailed out by government, all banks have equal risks for investors and, as a result, risk is not accurately priced.

Lastly, resolution planning is not an event, but an iterative process in which resolvability assessments continually lead to further improvements. Resolution planning for globally systemically important banks has been ongoing for over six years, and yet there are many areas that still need improvement.

4. Conducting an open-bank resolution

4.1 Introduction

The resolution of all banks will start with the decision-making process between the SARB and the Minister, once the SARB concludes that the POR is being approached. As a result of this process, the Minister will determine whether the bank should be placed in resolution.

After the decision by the Minister has been taken, the bank will enter resolution. An open-bank resolution has three phases. The stabilisation phase of the resolution starts once the public announcement is made. However, the actual resolution is likely to take several months, or even longer, to complete. This second and longer phase, during which viability is restored, is referred to as the restructuring phase. The last phase is when the bank exits resolution.

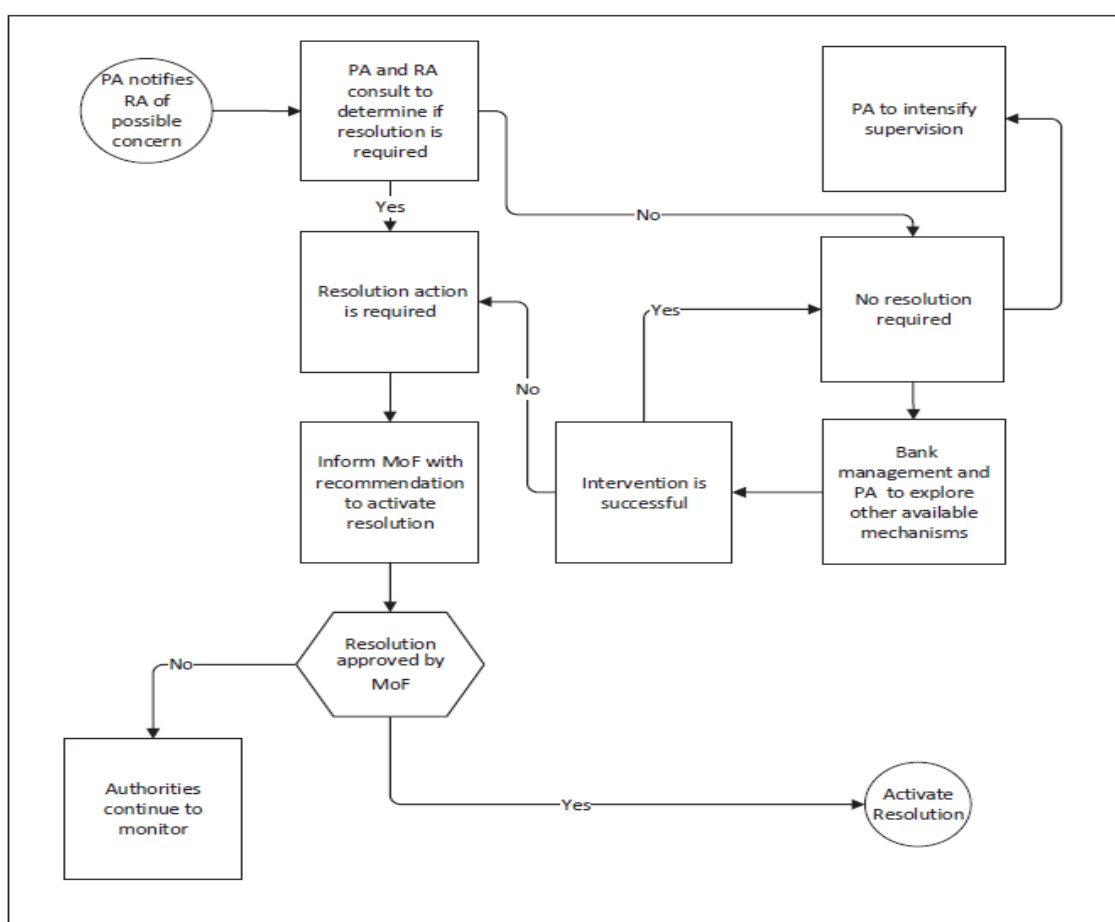
Each of the phases of resolution is discussed in this chapter.

4.2 Entry into resolution

When it becomes likely that a bank will become non-viable, a process of close cooperation between the SARB, the PA and National Treasury will be required to determine the appropriate course of action.

In terms of the FSRA, financial sector regulators have to support and cooperate with the SARB for it to achieve its financial stability mandate. The details of this cooperation have been set out in MoUs, which include how the financial sector regulators will report on matters relating to the viability of financial institutions to the SARB. Figure 4 sets out the decision chart that will be followed when placing a designated institution in resolution, in which the SARB, the PA and National Treasury each play a role.

Figure 4: Decision chart for entry into resolution



The PA should report to the SARB if there is an event or action taken by a financial institution that causes it to breach its early warning indicators or trigger its recovery plan. The PA must also inform the SARB if it is of the view that a bank will become non-viable or that the bank will have to take a recovery action to avoid becoming non-viable.

The SARB will consult with the PA and assess whether the bank will, or will be likely to, fail to meet its obligations. It will also assess the probability that recovery actions taken by the bank's management will be sufficient to prevent it from failing to meet its obligations. The PA must provide the SARB with all the information necessary to assess whether the bank may reach the POR. The information will include information about the event or action that caused the distress, corrective action taken and the likelihood of recovery. The SARB will participate in the PA's processes to assess recovery plans and should be familiar with the conditions for the bank's recovery actions to be successful and the shortcomings thereof.

When the SARB is notified of any event or action that may cause a bank not to fail in meeting its obligations, it will notify the National Treasury of the situation and the

Governor will engage with the Minister regarding possible actions that the SARB may need to take. If the SARB determines in its assessment that the designated institution has failed to meet, or will be unable to meet its obligations, it will make a recommendation to the Minister to place the institution in resolution. The recommendation will include a high-level description of the proposed resolution strategy and actions that the SARB intends to take and an overview on how these actions should result in an orderly resolution.

4.3 Stabilisation actions

Once the Minister has made the determination to place a bank in resolution, the SARB will announce the resolution and take immediate actions necessary to avoid further disruption to the institution and financial system. This section describes the main actions that the SARB will have to take immediately after the determination in order to ensure that it stabilises the institution and contains contagion to the rest of the financial system.⁹

4.3.1 Communication

If a SIFI deteriorates to the point where it is put in resolution, it is likely to be identified as a systemic event in terms of the FSRA and, as such, the SARB will have an obligation to publicly announce this event. In order to contain panic and provide reassurance to depositors, creditors and other counterparts, the SARB should clearly communicate how it intends resolving the institution to protect or restore financial stability. This communication should also be clear about any official support that will be provided to the bank, and provide confidence that the bank's critical functions will continue without interruption and that there will not be any defaults as a result of the bank entering resolution. Such reassurance is critical to achieving the objectives set in the resolution planning process.

In addition to the public communication by the SARB, there will be a number of specific stakeholders that would require, at a minimum, the following specific information:

- FMIs that support the execution of critical functions, to provide for continuity of access in resolution;

⁹ The elements in the execution phase should have been addressed in the resolution planning phase, and therefore most of the elements in Part 4 of the document have already been discussed in Part 3. However, Part 4 highlights the areas in which the SARB also has to develop its own internal capacity to effectively execute a resolution process.

- the controller and valuation firms that had been selected; and
- staff of the bank in resolution, in particular the staff that have to be retained for critical functions.

4.3.2 Recapitalisation and valuation

The first resolution action that the SARB will take in a resolution is to ensure that the bank's capital is restored to the level where it can continue meeting its regulatory requirements. This will be achieved through bail-in.

The FSLAB requires the SARB's decision on the write-down or write-off of any instruments to be informed by an independent valuation. The SARB will appoint an independent firm to conduct the valuations required by the FSLAB before taking resolution actions. To ensure that the SARB can recapitalise the designated institution within a reasonable period, it may be necessary to transfer the shares that would be subject to bail-in to a bridge vehicle until the valuation is finalised. This will allow for the conversion of the Flac instruments to new shares while the valuation is conducted.

The bail-in process will involve extensive consultation with stakeholders, including affected shareholders and creditors. The SARB will have to follow the administrative process requirements set out in the FSLAB. In line with these requirements, affected creditors and shareholders will be given the opportunity to review the intended action of the SARB and to make submissions.

After completion of the valuation and subsequent review by the affected parties, the instruments in the bridge vehicle will be bailed-in.

Bail-in is a complex process. The SARB is working on the detailed elements of bail-in execution and restructuring and will issue further guidance when this work, including industry consultation, has been completed.

4.3.3 Funding support

The bank is likely to require upfront funding support to pre-empt any liquidity shortages that may arise due to it entering resolution. These measures, along with effective communication, should aim to provide reassurance to the rest of the market and to clients.

4.3.4 Appointing a resolution controller

As required in terms of the FSLAB, the SARB will immediately appoint a resolution controller to assist it with executing the resolution strategy. By the time the SARB announces the entry into resolution, the controller should already be informed about this responsibility as well as the resolution path and the actions that should be taken on behalf of the SARB.

4.3.5 Temporary stays

In terms of the FSLAB, resolution in itself does not give rise to any termination rights and counterparties may not exercise early termination rights on the grounds of an institution entering resolution. It may, however, be necessary to issue a moratorium providing for a limited stay on the performance of the designated institutions' obligations to avoid the SIFI failing on any of its obligations during the stabilisation period.

4.4 Restructuring

After the firm has been stabilised, it may be necessary to restructure the institution or group. The purpose of the restructuring may be to address the cause of failure or to contribute to the restoration of the institution's viability. The extent of restructuring required will depend on the circumstances and the cause and extent of the failure.

The FSLAB does not prescribe a maximum time frame within which the restructuring stage has to be completed, as this may force sub-optimal decisions and actions on the SARB. Although the SARB will obviously prefer to keep the restructuring stage as short as possible, the duration will be determined by circumstances on a case-by-case basis.

Restructuring actions that require the use of resolution tools will have to be completed before the bank exits resolution. However, it is possible and likely that restructuring will continue after the institution exits resolution. In the latter scenario, the institution will have to develop a restructuring plan that satisfies the SARB and financial sector regulators that the institution can continue functioning as a viable bank after exiting resolution. The restructuring plan should also be informed by the valuations and additional assessments to ensure that the institution is able to continue meeting its

regulatory requirements and that it will have sufficient capital and liquidity, both during and after the restructuring.

The restructuring plan will build on the resolution plan developed by the SARB, which will identify different restructuring options that could be executed during a resolution.

4.5 Exit from resolution

If the SARB is satisfied that the bank will be able to implement its restructuring plan, subject to appropriate governance processes, and that it will be able to meet its regulatory requirements, the SARB will recommend that the bank can exit resolution. Just like entry into resolution, exit from resolution is decided by the Minister, on recommendation by the SARB. In terms of the FSRA, the SARB will have to announce a bank's exit from resolution, which will provide an opportunity to reaffirm the bank's future viability and ability to function as a going concern.

5. Conclusion

This discussion paper sets out the SARB's intended approach to planning for and conducting an open-bank resolution. This is a new area of responsibility for both the SARB and banks, and as more insights are gained, the contents of the paper will be refined.

In acknowledgement of the fact that ending TBTF is a new and complex discipline, the contents of this discussion paper should, at this stage, be interpreted as guidance, not policy. All policy decisions and formal requirements on banks will be published in due course after the promulgation of the FSLAB. In the meantime, industry is encouraged to comment on the contents of the paper and contribute to the collective understanding of how to implement effective resolution in South Africa.

References

Banks Act 94 of 1990.

<https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/2591/Banks+Amendment+Act+2007%5B1%5D.pdf>.

Bank of England. 2014. 'The Bank of England's approach to resolution'.

www.bankofengland.co.uk/financialstability/Documents/resolution/aproct17.pdf.

Bank of England. 2017. 'Consultation paper: The Bank of England's proposed policy on valuation capabilities to support resolvability'. www.bankofengland.co.uk/paper/2017/the-boes-proposed-policy-on-valuation-capabilities-to-support-resolvability.

Bank of England. 2017. 'Internal MREL – the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups, and further issues'. www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/internal-mrel-consultation-october-2017.pdf.

European Banking Authority. 2015. 'Draft Regulatory Technical Standards and Guidelines on business reorganisation plans under Directive 2014/59/EU'. EBA/RTS/2015/12 and EBA/GL/2015/21. www.eba.europa.eu/documents/10180/1312804/EBA-RTS-2015-12+RTS+and+EBA-GL-2015-21+GLs+on+Business+Reorganisation+Plans.pdf/9ecf6b00-dbcf-493d-9ff4-016d7442e410.

European Banking Authority. 2015. 'Technical advice on critical functions and core business lines'. EBA/op/2015/05.

<https://eba.europa.eu/documents/10180/983359/EBA-Op-2015-05>.

European Banking Authority. 2017. 'Final Draft Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms'. EBA/RTS/2017/05-06.

www.eba.europa.eu/documents/10180/1853532/Final+draft+RTSs+on+valuation+in+resolution+%28EBA-RTS-2017-05+%26+EBA-RTS-2017-06%29.pdf/88566587-ff6f-4116-a08e-282eb4ea2f78.

European Banking Authority. 2017. 'Final guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments'. EBA/GL/2017/04.
www.eba.europa.eu/documents/10180/1807527/Guidelines+on+the+treatment+of+shareholders+in+bail-in+%28EBA-GL-2017-04%29.pdf.

European Banking Authority. 2017. 'Final guidelines on the rate of conversion of debt to equity in bail-in'. EBA/GL/2017/03.
www.eba.europa.eu/documents/10180/1807514/Guidelines+on+the+rate+of+conversion+of+debt+to+equity+in+bail-in+%28EBA-GL-2017-03%29.pdf/c9f9a3e2-37d0-4643-a1ad-8503d827a3bd.

Federal Deposit Insurance Corporation. 2011. 'The orderly liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act'. *DDIC Quarterly* 5 (2): 31–49.
<https://www.fdic.gov/regulations/reform/lehman.html>.

Federal Deposit Insurance Corporation. 2013. *Resolutions Handbook*.
<https://www.fdic.gov/bank/historical/reshandbook/>.

Financial Sector Regulation Act 9 of 2017.
<http://www.treasury.gov.za/legislation/acts/2017/Act%209%20of%202017%20FinanSectorRegulation.pdf>.

Financial Laws Amendment Bill, 2018.
<http://www.treasury.gov.za/twinpeaks/Financial%20Sector%20Laws%20Amendment%20Bill.pdf>.

Financial Stability Board. 2014. 'Key Attributes of Effective Resolution Regimes for Financial Institutions'. https://www.fsb.org/wp-content/uploads/r_141015.pdf.

Financial Stability Board. 2012. 'FSB consults on making the Key Attributes requirements operational'. <https://www.fsb.org/2012/11/fsb-consults-on-guidance-for-recovery-and-resolution-planning/>.

Financial Stability Board. 2013. 'Recovery and resolution planning for systemically important financial institutions: guidance on identification of critical functions and critical shared services'. www.fsb.org/wp-content/uploads/r_130716a.pdf.

Financial Stability Board. 2015. 'Principles on loss-absorbing and recapitalisation capacity of G-SIBs in resolution: total loss-absorbing capacity (TLAC) term sheet'. www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

Financial Stability Board. 2015. 'Principles for cross-border effectiveness of resolution actions'. www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf.

Financial Stability Board. 2016. 'Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank (G-SIB): overview of responses to the public consultation'
<https://www.fsb.org/2016/08/guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-g-sib-overview-of-responses-to-the-public-consultation-2/>.

Financial Stability Board. 2016. 'Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank (G-SIB).
www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-G-SIB.pdf.

Financial Stability Board. 2016. 'Guidance on arrangements to support operational continuity in resolution'. www.fsb.org/wp-content/uploads/Guidance-on-Arrangements-to-Support-Operational-Continuity-in-Resolution-Overview-of-Responses-to-the-Public-Consultation.pdf.

Financial Stability Board. 2016. 'Resilience through resolvability – moving from policy design to implementation: Fifth Report to the G20 on Progress in Resolution' www.fsb.org/wp-content/uploads/Resilience-through-resolvability-E2%80%93moving-from-policydesign-to-implementation.pdf.

Financial Stability Board. 2017. 'Ten years on – taking stock of post-crisis resolution reforms: Sixth Report on the Implementation of Resolution Reforms'. www.fsb.org/wp-content/uploads/P060717-3.pdf.

Financial Stability Board. 2017. 'Guidance on continuity of access to financial market infrastructures (FMIs) for a firm in resolution'. www.fsb.org/wp-content/uploads/P060717-2.pdf.

Financial Stability Board. 2017. 'Guiding principles on the internal total loss-absorbing capacity of G-SIBs (Internal TLAC)'. www.fsb.org/2016/12/guiding-principles-on-the-internal-total-loss-absorbing-capacity-of-g-sibs-internal-tlac/.

Financial Stability Board. 2017. 'Funding Strategy Elements of an Implementable Resolution Plan'. <https://www.fsb.org/2017/11/funding-strategy-elements-of-an-implementable-resolution-plan/>.

Financial Stability Board. 2018. 'Principles on bail-in execution'. <https://www.fsb.org/wp-content/uploads/P210618-1.pdf>.

Financial Stability Board. 2018. 'Funding strategy elements of an implementable resolution plan'. <https://www.fsb.org/wp-content/uploads/P210618-3.pdf>.

Hong Kong Monetary Authority. 2017. 'The HKMA's approach to resolution planning'. https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/RA-2_The_HKMA_approach_to_resolution_planning.pdf.

Hong Kong Monetary Authority. 2017. 'Developing rules on loss-absorbing capacity requirements for authorized institutions in Hong Kong'. *Quarterly Bulletin*, September. <https://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201709/fa2.pdf>

Insolvency Act 24 of 1936. <http://www.justice.gov.za/legislation/acts/1936-024.pdf>

National Treasury (South Africa). 2011. *A safer financial sector to serve South Africa better*. <http://www.treasury.gov.za/twinpeaks/20131211%20-%20Item%202%20A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf>

National Treasury (South Africa). 2015. *Strengthening South Africa's Resolution Framework for Financial Institutions*. <http://www.treasury.gov.za/twinpeaks/Strengthening%20South%20Africa's%20Resolution%20Framework%20for%20Financial%20Institutions.pdf>

South African Reserve Bank. 2017. 'Designing a deposit insurance scheme for South Africa – a discussion paper'.

<http://www.treasury.gov.za/twinpeaks/Designing%20a%20deposit%20insurance%20scheme%20for%20South%20Africa.pdf>

Abbreviations

AT1	additional tier 1
CET1	common equity tier 1
CLF	committed liquidity facility
CMG	crisis management group
CoAG	cooperation agreement
ELA	emergency liquidity assistance
FMI	financial market infrastructure
FSB	Financial Stability Board
FSCA	Financial Sector Conduct Authority
FSLAB	Financial Sector Laws Amendment Bill, 2018
FSRA	Financial Sector Regulation Act, 9 of 2017
G20	Group of Twenty
KA	Key Attributes Key Attributes for Effective Resolution Regimes
LCR	liquidity coverage ratio
Minister	Minister of Finance
MoF	Minister of Finance
MoU	memorandum of understanding
MPE	multiple point of entry
OCIR	operational continuity in resolution
PA	Prudential Authority
POR	point of resolution
RA	Resolution Authority
RE	resolution entity
RSE	resolution support entity
SARB Act	South African Reserve Bank Act, 90 of 1989
SARB	South African Reserve Bank
SIFI	systemically important financial institution
SPE	single point of entry
T2	tier 2
TBTF	too big to fail
TLAC	total loss-absorbing capacity