RESOLUTION FUNDING, A CRITICAL COMPONENT TO ENABLE OPTIMAL BANK RESOLUTION IN SOUTH AFRICA

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20 July 2023

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Introduction

- The global financial crisis highlighted the critical importance of orderly bank resolution.
- Existing corporate insolvency regimes for bank resolution had limitations.
- Bailouts, especially for "Too Big to Fail" institutions, presented challenges such as moral hazard and increased risk-taking.
- The post-GFC regulatory paradigm, focused on financial stability as a core pursuit, is intent on the orderly resolution of financial institutions within the context of a financial safety net that includes robust prudential regulation and supervision, early intervention and an explicit deposit insurance framework.
- Orderly bank resolution is defined as special arrangements for the winding-up or restructuring of a failing bank by virtue of powers that go beyond the general powers conferred by the normal insolvency law applying to companies.
- In 2011 the Financial Stability Board published the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes). These Key Attributes enable the resolution of financial institutions while safeguarding economic functions and ensuring losses are borne by shareholders, unsecured creditors, and uninsured creditors based on a hierarchy of claims in liquidation.
- Effective resolution regimes need effective funding arrangements. Various resolution methods, from deposit transfers to bridge banks and bail-ins, may require resolution funding to preserve financial stability.
- Resolution funding refers to financing that supports the use of resolution powers and achieves resolution objectives.
- South Africa's previous framework for resolving banks via curatorship faced constraints, particularly for larger banks, relying on creditor cooperation and taxpayer-guaranteed retail deposit transfers.

The Basel Committee on Banking Supervision recommends:

“National authorities should have appropriate tools to deal with all types of financial institutions in difficulties so that an orderly resolution can be achieved that helps maintain financial stability, minimise systemic risk, protect consumers, limit moral hazard and promote market efficiency.”

Bank for International Settlements “Report and Recommendations of the Cross-border Bank Resolution Group” (2010)

Aims and objectives of the research

- The study aims to examine international best practices concerning bank resolution regimes, with a specific focus on resolution funding.
- To assess the appropriateness and effectiveness of resolution funding arrangements within South Africa's bank resolution regime.
- The study will analyze the extent to which South Africa's resolution funding aligns with the Key Attributes of Effective Resolution Regimes.
- To evaluate the potential benefits for consumers resulting from resolution funding mechanisms.
- To assess the capacity of resolution funding arrangements in minimizing moral hazard and mitigating the risks associated with "too big to fail" institutions.

Key Attributes of Effective Resolution Regimes

- Objectives of bank resolution regimes differ from ordinary insolvency frameworks, prioritizing the stability of the financial system.
- Key resolution objectives include the continuity of a bank's critical functions, smooth functioning of payment and settlement systems, and protection of depositors, requiring swift resolution actions.
- Resolution seeks to avoid unnecessary value destruction and minimize creditors' losses while aligning with statutory objectives.
- Key Attributes recommend establishing resolution funding arrangements in advance to avoid reliance on public ownership or bail-out funds for resolving firms.
- Temporary funding for maintaining essential functions should be obtained from shareholders and unsecured creditors, subject to the "no creditor worse off than in liquidation" safeguard, or from the financial system more widely if needed.
- Three types of resolution funding arrangements are recognized: (a) privately (industry)-financed deposit insurance funds, (b) privately funded resolution funds, or (c) temporary access to government funds with ex post recovery from the industry for government-incurred costs.

Key Attributes of Effective Resolution Regimes

- Conditions for Providing Temporary Funding:
  - Authorities should determine that providing temporary funding fosters financial stability and facilitates the implementation of an optimal resolution option to achieve orderly resolution objectives. Temporary funding should only be utilized after exhausting private sources of funding that cannot achieve resolution objectives.
  - Allocation of losses to equity holders and residual costs to unsecured and uninsured creditors, and the industry should be appropriately defined through ex-post assessments, insurance premiums, or other mechanisms.

South Africa's Bank Resolution Regime

- Financial stability risks in South Africa have increased due to various factors:
    - Ongoing electricity crisis impacting economic growth.
    - Universal impact of the Russia-Ukraine war posing a threat to financial institutions.
    - Grey listing by the Financial Action Task Force affecting financial reputation.
    - High ratios of state-owned enterprise debt burdening the government and domestic financial sector.
- New resolution regime for designated institutions in South Africa effective from 1 June 2023.
- Includes banks, systemically important financial institutions, the payment system operator, and participants of a systemically important payment system.
- Captured in the new Chapter 12A of the Financial Sector Regulation Act, as amended by the Financial Sector Laws Amendment Act 23 of 2021 (not in the Banks Act).
- The South African Reserve Bank designated as the resolution authority.
- Introduction of new tools such as bridge banks and the bail-in tool.

Resolution Regime Funding Arrangements in South Africa

- South Africa's resolution funding arrangements align with the Key Attributes:
  - Corporation for deposit insurance with a "paybox plus" mandate - Mandate includes administering the Deposit Protection Fund and effecting depositor pay-outs.
  - Expanded to include some resolution functions.
  - Section 166Y of the Financial Sector Regulation Act allows the South African Reserve Bank to recover temporary funding extended to maintain critical functions of a bank in resolution.

Resolution Funding Arrangements - Benefits to Consumers and Risk Mitigation

- Benefit to Consumers:
    - Ensure Continuity of Critical Functions: Resolution funding arrangements provide funding to maintain essential banking services during the resolution process.
    - Preserve Access to Payment Services: Consumers' access to payment services and liquidity is safeguarded, minimizing disruptions during bank resolution.
    - Protect Depositors' Interests: Consumers can have confidence that their deposits are secure even in times of financial distress.
- Capacity to Minimize Moral Hazard and 'Too Big to Fail' Risks:
    - Shift Risk from Taxpayers to Shareholders and Investors: Resolution funding mechanisms rely on private funds, reducing the burden on taxpayers and discouraging moral hazard.
    - Encourage Prudent Risk Management: Banks are incentivized to manage risks responsibly to avoid resolution actions and associated losses to shareholders and creditors.
    - Mitigate 'Too Big to Fail': Even large systemic banks can be subject to resolution actions without posing excessive risks to financial stability.

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