



## **DRAFT FOR CONSULTATION**

### **Financial Sector Regulation Act, 2017 (Act No. 9 of 2017)**

#### **Guidance Notice Flac GN [-] of 2023**

#### **Guidance on the Minimum Flac Requirements**

##### ***Objective of this Guidance Notice***

*This Guidance Notice sets out the practices and guidelines aimed to assist designated institutions with their compliance with respect to the requirements set out in RA03-Prudential Standard on Flac Instrument Requirements (Prudential Standard). The Prudential Standard sets out a formula to determine the minimum amount of Flac that designated institutions are required to hold and a formula to determine the minimum amount of Flac instrument issuances that should contribute towards the minimum Flac amount. In this regard, this Guidance Notice provides illustrative examples on the application of the formulas in the Prudential Standard.*

*The guidance notice makes reference to specific requirements contained in the Prudential Standard and as such must be read in conjunction with the Prudential Standard.*

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## **1 Introduction**

- 1.1 This Guidance Notice is issued in accordance with the provisions of section 141 of the Financial Sector Regulation Act, 2017 (Act No.9 of 2017) and should be read in conjunction with the draft Prudential Standard RA03 - Flac Instrument Requirements for designated institutions (DIs) (Prudential Standard).
- 1.2 The purpose of the Guidance Notice is to -
- (a) provide an overview of the requirements of the Prudential Standard;
  - (b) provide context around the terms and definitions used in the Prudential Standard as well as their application to the relevant formulas; and
  - (c) provide illustrative examples of how the DIs should apply the formulas provided in the Prudential Standard.

## **2 Overview of the Prudential Standard**

- 2.1 One of the objectives of an effective resolution framework is that there must be sufficient loss-absorbing and recapitalisation capacity available in resolution to implement an orderly resolution strategy that makes use of a bail-in<sup>1</sup> resolution tool.
- 2.2 A bail-in resolution tool will enable the Reserve Bank to assign losses to shareholders and creditors to absorb losses and recapitalise a DI in resolution, instead of relying on public funds to do so (which exposes taxpayers to loss). This tool, however, extends to all liabilities (with certain exceptions under section 166S (9)) which means operational creditor claims and uninsured deposits could be affected by a resolution bail-in.
- 2.3 In the South African context, bail-in is the primary resolution tool that will be used for an open-bank resolution strategy<sup>2</sup> which is envisaged for banks that have been designated as systemically important financial institutions (SIFIs).

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<sup>1</sup> Bail-in refers to a resolution action taken by the Reserve Bank, in terms of sections 166S and 166T of the Act, which results in the value of instruments and/or claims held by shareholders and creditors of the DI reduced and/or cancellation of instruments held by shareholders (without value)

<sup>2</sup> Open-bank resolution strategy refers to the way the Reserve Bank intends to deal with a failing SIFI bank. The main aim of this strategy is for the SIFI bank to remain open in resolution and continue providing critical functions (instead of closing the SIFI bank and using mechanisms such as liquidation).

- 2.4 Therefore, to successfully implement an open-bank resolution strategy (which necessitates sufficient loss absorption and recapitalisation capacity), a new class of unsecured and subordinated debt instruments (“bail-in instruments”), termed Flac<sup>3</sup> instruments, is required. These Flac instruments will rank junior to other unsecured liabilities (which include uninsured deposits and other operational creditor claims) but senior to regulatory capital instruments.
- 2.5 Flac instruments are a new requirement in addition to the minimum capital adequacy requirement <sup>4</sup>(minCAR) as determined by the Prudential Authority (PA). Therefore, the Prudential Standard aims to achieve the following two overarching objectives -
- (a) objective 1: to specify the characteristics of debt instruments that qualify as Flac instruments; and
  - (b) objective 2: to provide the calibration for the minimum Flac requirement (which must comprise of a minimum amount of Flac instruments and other qualifying instruments<sup>5</sup> that can be used as a top-up to meet the full requirement).

### **3 Context of the terms and definitions used in the Prudential Standard**

- 3.1 The calibration uses a number of terms and definitions, which are complex and thus the sections below are aimed at providing a basis for understanding the terminology used in the Prudential Standard.
- 3.2 The quantum of the minimum Flac requirements is underpinned by two main principles –

**Principle 1: The DI should be recapitalised to a level that meets the minCAR, excluding regulatory buffers, as determined by the PA.**

- 3.3 The minCAR comprises of the following elements -

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<sup>3</sup> Flac is not an acronym, it is a term that refers to the new class of debt instruments defined in the Standard.

<sup>4</sup> Minimum capital adequacy requirement refers to the minimum required amount of capital and reserve funds (prior to buffers) as specified in the bank’s capital adequacy legislation. This is also known as the South African minima (prudential minima).

<sup>5</sup> Other qualifying instruments refers to the excess regulatory capital instruments, that DIs are allowed to use in addition to the minimum Flac instrument issuance requirement, to meet the minimum Flac requirement. Essentially DIs have two options to meet the minimum Flac requirement: option 1 is to use Flac instruments only and option 2 is to issue the minimum amount of Flac instruments and use excess regulatory instruments as a top-up.

- (a) the relevant specified base requirement of no less than 8% of the risk-weighted exposures (baseCAR), standard for all banks; plus
- (b) the relevant specified Pillar 2A requirement for systemic risk, the standard for all banks; and
- (c) the relevant specified Pillar 2B requirement for idiosyncratic risk, which is institution specific.

Therefore **minCAR = baseCAR + Pillar 2A + Pillar 2B.**

- 3.4 To determine the minCAR that a DI is required to meet, a current balance sheet would be utilised as well as the risk weights assigned to each class of assets.
- 3.5 To determine the Minimum Flac Requirements (MFR), the losses that would be incurred before and in resolution must be considered to derive a post-loss balance sheet ( $pr$ )<sup>6</sup>. The post-loss balance sheet as well as the risk-weights assigned to each class of assets is then used to calculate the MFR.
- 3.6 Therefore, the elements of the minCAR using a post-loss balance sheet are denoted as follows -
  - (a) minCAR = min $pr$ CAR;
  - (b) baseCAR = base $pr$ CAR;
  - (c) Pillar 2A =  $pr$ Pillar; 2A and
  - (d) Pillar 2B =  $pr$ Pillar 2B.

**Principle 2: The DI must increase its ability to obtain funding in the market post a resolution.**

- 3.7 The DI must increase its ability to obtain funding in the market post a resolution. This will require the market to have confidence in the DI's ability to continue operating as a going concern and will attract a market confidence premium (Pm) which will be a percentage that ranges from 0 to 25%<sup>7</sup>. This Pm counts as additional Flac, above the MFR required to recapitalise the DI to a level that meets that PA's requirements.

<sup>6</sup> Post-loss balance sheet refers to a designated institution's balance sheet calculated by deducting the losses incurred (before and in resolution) from its assets, according to the risk weights assigned to the relevant assets in terms of the bank's capital adequacy legislation. The losses incurred before and in resolution are assumed to equal to the minimum amount of capital and reserves (prior to buffers) required for a DI.

<sup>7</sup> For the Pm, 25% represents the maximum premium (worst case).

3.8 In addition, when a DI takes the necessary steps to make itself more resolvable, the Reserve Bank may consider granting the DI a Resolvability Rebate (Rr) as a deduction against the additional Flac. This Rr is a percentage which will be between 0% to 15%<sup>8</sup>.

3.9 Therefore, the net effect on additional Flac equals market premium (Pm) less the resolvability rebate (Rr).

3.10 The additional Flac elements (Pm and Rr) are both institution-specific percentages. To determine the absolute value for additional Flac, the minimum amount needed to recapitalise the DI to a level that meets the PAs requirement will be multiplied by this institution-specific additional Flac percentage.

Therefore, the **additional Flac = minprCAR (Pm-Rr)**

#### **4 Formulas in the Prudential Standard**

4.1 The MFR comprises of two components -

- (a) the base minimum Flac requirement (bMFR); and
- (b) the institution-specific, additional Flac requirement (iMFR), as specified by the Reserve Bank.

Therefore **MFR = bMFR + iMFR**

4.2 The bMFR shall comprise of the components of the minCAR that are standard for all banks (when applicable) which is the baseCAR plus the relevant specified Pillar 2A capital requirements. The bMFR must be calculated using the post-loss balance sheet. Therefore, the bMFR formula is as follows -

**bMFR = baseprCAR + prPillar 2A**

where -

- (a) baseprCAR equals the base minimum capital requirement of 8% risk-weighted exposures, using a post-loss(pr) balance sheet; and
- (b) prPillar 2A equals the Pillar 2A systemic risk requirement, using a post-loss balance sheet.

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<sup>8</sup> For the Rr, 15% represents maximum deduction(best-case).

4.3 The iMFR shall comprise of the components of the minCAR which are idiosyncratic to the DI (which is the relevant specified Pillar 2B requirement) as well as additional Flac. The iMFR must also be calculated using the post-loss balance sheet. Therefore, the iMFR formula is as follows -

$$\mathbf{iMFR = minprCAR (Pm-Rr) + prPillar2B}$$

where –

- (a) MinprCAR is the sum of bMFR and Pillar 2B (which represents the total minimum capital requirement required by the Prudential Authority (PA), used as a base to determine the additional Flac;
  - (b) Pm is the market premium which will range between 0% to 25%, as determined by the Reserve Bank;
  - (c) Rr is the resolvability rebate which will range between 0% to 15%, as determined by the Reserve Bank; and
  - (d) prPillar 2B is the additional bank-specific minimum required for idiosyncratic risk, using a post-loss balance sheet.
- 4.4 The pr in the formulas above indicates that the values of the components of the formulas must be calculated using a post-loss or resolution balance sheet. That means the losses expected to be incurred before and during resolution have been accounted for in the post-loss or resolution balance sheet.
- 4.5 The instruments to meet the MFR must consist of a minimum amount of Flac instruments, which is calculated as 33.33% of the total loss-absorbing capacity (TLAC). DIs then have an option to “top-up” the remaining MFR balance with excess regulatory capital (CREG<sup>9</sup>).
- 4.6 It is important to note that the MFR is an additional requirement to the minimum capital adequacy requirement (minCAR) that is specified in the Regulations relating to Banks or prudential standards that deal with a bank’s capital adequacy (bank’s capital adequacy legislation). When added together, the MFR plus the minCAR equals TLAC. Therefore, to calculate the total going concern and gone concern capital requirements (excluding the capital buffer requirements), DIs must use the following formula -

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<sup>9</sup> Excess regulatory capital (CREG) refers to the difference between the total minimum required amount of capital and reserve funds including countercyclical, conservation and Domestic Systemically Important Bank (DSIB) buffers) and the total qualifying amount of capital and reserve funds as specified in the bank’s capital adequacy legislation.

$$\text{TLAC} = \text{minCAR} + \text{MFR}$$

## **5 Guidance – illustrative example of the MFR calculation**

5.1 Table A is an MFR calibration example for illustrative purposes only, using the following assumptions -

- (a) total Assets = 100 000 and risk-weighted exposures (RWAs) = 80 000
- (b) minCAR is 10% (baseCAR= 8%; Pillar 2A= 1% and Pillar 2B=1%)
- (c) additional Flac: Pm = 15% and Rr = 10%

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Table A: MFR calibration illustrative example

CURRENT BALANCE SHEET			
			Notes / Formulas
Total Assets (TA)	100 000	<b>A</b>	<i>assumption</i>
Risk-weighted exposures (RWAs)	80 000	<b>B</b>	<i>assumption</i>
RWA density	0.8	<b>C</b>	$B/A$
MinCAR	10%	<b>D</b>	<i>assumption</i>
Min CAR	8000	<b>E</b>	$B \cdot D$
• baseCAR (8%)	6400		$B \cdot 8\%$
• Pillar 2A (1%)	800		$B \cdot 1\%$
• Pillar 2B (1%)	800		$B \cdot 1\%$

RESOLUTION BALANCE SHEET				
			Notes / Formulas	
Estimated losses	8 000	F	<i>F equals E</i>	
Post-loss B/S	92 000	G	<i>A - F</i>	
RWA density	0.8	H	<i>H equals C</i>	
Resolution RWAs	73 600	I	<i>G * H</i>	
min <i>pr</i> CAR	7 360	J	<i>I * D</i>	
• base <i>pr</i> CAR (8%)	5888	K	<i>I*8%</i>	
• <i>pr</i> Pillar 2A (1%)	736	L	<i>I*1%</i>	
• <i>pr</i> Pillar 2B (1%)	736	M	<i>I*1%</i>	
MFR = bMFR+ iMFR				
bMFR = base <i>pr</i> CAR + <i>pr</i> Pillar 2A		iMFR = min <i>pr</i> CAR(Pm-Rr) + <i>pr</i> Pilar 2B		
=5888 + 736		=7360 (0.15 - 0.10) + 736		
=6624		=368 + 736		
		=1104		
Therefore MFR = 6624 + 1104 = 7728				

## 6 Guidance – illustrative example on the minimum Flac instruments

- 6.1 Drawing from the example in paragraph 5.1 above, table B further illustrates how DIs should calculate the minimum amount of Flac instrument issuances and how CREG could be used as a top-up if the DI does not prefer the MFR to fully comprise of Flac instruments.

Table B: Minimum Flac issuances illustrative example

MinCAR	8 000	<b>A</b>	{per table A}
MFR	7 728	<b>B</b>	{per table A}
CREG	4 500	<b>C</b>	{assumption}
TLAC	<b>15 728</b>		
• MinCAR	8 000	<b>A</b>	
• MFR	7 728	<b>B</b>	
Min Flac instrument issuance	<b>5 242</b>	<b>D</b>	{TLAC*33.333%}
TLAC “re-stack”	15 728		
• MinCAR	8000	<b>A</b>	
• Min Flac issuances	5242	<b>D</b>	
• CREG	2486	<b>E</b>	{“top-up”}
Therefore, the composition of MFR is as follows			
Min Flac instrument issuances + CREG			
=5242 + 2486			
<b>=7728</b>			

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Date: