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**Statement explaining the need for, intended operation, and expected impact of the prudential standard for designated institutions in respect of stays on early-termination rights and resolution moratoria**

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## Introduction

* 1. The statement explaining the need for, intended operation, and expected impact of the prudential standard for designated institutions in respect of stays on early-termination rights and resolution moratoria (Statement) is prepared and published by the Prudential Authority and the South African Reserve Bank as the resolution authority (the Authorities) in accordance with; and in fulfilment of the requirements under section 98(1) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) which stipulates that, a financial sector regulator must not make a regulatory instrument unless it has published the following documents:
     1. a draft of the regulatory instrument;
     2. a statement explaining the need for and the intended operation of the regulatory instrument;
     3. a statement of the expected impact of the regulatory instrument; and
     4. a notice inviting submissions in relation to the regulatory instrument, stating where, how and by when submissions are to be made.
  2. The Statement is intended to communicate to all relevant stakeholders, the policy context, intended outcomes and expected impact of the proposed prudential standard relating to stays on early-termination rights and resolution moratoria on contracts of designated institutions in resolution (Standard) and to assist designated institutions in complying with the Standard.
  3. A lesson learnt from the 2008 global financial crisis was that the disorderly termination of a financial institution’s contracts on a mass scale could cause significant contagion effects to the financial markets, thereby posing risks to the stability and effective working of the wider financial system. To address this, the Financial Stability Board (FSB) issued the Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes) which were adopted as the international standard for resolution regimes by the G20 Heads of States and Governments in 2015.
  4. The Key Attributes sets out the core elements for an effective resolution regime. As such, implementation of the Key attributes should improve authorities’ ability to resolve financial institutions in an orderly manner, without unduly exposing taxpayers to loss from solvency support, while maintaining continuity of their critical economic functions.
  5. In line with the Key Attributes, Chapter 12A of the Financial Sector Regulation Act, 2017 as amended by the Financial Sector Laws Amendment Act, 2021 (Act No. 23 of 2021) (the Act) forms part of the legislative measures undertaken by South Africa, as a member of the G20 and the FSB, to provide for the orderly resolution of designated institutions.
  6. The Standard complements and gives effect to some of the principles contained in Chapter 12A of the Act by setting out the requirements for sound practices and processes in respect of stays on early-termination rights and resolution moratoria on contracts of designated institutions in resolution (stays and resolution moratoria) for designated institutions.
  7. The Standard puts forward a contractual recognition approach the effect of which is the extension of the powers of the South African Reserve Bank as the resolution authority (the Reserve Bank) to impose stays and resolution moratoria in relation to covered contracts[[1]](#footnote-1) entered into by designated institutions, while protecting the enforcement of eligible netting and collateral agreements.

## The need for the Standard

## The powers of authorities to impose stays on the exercise of early-termination rights, that may be triggered upon entry of a designated institution into resolution or in connection with the use of resolution powers by authorities, and to impose moratoria on creditor actions, forms part of a suite of general resolution powers stipulated in the Key Attributes.

## Prospects for an orderly resolution will be hampered if a failing designated institution’s counterparties terminate their contracts with the institution on a mass scale based solely on such designated institution’s entry into resolution or the exercise of resolution powers by an authority on the designated institution. It is important for a resolution framework to be designed in a manner that enables the prevention of this type of situation and ensures the continued provision of critical functions and the related shared services, particularly in the case of an open resolution.

## To this end, the South African resolution framework must provide for effective stays and resolution moratoria on early-termination rights that may arise only as a result of, or in connection with, a designated institution’s entry into resolution, to prevent the close-out of contracts in significant volumes.

## Section 166L of the Act provides for stays on early-termination rights which entail the prohibition on the exercise of early-termination rights that arise on the basis that a designated institution has been or is proposed to be placed in resolution, or on the basis of a resolution action or proposed resolution action in relation to a designated institution.

## The Standard serves an important complementary function to the provisions under section 166L of the Act and provides for among others, the adoption of contractual recognition provisions in specified types of contracts (covered contracts).

## The effect of the contractual recognition provisions provided for in the Standard will be to extend the application of the Reserve Bank’s resolution powers in terms of the Act to covered contracts. In the absence of the Standard, the placing or proposal to place a designated institution into resolution will expose the covered contracts entered into by such designated institution to the exercise of early-termination rights by counterparties.

## Section 166R (1)(d) of the Act empowers the Reserve Bank to temporarily suspend a designated institution’s contractual obligations, subject to certain specified conditions.

## The Standard also complements and provides clarity on the principles contained under section 166R(1)(d) read with section 166R(4) of the Act, thus ensuring that the South African resolution framework complies with international best practices, by stipulating the extent of the period for which moratoria provided for under section 166R(1)(d) of the Act may be imposed.

## The intended operation of the Standard

## The Standard applies to early-termination rights that arise only by reason of entry of a designated institution into resolution or in connection with the use by the Reserve Bank of its resolution powers in relation to a designated institution.

## A stay on early-termination rights, as provided for under section 166L of the Act and consequently by the Standard, does not affect the rights of counterparties that may arise due to the non-performance of obligations by a designated institution. Accordingly, section 166L of the Act and the Standard does not absolve a designated institution in resolution from performing any of its contractual obligations, including payment and delivery obligations.

## Notwithstanding paragraph 3.2 above, it is worth noting that, to enable the orderly resolution of a designated institution, certain situations may necessitate that the Reserve Bank allows a designated institution to temporarily not perform on some of its obligations in terms of its covered contracts without such designated institution’s counterparties exercising their right to terminate the relevant contracts.

## A moratorium may only be issued by the Reserve Bank when the conditions for triggering a resolution have been met and a designated institution is placed in resolution. Section 166R(4) of the Act stipulates that the moratorium must be temporary in nature. The section enjoins the Reserve Banks to state the period for the moratorium and goes further to prescribe that the said period of the moratorium must be a reasonable period.

## To ensure that moratoria issued by the Reserve Bank will be in line with international best practice, the suspension of any obligations that may be provided for in moratoria issued by the Reserve Bank in terms of section 166R(1)(d) shall not exceed forty-eight (48) hours.

## Central banks, market infrastructures as defined under section 1 of the Act as well as financial market infrastructures as defined in the Principles for Financial Market Infrastructures, are excluded from the provisions of the Standard. Market infrastructures and financial market infrastructures facilitate the trading, clearing, settlement, and recording of monetary and other financial transactions, such as payments, securities, and derivative contracts. These institutions enable the efficient functioning of the financial system thus fostering financial stability.

## Designated institutions will be required to ensure that the covered contracts they enter into contain clauses that recognises the Reserve Bank’s stays and resolution moratoria powers, and to put measures in place to ensure that they have detailed records on such covered contracts. Additionally, designated institutions will be required to develop capabilities to report the extent of their compliance with the requirements in the Standard to the Reserve Bank.

## A designated institution’s governing body will be ultimately responsible for overall compliance with the Standard.

## The Standard will come into effect twelve (12) months from the date on which the resolution provisions in the Financial Sector Laws Amendment Act, 2021 comes into operation. The commencement schedule for the Financial Sector Laws Amendment Act, 2021 will be published by the Minister of Finance in a Gazette.

## Expected impact of the Standard

## The Authorities expect the Standard to improve the overall credibility of the South African resolution regime. This is primarily because the Standard gives meaning to the principles adopted in the Act thereby ensuring alignment of the South African resolution framework with international standards and best practices. In this regard, it is expected that adequate preparedness by designated institutions to implement and comply with the requirements provided for in the Standard will increase the resolvability of designated institutions thus improving the Reserve Bank’s ability to achieve its objective of assisting in the maintenance of financial stability through the orderly resolution of designated institutions in resolution.

## As part of the consultation process, and to assist the Authorities to assess the expected impact of the Standard, a set of questions were included under Section C of the published Comments Template to solicit industry inputs on the expected impact of implementing the Standard.

## Of the eight respondents who participated in the consultation process, only two systemically important banks provided responses to the impact questions under Section C of the published Comments Template. The information obtained from the respondents in this regard were analysed and a summary of the key take-aways therefrom is presented herewith.

* + 1. Overall, respondents found the Standard to be necessary for the maintenance of financial stability in the South African market and for the alignment of the South African resolution framework with international standards.
    2. Respondents indicated that whilst the Standard introduces some new administrative requirements, designated institutions will be able to leverage their existing governance and internal control arrangements to ensure readiness and compliance with the requirements set out in the Standard. All respondents confirmed that they currently keep records of contracts that would meet the Standard’s definition of covered contracts.
    3. Respondents cited the alignment of South Africa’s resolution framework with international standards and international best practices, improved consistency in the resolution of banks, as well as the removal of barriers to resolution as some of the main advantages to be brought about by the Standard.
    4. Respondents cautioned that, the failure to afford Global Master Securities Lending Agreements (GMSLA) and Global Master Repurchase Agreements (GMRA) a similar status in resolution as that afforded to derivative instruments in the Act and the Standard may create uncertainty in the market which in turn may result in international counterparties to these agreements being reluctant to transact with South Africa counterparties. The Reserve Bank and the National treasury initiated focused engagements with the relevant industry participants to gain better insights on the issues raised and to explore and agree on viable avenues to resolve these issues.
    5. Generally, respondents indicated that while they did not foresee any material challenges in complying with the Standard, implementation complexities may vary depending on the structure and size of designated institutions as well as the applicability of the Standard to a particular designated institution’s group entities. Respondents further indicated that designated institutions that have been designated as financial conglomerates would need more time to adopt and ensure compliance with the Standard.
    6. Respondents anticipate that compliance with the Standard will impose additional costs, particularly in relation to legal costs, systems costs as well as costs to implement changes to processes. However, none of the respondents provided quantitative information relating to the anticipated additional costs.
    7. Respondents indicated that the industry would need a minimum of 12 months to implement and comply with the Standard.

## In conclusion, based on the qualitative information obtained from the respondents, the Standard is mostly in line with the international standards and its implementation can reasonably be expected to yield more advantages than disadvantages for the South African market.

## Furthermore, save for a few concerns that have been addressed in the drafting of the revised Standard, it is clear that the requirements making up the Standard would not unduly overburden the industry from a cost, governance as well as control arrangements perspective.

## The Authorities are amenable to the proposals received from industry regarding the implementation timeline for the Standard and will ensure that designated institutions are afforded a minimum period of 12 months to ensure compliance with the requirements in the Standard.

## Conclusion

## It is an established practice for designated institutions to enter into contracts with foreign counterparties and for such contracts to be regulated in terms of foreign law. The Standard seeks to ensure that such contracts contain clauses that recognise the provisions of the Act.

## The stays and resolution moratoria powers provided for in the Standard are a key element of the South African resolution framework because they enable the Reserve Bank to prevent counterparties from terminating their contracts with a designated institution in resolution on a mass scale based solely on such designated institution’s entry into resolution or because of the exercise of resolution powers by the Reserve Bank.

1. The term ‘covered contracts’ is defined in the prudential standard relating to stays on early-termination rights and resolution moratoria on contracts of designated institutions in resolution as specified contracts that are governed under foreign laws and contain provisions for early termination rights. [↑](#footnote-ref-1)