



SOUTH AFRICAN RESERVE BANK  
Prudential Authority

# **Statement\* explaining the need for, intended operation and expected impact of the draft Prudential Standard RA03 – Flac Instrument Requirements for designated institutions.**

**December 2023**

\*This statement is prepared and published 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)

1	Introduction.....	2
2	The need for the Prudential Standard .....	3
3	Statement of expected impact .....	5
4	Costs and benefits of implementing the Prudential Standard .....	18
5	The intended operation of the Prudential Standard .....	19
6	Conclusion.....	21

## **1 Introduction**

- 1.1 In the aftermath of the global financial crisis (GFC), the Financial Stability Board (FSB) developed a framework for dealing with the failure of certain systemic financial institutions (“Too-Big-To-Fail” institutions). This framework is titled the Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes) and it constitutes resolution principles, from which all the G20 member jurisdictions derive their resolution frameworks.
- 1.2 The Key Attributes set out the core elements that the FSB considers necessary for an effective resolution regime, including the adequacy of loss absorption and recapitalisation capacity for systemically important institutions when they fail. This loss absorption and recapitalisation capacity is the main subject of discussion for this document.
- 1.3 In principle, the FSB states that there must be sufficient loss-absorbing and recapitalisation capacity (termed Total Loss Absorbing Capacity (TLAC)) available in resolution to implement an orderly resolution that minimises impact on financial stability, ensures continuity of critical functions and avoids exposing taxpayers to loss.
- 1.4 In line with this principle, the FSB issued a standard<sup>1</sup> in 2015 titled “Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs<sup>2</sup> in Resolution”, which sets out the principles for TLAC.
- 1.5 Although South Africa does not have G-SIBs, there remains a high degree of concentration in banking services amongst the 6 banks that are designated Systemically Important Financial Institutions (SIFIs). Therefore, the principle of sufficient TLAC still applies domestically.
- 1.6 In the South African context, the draft Prudential Standard RA03 - Flac<sup>3</sup> Instrument Requirements for designated institutions (Prudential Standard) is the regulatory instrument used to specify the domestic requirements on loss absorption and recapitalisation capacity.

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<sup>1</sup> Available at: <https://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf>

<sup>2</sup> G-SIB is an abbreviation for global systemically important banks.

<sup>3</sup> Flac refers to a new class of unsecured subordinated debt instruments introduced by the Financial Sector Regulations Act, 2017 for resolution purposes.

- 1.7 The Financial Sector Regulation Act 9 of 2017 (FSR Act) stipulates that a regulatory instrument (i.e., a standard) must not be made unless the maker, in this case, the Prudential Authority (PA)<sup>4</sup> has published -
- (a) the draft of the regulatory instrument;
  - (b) a statement explaining the need for and the intended operation of the regulatory instrument;
  - (c) a statement of the expected impact of the regulatory instrument; and
  - (d) a notice inviting submissions in relation to the regulatory instrument and stating where, how and by when submissions are to be made.
- 1.8 In line with the requirements specified in the FSR Act, the PA, as directed by the Reserve Bank, has prepared this statement to explain the need for the Prudential Standard, the expected impact as well as the intended operation of the Standard (Statement).
- 1.9 The Prudential Standard is made in terms of section 105(2)(c) read with section 30(1A) of the FSR Act.

## **2 The need for the Prudential Standard**

- 2.1 One of the objectives of the resolution framework is to reduce reliance on public funds (which exposes taxpayers to loss) and empower the resolution authority to assign losses to shareholders and creditors in resolution. This objective underpins the principle of sufficient loss-absorbing and recapitalisation capacity which is a critical component of a resolution framework that enables the effective use of a bail-in tool in resolution.
- 2.2 Recapitalisation through bail-in must enable a designated institution (DI) to continue operating during a resolution and to exit resolution as a viable entity. This requires the recapitalisation to be sufficient to restore the capital levels of a DI to meet regulatory capital requirements (as set out in the Regulations relating to Banks or prudential standards that deal with a bank's capital adequacy (bank's capital adequacy legislation)) and restore the confidence of the market that a DI can continue to successfully conduct business.

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<sup>4</sup> In terms of section 30(1A), the Reserve Bank has directed the PA to make the draft Prudential Standard RA03 -Flac Instrument Requirements for designated institutions.

- 2.3 The FSR Act empowers the Reserve Bank to perform a bail-in, in resolution, by enabling it to perform the following (in a manner that respects the creditor hierarchy) -
- (a) write-down shareholders' equity and unsecured subordinated debt instruments to the extent necessary to absorb losses; and
  - (b) convert all or parts of unsecured debt instruments into shareholders' equity to recapitalise a DI in resolution.
- 2.4 The Reserve Bank's power to write down unsecured subordinated debt extends to all liabilities of a DI (including depositors and operational creditors), except those specifically excluded by section 166S(9) of the FSR Act or an instrument issued by the Reserve Bank.
- 2.5 Therefore, to mitigate the potential negative effects and systemic risk that could be posed by such a bail-in, the FSR Act introduces a new class of instruments, termed Flac instruments. In terms of the creditor hierarchy in the Insolvency Act, as amended by the Financial Sector Laws Amendment Act of 2021, these instruments will rank senior to shareholders' equity and other regulatory capital instruments but subordinated to other unsecured liabilities.
- 2.6 To achieve a successful bail-in, a DI will need to maintain a sufficient level of Flac instruments (and other qualifying instruments) that will be available in resolution for loss absorption and recapitalisation (by being converted to regulatory capital).
- 2.7 Therefore, the purpose of the Prudential Standard is to set out the following -
- (a) the qualifying criteria for Flac instruments to ensure that they are available for bail-in during a resolution; and
  - (b) the quantum of Flac instruments (and other eligible instruments) that DIs are required to build, to ensure sufficient loss absorption and recapitalisation capacity.

### 3 Statement of expected impact

#### 3.1 Overview

- 3.1.1 The impact assessment is performed ex-ante, using 31 March 2023 as the reference date. Certain assumptions were also made to provide a preliminary view of the impact of the regulatory instrument (Prudential Standard).

#### 3.2 Scope of the impact study

- 3.2.1 Flac requirements are only applicable to SIFI banks and their holding companies. The narrow scope of application is due to the primary resolution strategy for these DIs, which is an open-bank resolution strategy. Therefore, the data used for the impact study was obtained from all six SIFI banks.

#### 3.3 Data

- 3.3.1 The data used in the calibration was obtained from the following sources –
- (a) information requested from banks (i.e., forecasted growth in risk-weighted exposures, senior unsecured debt that can be substituted by Flac instruments, current risk premia<sup>5</sup> for market instruments (such as senior unsecured debt instruments) and expected risk premia for Flac instruments);
  - (b) BA returns submitted to the PA; and
  - (c) JIBAR<sup>6</sup> rates obtained from the Financial Markets Department (FMD).

#### 3.4 Background

- 3.4.1 The formulas stipulated in the Prudential Standard form the basis of the *ex-ante* estimation of the financial impact study. There are three main formulas in the standard –
- (a) the Minimum Flac Requirement (**MFR**): which represents the total level of loss absorption and recapitalisation capacity. The MFR has two components, a base component and an idiosyncratic component, as follows –

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<sup>5</sup> Risk premia refers to the excess return that is required by an investor to be compensated for being subjected to an increased level of risk.

<sup>6</sup> JIBAR stands for the Johannesburg Interbank Average Rate which is widely used as a reference rate that underpins a significant number of financial contracts and valuations.

- (i) the base Minimum Flac Requirement (**bMFR**); is the base component of the MFR, and it is a standard requirement for all banks. This component is driven by the level of recapitalisation that will be required to restore a DIs capital (after losses have been absorbed) to the point where it complies with its minimum capital adequacy requirements (minCAR) as determined by the PA; and
- (ii) the idiosyncratic Minimum Base Requirement (**iMFR**): is the idiosyncratic component of the MFR and it is an institution-specific requirement. This component consists of Pillar 2B requirements (for idiosyncratic risk) and additional Flac requirements (driven by a market confidence premium (Pm) to secure funding in the market post resolution). This additional Flac will be offset by a resolvability rebate (Rr), which the Reserve Bank may grant to DIs that take the necessary action to make themselves easily resolvable.

3.4.2 The MFR formula is denoted as **MFR = bMFR + iMFR** and its components are as follows –

- (a) The bMFR which is calculated as follows –

$$\text{bMFR} = \text{baseprCAR} + \text{prPillar2A}$$

where-

- (i) baseprCAR equals the base minimum capital requirement of 8% risk-weighted exposures, using a post-loss(pr)<sup>7</sup> balance sheet; and
- (ii) prPillar 2A equals the Pillar 2A systemic risk requirement, using a post-loss balance sheet.

- (b) The iMFR is calculated as follows –

$$\text{iMFR} = \min \text{prCAR} (\text{Pm}-\text{Rr}) + \text{prPillar 2B}$$

Where –

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<sup>7</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.

- (i) MinprCAR is the sum of bMFR<sup>8</sup> and prPillar 2B (which represents the total minimum capital requirement required by the PA, used as a base to determine the additional Flac);
- (ii) Pm is for the market premium which will range between 0% to 25%, as determined by the Reserve Bank;
- (iii) Rr is for the resolvability rebate which will range between 0% to 15%, as determined by the Reserve Bank; and
- (iv) prPillar 2B which is the additional bank-specific minimum requirement for idiosyncratic risk, using a post-loss balance sheet.

3.4.3 Therefore, to perform the impact study the following three areas were investigated:

- (a) The quantum of MFR that DIs will have to raise;
- (b) The cost of MFR; and
- (c) The implications of the nature of instruments that make up the MFR (i.e., Flac instruments or regulatory capital instruments), on the availability of recapitalisation capacity in resolution.

### 3.5 **The MFR**

3.5.1 The methodology used to determine the level of MFR that DIs will have to raise, is based on the MFR formula(s) discussed under paragraph 3.4.2 above, using data as at 31 March 2023 under two scenarios (best and worst case).

3.5.2 The assumptions made under the two scenarios are as follows –

- a) worst-case scenario: Pm is at the maximum percentage (25%) and Rr at the minimum percentage (0%). Therefore, under the worst-case scenario DIs will incur the maximum additional Flac;
- b) best-case scenario: Pm is at the minimum percentage (0%) and Rr is at the maximum percentage (15%), limited to zero. Rr should reduce the additional Flac and not the base Flac requirement. Therefore, under the best-case scenario, DIs will not incur any additional Flac.

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<sup>8</sup> As stated under paragraph 3.4.2(a)  $bMFR = baseprCAR + prPillar2A$

- c) The 6-year phase-in period for the MFR will only apply to the bMFR component. The phase-in period for the iMFR component can only be fully determined once the drafting of resolution plans has reached maturity and the Reserve Bank is able to conduct resolvability assessments.

### 3.5.3 Results –

- (a) The industry MFR (bMFR + iMFR) amounts to R360bn for the worst-case scenario and R288bn for the best-case scenario. Therefore, DIs will need to issue Flac instruments and other qualifying instruments between R288bn and R360bn to build adequate total loss-absorbing capacity (TLAC).
- (b) Table 1 below details the components of the MFR and Figure A illustrates the phase-in period for the bMFR component (which is the same under both scenarios).
- (c) The shift in TLAC from the current status quo to the end state (when Flac requirements are fully phased-in) is discussed in paragraphs 3.5.6 to 3.5.10.

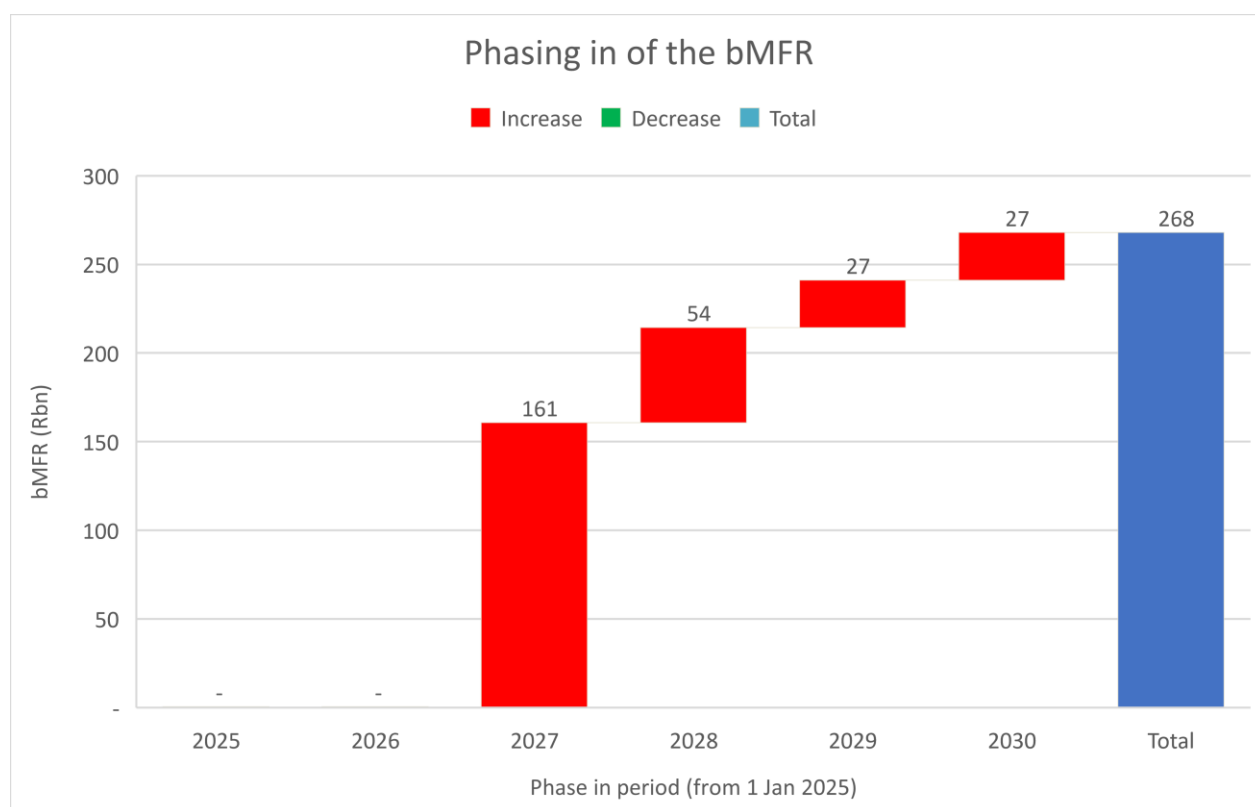
Table 1: *Components of the MFR*

<b>Components</b>	<b>Worst-case ('R000)</b>	<b>Best-case ('000)</b>
<b>bMFR</b>	<b>R268bn</b>	<b>R268bn</b>
<b>iMFR</b>	<b>R92bn</b>	<b>R20bn</b>
<b>MFR</b>	<b>R360bn</b>	<b>R288bn</b>

### 3.5.4 Commentary based on Table 1 -

- (a) The bMFR contributes approximately 74% and 93% to the MFR for the best-case and worst-case scenarios, respectively. The iMFR contributes only 26% and 7 % to the MFR for the best-case and worst-case scenarios, respectively.
- (b) Therefore, a significant portion of the MFR is made up of the bMFR, which is the component that will be phased in first.

Figure A – phase-in of the bMFR component



### 3.5.5 Commentary based on Figure A –

- (a) The envisaged commencement date for the phase-in period is 1 January 2025; however, the Reserve Bank will only require DIs to meet requirements for Flac instruments (and other qualifying instruments) from year 3 of the phase-in period (which is the year 2027).
- (b) Therefore, the largest portion of the Flac requirement, which amounts to R161bn (60% of the bMFR), will only be required from 2027, to provide designated institutions with sufficient time to build up their Flac and other qualifying instruments.

3.5.6 It is important to note that the MFR is an additional requirement to the minimum capital adequacy requirement (minCAR) that is specified in the bank's capital adequacy legislation. When added together, the MFR plus the minCAR equals TLAC.

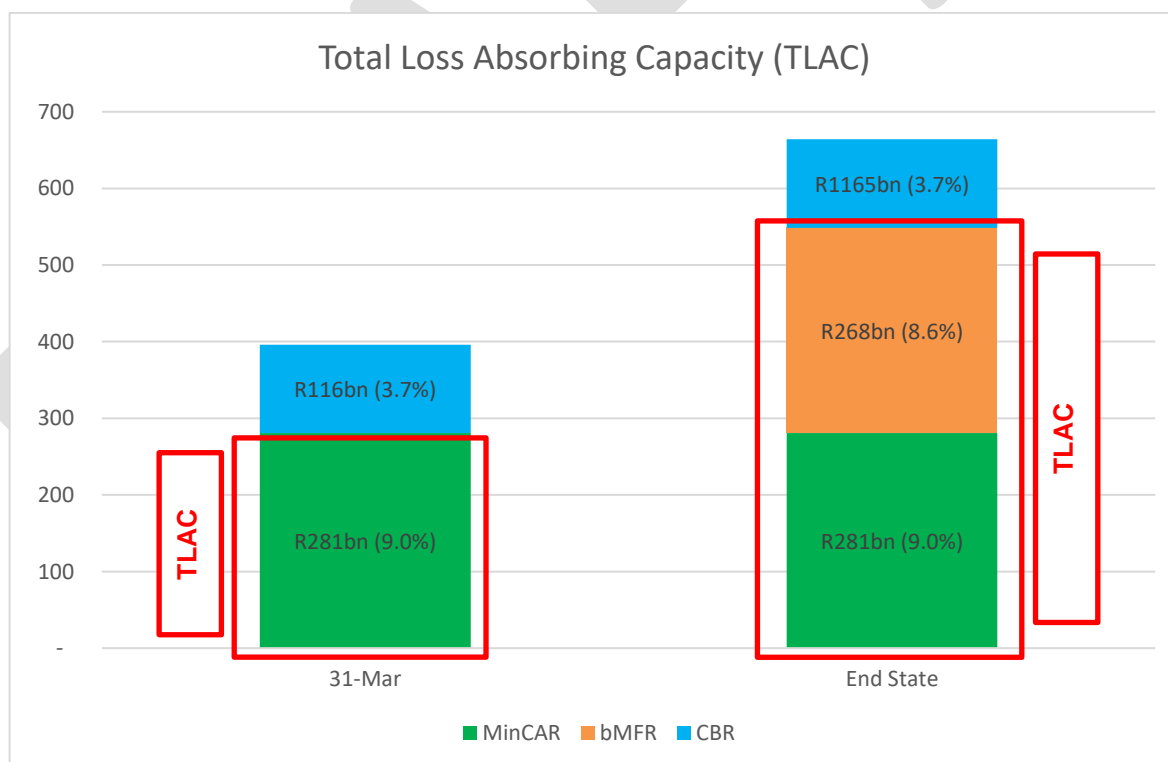
Therefore  $TLAC = minCAR + MFR$

3.5.7 Based on Figure B, the DIs combined TLAC will increase from R281bn to R549bn (minCAR plus bMFR). Thus, TLAC will increase from 9% to 17.6% of

risk-weighted exposures at 31 March 2023. The minCAR constitutes 51% of the TLAC and the bMFR 49% of the TLAC.

- 3.5.8 The minCAR is aimed at loss absorption for the DI whilst it is a going concern. The minCAR plus MFR is aimed at both loss absorption and recapitalisation under both going concern and resolution scenarios using resources within the DI itself, instead of relying on public funds.
- 3.5.9 The TLAC excludes the capital buffer requirements (CBR) as specified in the bank's capital adequacy legislation, which means DIs will still need to hold the required buffers above the TLAC.
- 3.5.10 Total going concern plus gone concern capital requirements (including the CBR) for the DIs will increase from 12.7% to 21.3% of risk-weighted exposures as at 31 March 2023.

*Figure B – TLAC*



Note: the values above exclude Pillar 2B for the minCAR and exclude the iMFR component of the MFR.

- 3.5.11 Please take note that for the rest of the impact analysis, only bMFR will be assessed due to the limitations on the iMFR component at this point.

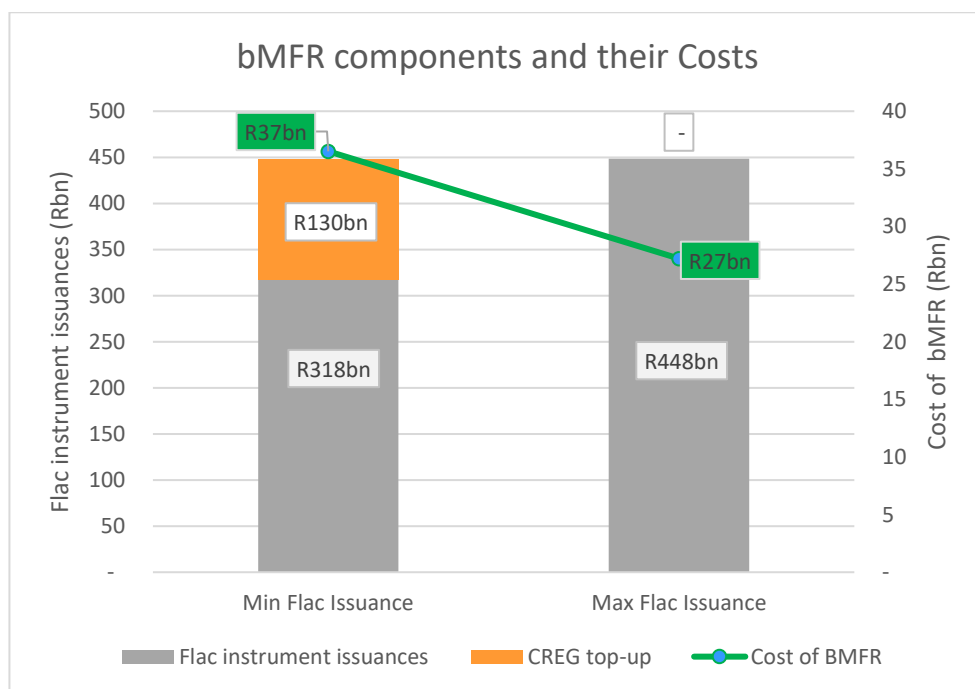
### 3.6 **Cost of MFR**

- 3.6.1 The assumptions regarding the costs to be borne by DIs are mainly driven by whether the bMFR consists of Flac instruments (which attract a cost of issuance<sup>9</sup>) or excess regulatory capital instruments (which attract a cost of equity).
- 3.6.2 Furthermore, the costs of issuances are also influenced by whether DIs have current instruments that can be replaced by Flac instruments (i.e., Senior Unsecured Debt (SUDs)).
- (a) If DIs have SUDs that can be replaced by Flac instruments, then the cost of Flac instrument issuances will only be the marginal difference between issuing a Flac instrument instead of an SUD (i.e., the cost will only be the additional premium of issuing a Flac instrument instead of an SUD, and not the full cost of a Flac instrument issuance).
  - (b) However, if DIs do not have instruments that can be replaced by Flac instruments, then the cost of issuance will be the full cost of issuing such an instrument in the market (with all the risk premia factored in).
- 3.6.3 The methodology used to determine the cost of bMFR projects the growth in the risk-weighted exposures (in line with the DIs strategic goals to grow their books over the 6-year transitional period). Therefore, the expected growth in the risk-weighted exposures will result in a higher Flac requirement for each year, due to the increased base (being the risk-weighted exposures).
- 3.6.4 The assumptions used are as follows -
- (a) Worst-case scenario: the bMFR consists of a minimum Flac instrument issuance (which is 33.33% of TLAC) and the remainder of the bMFR balance consists of excess regulatory capital instruments;
  - (b) Best-case scenario: the bMFR consists of 100% minimum Flac instrument issuance (which is a maximum Flac instrument issuance); and
  - (c) both these scenarios will take into account the SUDs that can be replaced by Flac instruments.

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<sup>9</sup> The cost of issuance refers to the interest or coupon payments, which is the return for Flac instrument holders.

Figure C: bMFR components and their related costs

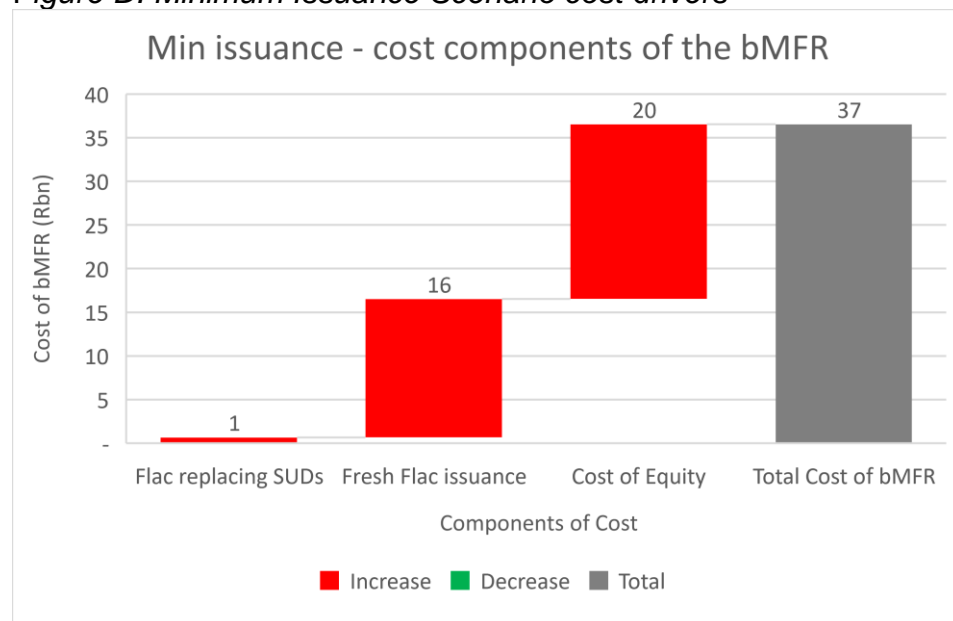


Commentary based on Figure C –

(a) For both minimum and maximum Flac instrument issuance scenarios, the projected bMFR at the end of the 6-year transitional period (the year 2030) amounts to R448bn.

- (b) The Flac instrument issuance for the minimum issuance scenario is approximately R318bn, and the excess regulatory capital contribution for the same scenario amounts to R130bn. The Flac instrument issuance for the maximum issuance scenario is the full R448bn.
- (c) Although the minimum Flac instrument issuance scenario has fewer Flac instrument issuances (R318bn) when compared to the maximum Flac instrument issuance scenario (R448bn), the expected bMFR costs for the minimum issuance scenario are cR10bn higher than the maximum issuance scenario. The total expected costs are R37bn and R27bn for the minimum and maximum issuance scenarios respectively.
- (d) Therefore, it can be concluded that using excess regulatory capital to contribute to the bMFR attracts higher costs to be borne by the DIs (as illustrated by the R37bn costs under the minimum Flac instrument issuance scenario).

Figure D: Minimum Issuance Scenario cost drivers



Commentary based on Figure D -

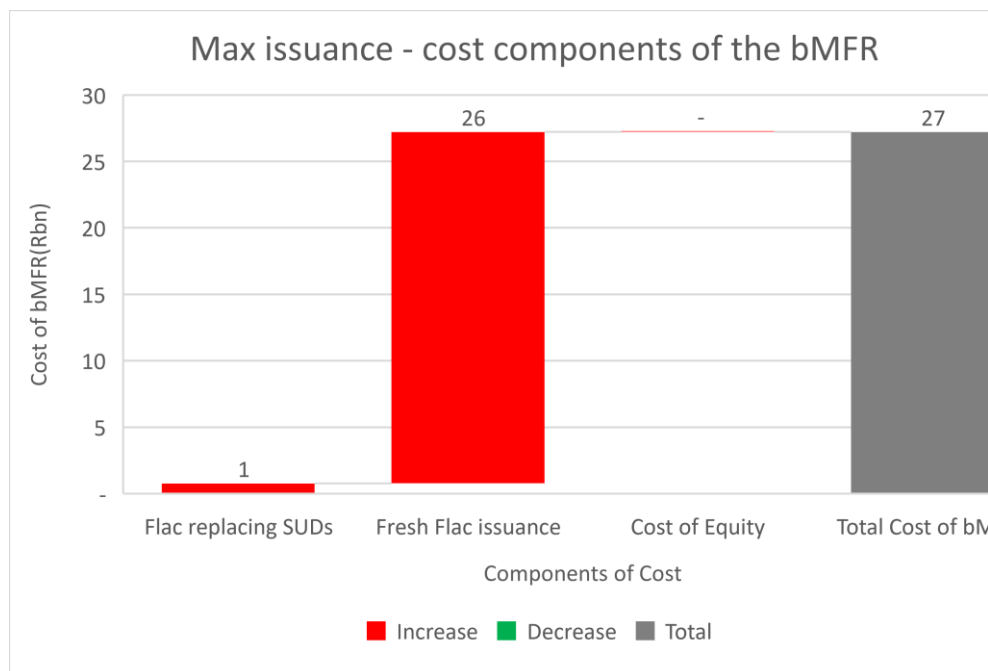
(a) Overall, the R37bn cost for the minimum Flac instrument scenario can be broken down as follows -

- (i) R1bn for the cost of Flac instruments replacing SUDs;
- (ii) R16bn for the cost of “fresh” Flac instrument issuances; and
- (iii) R20bn for the cost of equity.

(b) The analysis of the cost drivers per category -

- (i) **Cost of Flac instruments replacing SUDs:** The quantum of SUD instruments that can be replaced by Flac instruments accounts for 35% of the bMFR (with a cost of less than R1bn which is approximately 2% of the total costs). Premiums for replacing an SUD with Flac instruments range from 20bps to 200bps.
- (ii) **Cost of fresh Flac instruments:** The quantum of fresh Flac instrument issuances accounts for 36% of the bMFR (with a cost of R16bn which accounts for approximately 43% of the total costs). The cost of fresh Flac instrument issuances ranges from 8.91% to 11.28%
- (iii) **Cost of Equity:** The excess regulatory capital top-up to the bMFR accounts for 29% of the bMFR (with a cost of R20bn which accounts for 55% of the total costs). The cost of equity ranges from 14.25% to 25%, with the lowest cost of equity of 14.25% still 297bps above the highest cost of Flac instrument issuance (11.28%).

Figure E – Maximum issuance scenario cost drivers



Commentary based on Figure E -

- (a) Overall, the R27bn cost for the maximum Flac instrument issuance scenario can be broken down as follows -
- (i) R1bn for the cost of Flac instruments replacing SUDs; and
  - (ii) R26bn for the costs of “fresh” Flac instrument issuances.

(b) The analysis of the cost drivers per category -

- (i) **Cost of Flac instruments replacing SUDs:** The quantum of SUDs that can be replaced by Flac instruments accounts for 40% of the bMFR (with a cost of less than R1bn which accounts for approximately 4% of the total costs). Premiums for replacing an SUD with Flac instruments range from 20bps to 200bps.
- (ii) **Cost of “fresh” Flac instruments:** The quantum of fresh Flac instrument issuances accounts for 60% of the bMFR (with a cost of R26bn which accounts for approximately 96% of the total costs). The cost of Flac issuances ranges from 8.91% to 11.28%

(c) In conclusion, when comparing the minimum Flac instrument issuance scenario (under Figure D) and the maximum Flac instrument issuance scenario (under Figure E), Flac instruments are expected to attract lesser costs, when compared to excess regulatory capital instruments which attract cost of equity.

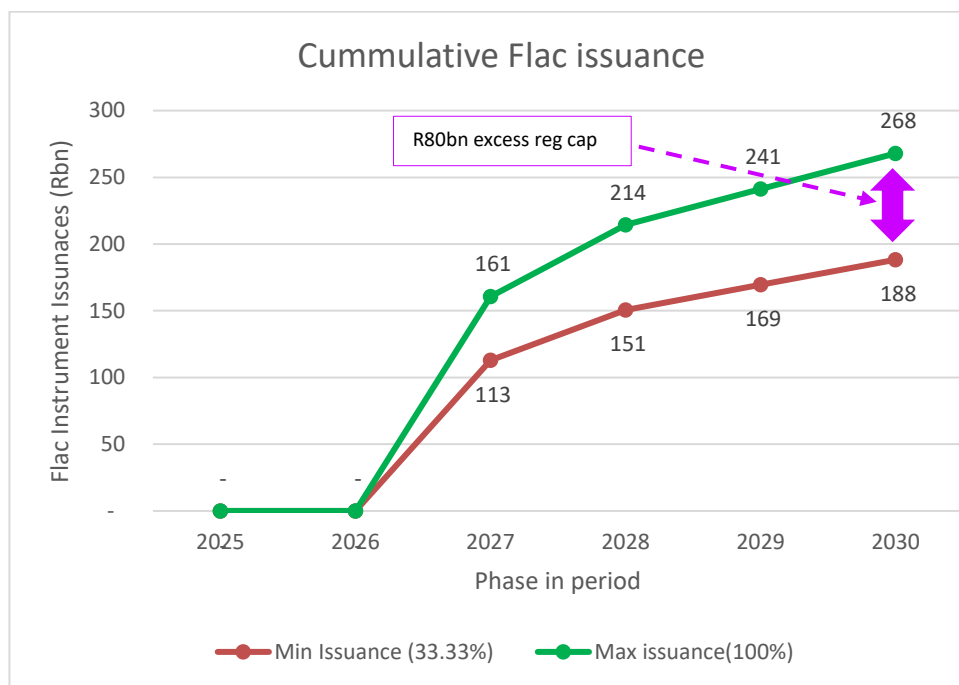
### 3.7 ***Nature of MFR instruments***

- 3.7.1 The amount of TLAC available in resolution to recapitalise the DI is dependent on the nature of instruments that make up the bMFR (i.e., Flac instruments versus excess regulatory capital instruments, which have a different ranking in the creditor hierarchy).
- 3.7.2 Statutory bail-in will follow the creditor hierarchy, which means that regulatory capital instruments e.g. Common Equity Tier 1(CET1), Additional T1(AT1) and Tier 2(T2) will be written off and/or converted first, despite the DI's intention for these instruments to contribute towards the minCAR or the bMFR.
- 3.7.3 The methodology used to assess the implications of the nature of instruments that make up the bMFR, uses the level of bMFR at 31 March 2023 (the same one calculated under paragraph 3.5) broken down into the creditor hierarchy rankings to test the availability of recapitalisation capacity in resolution.
- 3.7.4 The assumptions used are as follows -
- (a) worst-case scenario: DI's issue a minimum of Flac instruments issuances (which is 33.33% of TLAC) and use excess regulatory capital as a top-up to meet the bMFR;
  - (b) best-case scenario: DI's meet the full bMFR with 100% Flac instrument issuances;
  - (c) additional assumptions: the minCAR is split into CET1, AT1 and T2 using the percentage split provided in Table 2 below (as per Directive 5 of 2021 guidelines); and
  - (d) all the excess regulatory capital used to contribute towards the bMFR is assumed to only consist of CET1 instruments.

Table 2: assumptions for the breakdown of minCAR

	CET1	AT1	T2
Base	56.25%	18.75%	25.00%
Pillar 2A	50.00%	25.00%	25.00%
Pillar 2B	50.00%	25.00%	25.00%

Figure F: Cumulative Flac instruments issuances



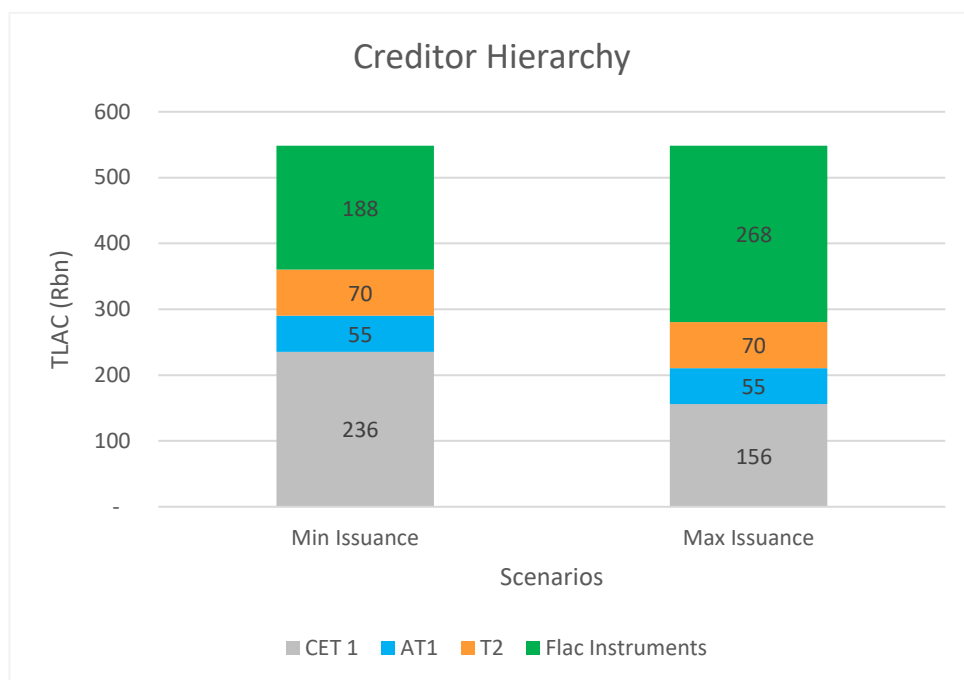
Commentary based on Figure F -

- (a) The cumulative difference between the two scenarios at the end of year 6 is approximately R80bn (R268bn – R188bn) which is the excess regulatory capital (assumed to only consist of CET1 instruments).
- (b) The impact of this R80bn difference on the Creditor Hierarchy is illustrated in Figure G below.

(c) It is worth noting the following observations under the minimum Flac instrument issuance (worst-case scenario) –

- (i) The Flac instruments issuances cover approximately 70% of the bMFR (when excluding Capitec). Which means approximately 30% will consist of excess regulatory capital instruments.
- (ii) For certain DIs, the minimum Flac issuance requirement of 33.33% of TLAC came out to be more than the required level of bMFR. Therefore, for these specific DIs the nature of bMFR could only consist of Flac instruments, since the minimum that would determine the amount of Flac issuances was more than the bMFR itself.

Figure G: TLAC in the form of Creditor Hierarchy



Commentary based on Figure G:

- (a) The first tranche of instruments to absorb losses will be CET1, which is R236bn and R156bn under the minimum and maximum issuance scenarios, respectively.
- (b) The R80bn difference (R236bn – R156bn) is the excess regulatory capital intended to contribute towards the bMFR, however it ranks lower in the creditor hierarchy.

- (c) Under the minimum Flac instrument scenario, the portion of TLAC that the Reserve Bank is guaranteed to be available in resolution, to recapitalise the designated institution will only amount to R188bn (which is the Flac instrument issuances).
- (d) On the contrary, the maximum Flac instrument scenario (best-case) provides the Reserve Bank with the assurance that R268bn of Flac instruments will be available in resolution to recapitalise the DI.
- (e) In conclusion, in circumstances where DIs prefer to comply with the bMFR requirement by having minimum Flac instruments and excess regulatory capital as a top-up, the Reserve Bank will have to carefully consider the point at which the DI is put into resolution to ensure that -
  - (i) loss absorbing instruments (CET1, AT1 and T2) are not fully depleted before resolution; and
  - (ii) there will be sufficient Flac instruments (and other qualifying instruments) to recapitalise the designated institution fully.

## **4 Costs and benefits of implementing the Prudential Standard**

### **4.1 Benefits of implementing the Prudential Standard**

4.1.1 Adequate loss absorption and recapitalisation capacity of systemic financial institutions reduces the likelihood of a banking crisis as it enables banks to absorb unexpected losses and to continue providing critical functions to the economy. Additional benefits include -

- (a) moving from bail-out to bail-in which will shift losses from the government to shareholders and creditors which in turn also reduces the risk of higher taxes to fund the resolution of DIs;
- (b) prevention of moral hazard and containing contagion by providing confidence that the failing institution has adequate capacity to recapitalise itself; and
- (c) lesser negative impact on GDP as imposing losses on shareholders and creditors generally has a smaller impact on GDP when compared to imposing the same losses on taxpayers.

### **4.2 The cost of not implementing the Prudential Standard**

4.2.1 The lack of clear and sufficient capacity to recapitalise failing financial institutions from resources within the financial sector leads to the cost of bailing out financial institutions falling on the central government.

4.2.2 This involves the injection of large amounts of capital funded by the government, either by borrowing or by diverting public funding from other expenditures. These fiscal costs have an impact on the capacity of the government to provide funding for alternative purposes, such as education, health and infrastructure. In some cases, it might result in a substantial increase in government debt. The costs are therefore both financial and of an 'opportunity cost' nature (i.e., the cost of foregone alternative uses of the funds).

4.2.3 Fiscal costs associated with resolving failures in the financial sector can impose higher public debt burdens due to accumulated fiscal deficits. In turn, this places a continuing drain on public finances to service the debt. It can also result in a lower credit rating for the government (with flow-on impacts on

the credit ratings of banks and corporations) and an increase in the risk premium on interest rates.

4.2.4 When authorities intervened in 2014 to prevent the failure of African Bank Limited, the recapitalisation costs incurred (excluding guarantees to protect depositors and other costs) were approximately R10bn, with R5bn being funded by the Reserve Bank. Using total assets as a size indicator (31 March 2023), the sizes of the six SIFI banks range from 6 times to 40 times larger than African Bank Limited, with the average being 28 times larger than African Bank Limited. Therefore, using the average size of 28 times larger (and assuming the same recapitalisation mechanism), the Reserve Bank would have to fund recapitalisation costs of approximately R140bn ( $R5bn \times 28$ ), before considering other interventions such as liquidity assistance, guarantees etc. if an “average” sized SIFI bank failed. This is an indication of the burden that could be imposed on the fiscus if adequate loss absorption and recapitalisation capacity is not raised to ensure an orderly resolution.

4.3 Unintended consequences of implementing the Prudential Standard (trade-offs)

4.3.1 The trade-offs against adequate loss absorption and recapitalisation capacity are the costs to the economy associated with higher bank funding costs (whether it's in the form of equity or wholesale debt). The increase in funding costs of banks could be passed down to their borrowers (through increased lending rates). If the increase in these lending rates is substantial, the economic output could be dampened.

4.3.2 The Reserve Bank acknowledges the possibility of these trade-offs and will review the impact of implementing the Prudential Standard on an ongoing basis and perform a post implementation evaluation once DIs have started building up the required Flac requirement levels.

## **5 The intended operation of the Prudential Standard**

5.1 The Prudential Standard is only applicable to banks that have been designated as SIFIs and their holding companies. These are the DIs that are expected to have an open-bank resolution strategy, thus the importance of being able to absorb losses and recapitalise themselves.

- 5.2 Each SIFI bank is expected to calculate its minimum Flac requirements and then -
- (a) their holding companies are expected to issue Flac instruments to external counterparties and invest (downstream) these funds into the SIFI bank; and
  - (b) the SIFI banks are expected to issue internal Flac instruments to the holding company to facilitate the down streaming (investment) of the funds received from the external issuances of Flac instruments, so that the Flac instruments are funded ex-ante and ensure their availability in a resolution scenario.
- 5.3 Both the externally and internally issued Flac instruments must meet the qualifying criteria stipulated in the Prudential Standard.
- 5.4 The Standard is envisaged to be published in Q2 of 2024 but only become effective from 1 January 2025.
- 5.5 The base component of the MFR (bMFR) will be phased in over a 6-year period as set out in Table 3 below.

*Table 3 phase-in of the bMFR*

Effective date (1 Jan 2025)	0%
End of year 3 (2027)	60%
End of year 4 (2028)	80%
End of year 5 (2029)	90%
End of year 6 (2030)	100%

- 5.6 The idiosyncratic component of the MFR (iMFR) will only be determined and phased in once the resolution planning process has reached a mature state. The PA will communicate the effective date and the phase-in period for this component, as directed by the Reserve Bank.
- 5.7 The Flac instrument issuance component of the bMFR will also be subject to phase-in (as a percentage of TLAC) as set out in Table 4 below.

*Table 4: phase-in of the Flac instrument issuances*

Effective date (1 Jan 2025)	0%
End of year 3 (2027)	20%
End of year 4 (2028)	27%
End of year 5 (2029)	30%
End of year 6 (2030)	33.33%

- 5.8 Following the implementation of the Prudential Standard, the Reserve Bank will evaluate the impact of the requirements on an ongoing basis and perform a post implementation evaluation, to determine if there are any necessary adjustments to be made to the requirements.
- 5.9 The form, manner and period for reporting obligations in terms of the Prudential Standard, where such requirements have not been specified in the standard itself, will be determined by the PA as directed by the Reserve Bank and be published on the PA's website.

## **6 Conclusion**

- 6.1 The requirements specified in the Prudential Standard are a key element of South Africa's resolution framework. They will enable the Reserve Bank to execute an effective open-bank resolution strategy with adequate loss-absorbing and recapitalisation capacity.
- 6.2 On the downside, these Prudential Standard requirements are not without cost implications and certain trade-offs. However, the net benefits far exceed the costs, with alleviation to fiscal costs, increased resilience of the financial sector, improved financial stability and overall confidence in the South African banking industry through a robust resolution regime.

## Annexure A:

Prior to the Prudential Standard, the Reserve Bank performed work on Flac requirements, which is captured on a timeline Figure H below.

Figure H: timeline of past discussion papers in relation to Flac requirements

