

—
P O Box 427 Pretoria 0001 South Africa
370 Helen Joseph Street Pretoria 0002
+27 12 313 3911 / 0861 12 7272
www.resbank.co.za



SOUTH AFRICAN RESERVE BANK



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Financial Stability Department

Discussion document

Proposed requirements for funding in resolution

Contents

1. Definitions.....	2
2. Introduction.....	5
3. Scope.....	6
4. Objective.....	6
5. Principles.....	7
6. Requirements for designated institutions.....	7
7. Funding support by the participants in the financial safety net (public sector backstop mechanisms).....	10
8. Governance.....	12
9. Testing.....	12
10. References.....	13

Note: This discussion paper sets out proposed principles and requirements that will be adapted into a regulatory instrument upon conclusion of the consultative process and after promulgation of the Financial Sector Laws Amendment Bill.

1. Definitions

critical function means, as defined in the Financial Sector Laws Amendment Bill (FSLAB), in relation to a designated institution, a function that is –

- a. essential to, or that contributes substantially to, financial stability and is performed by the designated institution; or
- b. provided to, and essential to the continued operation of, the designated institution.

closed resolution strategy means a resolution strategy, typically adopted in relation to a designated institution that has not been designated as a systemically important financial institution (SIFI), where such designated institution is wound up in terms of clause 166H of the FSLAB.

designated institution means, as defined in clause 42 of the FSLAB –

- a. a bank;
- b. a SIFI;
- c. the payment system operator and participants of a systemically important payment system;
- d. a company that is a holding company of a bank, a systemically important financial institution or a payment system operator of a systemically important payment system; and
- e. subject to any determination in terms of subsection (2), if a bank or a SIFI is a member of a financial conglomerate in terms of section 160 of the FSR Act 9 of 2017, each of the other members of the financial conglomerate.

designated institution in resolution means, as defined in the FSLAB, a designated institution in respect of which a determination in terms of clause 166J (2) is in force.

FSLAB means the Financial Sector Laws Amendment Bill [B15-2020].

open resolution strategy means a resolution strategy in terms of which an institution that is designated as a SIFI in terms of clause 42 of the FSLAB is stabilised and continues to function in its existing form under its own licence.

orderly resolution of a designated institution means, as defined in the FSLAB, the management of the affairs of the designated institution as provided for in Chapter 12A in a way that –

- a. maintains financial stability; and
- b. in the case of a bank, protects the interests of depositors,

including by ensuring that the critical functions performed by the designated institution continue to be performed.

resolution means, as defined in the FSLAB – of a designated institution – means the management of the affairs of the designated institution as provided for in Chapter 12A.

resolution action means, as defined in the FSLAB, action in terms of clause 166S.

2. Introduction

- 2.1. The process of resolution planning includes, among other elements, the determination of a viable resolution strategy, the *ex ante* assessment of potential funding and liquidity needs of a designated institution in resolution, and the identification of possible and probable sources of funding for a designated institution in resolution in the interest of financial stability.
- 2.2. Funding in resolution refers to the financing that can be used to support a chosen resolution strategy and the use of relevant and applicable resolution powers in order to achieve orderly resolution.
- 2.3. Conceptually, funding in resolution comprises two interrelated aspects, namely arrangements by a designated institution to: (i) source funding to maintain operations and support the continued provision of critical functions; and (ii) ensure the availability of sufficient liquid assets to enable it to honour its financial obligations as they fall due.
- 2.4. Resolution strategies are broadly classified into ‘open resolution’ and ‘closed resolution’. Open resolution strategies are typically adopted for SIFIs and require the affected institution to continue with its operations to the extent that they are critical to the functioning of the financial system.
- 2.5. A designated institution for which an open resolution strategy is applicable (in-scope designated institution), must put arrangements in place to ensure that it has sufficient funding and liquid assets to enable it to continue providing critical functions and meet its obligations to support orderly resolution.
- 2.6. Funding in resolution is meant to improve the resolvability of designated institutions and should be viewed as a component of the overall resolution framework that has inherent interdependencies with other core elements of the resolution framework, including but not limited to, determination of resolution entities, stabilisation, recapitalisation and valuation.
- 2.7. The proposals in this discussion paper acknowledges the interrelatedness of recovery and resolution, insofar as both disciplines rely on a designated institution’s capability to measure and model funding and liquidity needs in stress situations, and build on the work undertaken by designated institutions in the development of recovery plans.

2.8. In this regard, where problems in a designated institution are detected early enough, corrective measures may generally be financed through the designated institution's internal and private resources and, in principle, viable designated institutions facing temporary liquidity problems may seek emergency liquidity assistance (ELA) from the South African Reserve Bank (SARB). However, where a designated institution's viability is jeopardised, resolution may be required to ensure continuity of critical functions and orderly market exit.

3. Scope

3.1. The proposals outlined in the paper will apply to those designated institutions which have been designated as SIFIs in terms of clause 42 of the FSLAB.

4. Objective

4.1. The paper expands on the proposals set out in the 2019 discussion paper published by the SARB under the title 'Ending too big to fail: South Africa's intended approach to bank resolution'.

4.2. The paper proposes –

4.2.1. requirements for designated institutions to estimate, assess and report on their potential funding and liquidity needs in resolution;

4.2.2. requirements for *ex ante* funding arrangements to be put in place by designated institutions to finance their liquidity needs and preserve the critical functions they provide, so as to support orderly resolution; and

4.2.3. arrangements by the SARB, as a participant in the financial safety net¹, to ensure that a designated institution in resolution will have access to liquidity to facilitate its continued provision of critical functions and support orderly resolution.

¹ The financial safety net refers to the operationally independent functions of the Prudential Authority, the resolution authority, the deposit insurance authority, the central bank as lender of last resort and the ministry of finance, as informed by their individual mandates but which functions are coordinated in the interest of financial stability.

5. Principles

- 5.1. The guiding principle on funding in resolution is that a designated institution's internal and private market sources of funding are the preferred source of funding in resolution.
- 5.2. Designated institutions should have the capability to estimate, monitor and report their funding needs in resolution. This entails that the designated institution should be able to identify and measure the potential sources, positioning and fungibility of funding and liquidity across the resolution group, estimate funding needs in resolution, report liquidity information on a daily basis once in resolution, and identify and rapidly mobilise assets across the group that could be used as collateral.
- 5.3. Estimations of funding likely to be required in resolution should include both the funding needs of a designated institution while in resolution, and when it exits resolution. It is likely that the market may not immediately have confidence in an institution exiting resolution, and as such, the affected institution may struggle to attract funding from private sources for some time.

6. Requirements for designated institutions

- 6.1. Estimation, assessment, monitoring and reporting of funding and liquidity needs
 - 6.1.1. A designated institution will be required to have the capability to estimate its liquidity needs in resolution based on its current and estimated future (distressed) balance sheets.
 - 6.1.2. A designated institution will be required to have the ability to estimate its liquidity needs in resolution for at least 90 days from the point of entry into resolution, taking into account the likelihood that it may experience a period of protracted liquidity stress prior to entering resolution.
 - 6.1.3. A designated institution's determination of its liquidity needs in resolution should include a viable path for the restoration of its compliance with prudential requirements so as to be able to maintain its authorisation (licence).
 - 6.1.4. Any operational, legal and regulatory impediments to accessing and mobilising funding or liquidity, including on a cross-border intragroup basis, should be identified and removed, to the extent possible.

- 6.1.5. A designated institution will be required to –
- 6.1.5.1. have in place measures necessary to determine its funding needs, including in different currencies, as part of resolution planning;
 - 6.1.5.2. understand the legal, regulatory or operational obstacles to transferring funds among entities within the group, and take steps to mitigate such obstacles;
 - 6.1.5.3. ensure that its management information systems enable it to monitor and report on its possible funding needs during a resolution;
 - 6.1.5.4. estimate the aggregate amount of liquidity it would need to ensure that material operating entities within the group can be stabilised and continue to operate without disruption in resolution;
 - 6.1.5.5. estimate how its intra-group funding needs would impact on its liquidity needs in resolution and how an open-resolution strategy would influence the movement of liquidity throughout the group;
 - 6.1.5.6. estimate the liquidity required to meet all obligations related to its payment, clearing and settlement activities, including any change in demand for and sources of liquidity needed to meet such obligations;
 - 6.1.5.7. estimate the potential liquidity effects of potential adverse actions by market infrastructures;
 - 6.1.5.8. model expected counterparty behaviour and include relevant counterparty requirements, such as increased initial or variation margin requirements, during resolution;
 - 6.1.5.9. identify and measure, for each material operating entity within the group, intra-day liquidity needs, operating expenses and working capital needs based on current and estimated future exposures and taking account of how their peak needs may evolve in resolution;
 - 6.1.5.10. estimate their likely intra-day liquidity needs in resolution based on current and estimated future exposures and taking account of how their peak liquidity needs may evolve in resolution. Also, engage relevant counterparties in business-as-usual conditions to understand the likely implications of resolution on its intra-day liquidity needs;

- 6.1.5.11. ensure that it has the operational capacity to identify assets that can be mobilised and used as collateral and the appropriate governance and systems to do so rapidly in resolution;
 - 6.1.5.12. where usage of collateralised facilities is envisioned, understand the relevant collateral requirements, including the applicable haircuts, and have the capability to mobilise and pre-package such collateral pre-resolution; and
 - 6.1.5.13. have the capability to perform in-house valuations for assets that have been identified for use as collateral. The valuations must be based on realistic assumptions and modelled for a severe but plausible stress scenario.
- 6.2. Private sources of funding
- 6.2.1. A designated institution will be required to have in place a methodology to determine the availability of own assets as well as private sources of funding that may be available in resolution, and the time frames within which such funding would likely become available. The methodology should consider and address the following matters, the list of which is not exhaustive:
 - 6.2.1.1. a possibility that, at the point of resolution, a designated institution may have significantly less high-quality liquid assets available to secure funding in the private market;
 - 6.2.1.2. the extent to which those sources of funding can meet the funding needs of the designated institution in resolution in different stress scenarios;
 - 6.2.1.3. the process for using such sources of funding, including the mobilisation of unencumbered assets as collateral and the distribution of funding throughout the group;
 - 6.2.1.4. behavioural assumptions and scenario analysis used to support cash flow forecasts, and the identification of key drivers of liquidity needs in resolution; and
 - 6.2.1.5. the integration of the designated institution's assumptions in its formulation and development of a recovery plan.

7. Funding support by the participants in the financial safety net (public sector backstop mechanisms)

7.1. Private sector sources of funding are the preferred sources of funding for a designated institution in resolution. However, it is acknowledged that a designated institution in resolution will most likely find it increasingly challenging to attract or access private sources of funding.

7.2. Funding support by participants of the financial sector safety net may be required to foster financial stability and to enable the implementation of a resolution strategy that is best able to achieve the objectives of orderly resolution.

7.3. Any funding support provided by the financial safety net participants to a designated institution in resolution should be subject to certain terms and conditions aimed at reducing the risk of moral hazard.

7.4. Emergency liquidity assistance by the SARB

7.4.1. To the extent that a designated institution in resolution is unable to attract sufficient private sector funding, the SARB may be called upon to provide temporary funding to enable such designated institution to maintain the continuity of critical functions in the interest of financial stability.

7.4.2. In addition to the normal liquidity facilities provided by the SARB, section 10(1)(f) read with section 10(1)(s) of the South African Reserve Bank Act 90 of 1989 (SARB Act) empowers the SARB, in accordance with the recognised and established customs and functions of central banks, to grant loans and advances (as lender of last resort), without limiting the types of counterparties to which the SARB can lend funds.

7.4.3. The SARB's authority to provide ELA is founded on the provisions of the SARB Act, as described under paragraph 7.4.2. However, the SARB Act imposes a condition that any lending by the SARB, including in the form of ELA, should be collateralised.

7.4.4. The granting of ELA to a designated institution in resolution will be considered in line with the process as well as the criteria as outlined in the internal policies of the SARB.

7.5. Committed liquidity facilities provided by the SARB

- 7.5.1. The committed liquidity facility (CLF) was initiated as an alternative approach under the Basel III liquidity framework for banks to meet their liquidity cover ratio.
- 7.5.2. South African banks are allowed to apply for a CLF (*to be replaced by the restricted committed liquidity facility (R-CLF) with effect from 1 December 2021²*) with the SARB, which is a going-concern/business-as-usual facility provided at a pre-determined fee against pre-approved sets of collateral.
- 7.5.3. Committed liquidity facilities offer the benefit of efficiency with which liquidity can be provided when legal agreements and collateral arrangements are pre-established.
- 7.5.4. Because committed facilities are pre-positioned and are available to institutions during business as usual, they may be drawn down prior to an institution being placed in resolution, and as such may not be available in resolution. The intended use of committed facilities during either recovery or resolution should be an explicit part of a designated institution's plan for funding in resolution.
- 7.6. Support by the Corporation of Deposit Insurance
 - 7.6.1. The Corporation for Deposit Insurance (CoDI) forms part of the financial sector safety net, and deposit insurance provided by CoDI supports an orderly resolution by guaranteeing the safety of covered deposits.
 - 7.6.2. The deposit insurance fund may, in accordance with the FSLAB and subject to specific conditions and at the discretion of the SARB and CoDI, support an orderly resolution in other ways than paying out covered depositors, including providing funding and liquidity.
 - 7.6.3. The support from the CoDI will be limited to the amount or value of covered deposits for the deposit insurance in question and will depend on approval by the Board of Directors of CoDI.
 - 7.6.4. To enable adequate and timely support by CoDI, the participants in the financial safety net must have effective communication and information sharing protocols in place.

² Prudential Authority Guidnace Note, GN 8/2020

8. Governance

- 8.1. A designated institution will be required to have internal governance arrangements in place for reporting liquidity risks in resolution to the institution's senior management, appropriate risk committees, and relevant authorities.
- 8.2. A designated institution's internal governance framework will be required to integrate its management of liquidity risk in resolution into its existing liquidity management framework, alongside any existing legal entity-specific liquidity requirements, and internal stress tests.
- 8.3. A designated institution will be required to consider the appropriate frequency with which it estimates and reports its projected liquidity needs and resources to the institution's senior management, appropriate risk committees and relevant authorities, and should have in place, processes to increase the frequency of reporting as required during a period of stress.
- 8.4. A designated institution's internal governance framework should facilitate effective and timely decision-making.

9. Testing

- 9.1. A designated institution will be required to:
 - 9.1.1. conduct scenario analysis to test the capabilities and governance arrangements set out herein, at least biennially;
 - 9.1.2. document the outcomes of the scenario analysis and report the outcomes to the resolution authority; and
 - 9.1.3. conduct these scenario analyses in a manner that facilitates assurance to the designated institution and the resolution authority and review the outcomes of these exercises, which review may involve internal audit or third-party assurance providers.

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