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A DEPOSIT GUARANTEE FRAMEWORK FOR SOUTH AFRICA: A COMPARATIVE APPRAISAL

By

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When I started my doctoral journey in 2017, I had often heard stories about how pursuing a Ph.D. can be a lonely endeavour, but never did I ever imagine that writing could become such a draining and frustrating exercise. At the beginning of my journey, I felt like I was on the right path. I enjoyed writing. It felt like a dream come true and indeed it was. I had often fantasised about pursuing this journey, so it felt both right and fulfilling. The first three years were easy. I love research and I knew writing was my thing. However, despite my love for research and eagerness to finish, writing slowly became a gruesome exercise. Life also took different turns. Firstly, the world was confronted with the COVID-19 pandemic in 2020, calling for governments to take unprecedented measures to curb the spread of the coronavirus and forcing the world to adjust to a new way of life. This affected my journey and immensely slowed down my progress. Secondly, when I thought I was getting used to the new way of life introduced to me in 2020, the year 2021 became a year of disruption for me in many ways. Some major life events happened during that year which includes losing my dad at the beginning of the year, ending my 10-year marriage, moving to Johannesburg with the kids to start a new job, and giving birth to my last-born son. I found it increasingly difficult to look at my thesis. Procrastination was my only agenda.

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DECLARATION OF ORIGINALITY

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SUMMARY

This thesis appraises the features of the new South African explicit deposit insurance system (EDIS) as set out in the Financial Sector Laws Amendment Act 23 of 2021 which introduces a comprehensive deposit insurance framework into Chapter 12A of the Financial Sector Regulation Act 9 of 2017 (being the framework Act that introduced South Africa's new Twin Peaks model of financial regulation in 2017). Notably, the Financial Sector Laws Amendment Act also introduced a comprehensive new bank resolution regime for South Africa, which, like the new EDIS, is captured in Chapter 12A of the Financial Sector Regulation Act. These two new frameworks will operate in tandem to ensure that depositors' interests are protected during bank resolution - whether through pay-outs to depositors if a bank is liquidated or through funding for other resolution measures obtained from the Corporation for Deposit Insurance. The new EDIS will also in the first instance seek to contribute to financial system stability by imposing levies and premiums on banks in an effort to instil greater market discipline and minimize the risk of bank failure.

While the world's first explicit deposit insurance system was pioneered in the United States of America in 1933, the 2008 Global Financial Crisis (GFC) highlighted the very important role of deposit insurance in protecting depositors and contributing to financial system stability. Not only did the GFC emphasize the need for a clear depositor protection framework in the form of an EDIS, but it also tested the effectiveness of the design features for the then existing EDIS frameworks globally. In response to the GFC, the International Association for Deposit Insurers (IADI), together with the Basel Committee on Banking Supervision (BCBS), issued the first set of internationally agreed principles, the *IADI Core Principles for Effective Deposit Insurance Systems* in 2009, which were later revised in 2014. These principles were established to serve as good practice benchmark for countries wishing to establish EDIS and those wishing to reform their existing systems.

South Africa has, over the years, always had a robust approach to banking regulation, which is well-aligned with various international standards introduced by the Basel Committee such as the *Basel Core Principles for Effective Banking Supervision* and the various *Basel Accords*. However, it was one of only a few G-20 members at the time of the GFC that had always been operating on the ambiguous basis of implicit

deposit insurance in the event of bank failure –thus taking a reactive rather than a pro-active approach in this regard. The debate on introducing a legal framework for a South African EDIS commenced approximately a decade ago, soon after the GFC. However, it was only in 2018 that the *Financial Sector Laws Amendment Bill* 2018, incorporating provisions on a comprehensive EDIS framework, was eventually tabled in Parliament. Subsequently, an updated version of the aforesaid Bill was issued in 2020 and signed into law in 2021 as the Financial Sector Laws Amendment Act 23 of 2021, introducing, as mentioned above, a comprehensive EDIS for South Africa that has yet to be implemented.

This thesis interrogates the features of this new South African EDIS, examining in particular, the extent to which the main features of the South African EDIS are aligned with the *IADI Core Principles for Effective Deposit Insurance Systems* as an international good practice benchmark. Considering the design features of an effective EDIS as captured in the *IADI Core Principles* together with a comparative study of the United States of America (US) and the Australian EDIS frameworks, the South African EDIS framework is critically analysed and recommendations are eventually made for strengthening the South African EDIS framework to ensure its optimal alignment with international good practice.

Keywords: explicit deposit insurance, implicit deposit insurance, moral hazard, bank runs, bank failure, deposits, reimbursements.

ACRONYMS

ADI	Authorised deposit-taking institutions
APRA	Australian Prudential Regulation Authority
BCBS	Basel Committee on Banking Supervision
BIF	Bank Insurance Fund
CBA	Commonwealth Bank of Australia
CFPB	Consumer Financial Protection Bureau
CoDI	Corporation for Deposit Insurance
DFA	Dodd-Frank Wall Street Reform and Consumer Protection Act
DIF	Deposit Insurance Fund
DIS	Deposit Insurance System
DRR	Designated Reserve Ratio
DWFG	Deposit and Wholesale Funding Guarantee
EDIS	Explicit Deposit Insurance System
ELA	Emergency Lending Assistance
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FDIC	Federal Deposit Insurance Corporation
FDIRA	Federal Deposit Insurance Reform Act
FIRREA	Financial Institutions Reform Recovery and Enforcement Act

FSB	Financial Stability Board
FSCA	Financial Sector Conduct Authority
FSCF	Financial Sector Contingency Forum
FSF	Financial Stability Forum
FSLAB	Financial Sector Laws Amendment Bill
FSRA	Financial Sector Regulation Act
FSTR	Financial Sector (Transfer and Restructure) Act
GFC	Global Financial Crisis
IADI	International Association for Deposit Insurers
IDIS	Implicit Deposit Insurance System
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commission
KAs	Key Attributes for Effective Resolution Regimes For Financial Institutions
MoU	Memorandum of Understanding
OLF	Orderly Liquidation Fund
ORS	Operational Risk Subcommittee
PA	Prudential Authority
RFC	Resolution Funding Corporation
RTC	Resolution Trust Corporation
SAIF	Savings Association Insurance Fund
SARB	South African Reserve Bank
SMEs	Small and Medium-Sized Enterprises

SR	Special Resolution
USA	United States of America

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CHAPTER 1

INTRODUCTION

1.1 Introduction

Banks are, very often, the most dominant players in a financial system.[1] As pointed out by Corrigan, banks perform three essential functions that make them "special" in comparison to other financial institutions, namely:[2] they issue transactions accounts, (meaning that they hold liabilities in the form of deposits payable on demand at par and that are readily transferrable to third parties); they are the back-up source of liquidity to other institutions; and they are also the "transmission belt" for monetary policy. Taking deposits from members of the public, the main activity that distinguishes banks from other institutions has always been an integral part of "the business of a bank", which cemented the critical role of banks in the economy. The bank-customer agreement usually entitles the bank to use these deposits for various purposes, of which lending out the money obtained through deposits to prospective borrowers has, over the years, been the most common function.[3] "Deposit" in this context generally means that the bank's customer who deposits his money with the bank obtains a personal right to have such money repaid to him on demand.[4]

The business model of banks is based on the concept of "fractional reserve banking" which means that banks are required to maintain a portion of their deposits in reserves and can thus not lend out the whole amount of all their deposits.[5] Banks are further said

[1] Haentjens "Bank recovery and resolution: an overview of international initiatives" 2014 *International Insolvency Review* 255.

[2] Corrigan "Are banks special?" In *Federal Reserve Bank of Minneapolis Annual Report* 1982 available at https://econpapers.repec.org/article/fipfedmar/y_3a1982.htm (accessed 2 April 2018) at 507.

[3] This arrangement is referred to as *mutuum*, i.e loan by consumption. This means the depositor is the creditor of the bank who, as debtor, has to repay, on demand, the money it loans from the depositor for purposes of on lending such money at a profit.

[4] See for example the definition of "deposit" in s 1 of the South African Banks Act 94 of 1990.

[5] As explained by Alifanov "On the dangers inherent in a fractional reserve banking system" 2015 29 *Student Economic Review* 117: "Under a fractional reserve banking system, the central bank imposes a legal requirement on all banks operating under its mandate to maintain a specified proportion of their deposits in reserves. Reserves against these deposits can take the form either of currency on hand (vault cash) or balances at the central bank itself. Originally reserve requirements were designed as a safeguard against 'runs' on the banks that were quite widespread over the world until roughly the 1930s-40s. The rationale

to "borrow short and lend long", as explained below, which has the effect that there is a maturity mismatch between its assets and liabilities that may create liquidity risk. As part of their critical intermediation functions, banks transform short-term deposits into longer-term lending.[6] This suggests that banks channel funds from lenders to borrowers through deposit and credit facilities, and in so doing transform liabilities into loans.[7] As financial intermediaries, banks also offer contracts for liquid deposits and utilize the proceeds to finance the acquisition of illiquid assets.[8] However, due to the varying prospects of risks that banks are exposed to, the values of these illiquid assets are normally uncertain.[9] This means that the unique function of banks in converting liquid liabilities into less liquid loans, also makes them susceptible to fragility by exposing them to risks of illiquidity and possibly insolvency.[10]

When the bank's borrowers fail to repay their loans as they fall due, resulting in the bank encountering financial difficulty, it predisposes the bank's depositors to the risk of loss of their deposits, as they would be concurrent creditors only in the absence of legislative depositor protection.[11] Since banks rely on depositors' funds for funding of their business operations and given that these deposits can generally be withdrawn any time, banks

behind this system was that by requiring financial institutions to hold some liquid assets on hand, central banks wished to reassure the depositors that their money was available on demand." The fractional reserve model is also referred to as the money multiplier model – see Werner "Can banks individually create money out of nothing? - the theories and the empirical evidence" 2014 *International Review of Financial Analysis* 1.

[6] Bollard *et al* "The role of banks in the economy – improving the performance of the New Zealand banking system after the global financial crisis" 2011 *A speech delivered to New Zealand Association Annual Meeting* in Touranga.

[7] Coetzee *Bank Management in South Africa: A risk-based approach* (2016) 15.

[8] De Jager "Central bank, lender of last resort assistance: An elusive concept?" 2010 *De Jure* 230.

[9] De Jager (2010) *De Jure* 230.

[10] Kaufman believes the adverse implications of this fragility are intensified by the fear that banks invest in assets that are opaque, illiquid and difficult to market, contain private information and can change in market value very quickly as well as the fear that depositors may run on banks, thus forcing unnecessarily large fire-sale losses. See Kaufman "Bank failures, systemic risk and bank regulation" 1996 *The CATO Journal* 20. See also Bollard *et al* (2011) *New Zealand Speech* 5.

[11] Bhatta "Core Principles and Global Practices of Deposit Insurance Scheme: A Comparison of the Trend with the Nepalese System" 2012 *Banking Journal* 60.

have, over the years, been exposed to the risk of 'bank runs'[12] where depositors seek to withdraw their funds *en masse* ahead of the possible insolvency of a distressed bank.[13] Over time, it has also transpired that bank runs are not only confined to banks that are clearly failing. In fact, bank runs on solvent banks may be triggered by mere rumours that a specific bank that is interconnected to a failing bank may also be in distress and may thus lead to the ruin of such a bank despite it actually having been solvent prior to the bank run. As observed by Ellyne and Cheng, depositors' psychological fear that a bank may fail can cause a bank run, regardless of the underlying financial condition of the bank and banks runs, depending on their severity, may compromise financial stability[14] (also referred to interchangeably in this thesis as financial system stability or systemic stability).[15]

Consequently, in order for banks and the banking system to continuously keep on providing their products and services, confidence is essential to overcome the risk posed by the inherent maturity mismatch between banks' short-term liabilities (deposits) and their long-term assets (loans).[16] This is because whenever depositors' confidence is undermined, the public's ability to collect and utilise its savings is impaired and thus

[12] Diamond & Dybvig stipulate that a bank run occurs when depositors run to the bank to withdraw their deposits in fear that the bank might fail. As such, bank runs are costly and have the ability to reduce social welfare by interrupting production and by destroying optimal risk sharing among depositors. See Diamond & Dybvig "Bank runs, Deposit Insurance, and Liquidity" 1983 *Journal of Political Economy* 401.

[13] According to Ellyne & Cheng, the risk is that if all depositors at a bank decide to withdraw their deposits at once, the bank would be unable to meet its short-term liabilities and be forced to liquidate its assets and close. See Ellyne & Cheng "Valuation of Deposit Insurance in South Africa Using an option-based model" 2014 *African Development Review* 149. See also Bhatta (2012) *Banking Journal* 59.

[14] Allen "What is "financial stability"? The need for some common language in international financial regulation**"** 2014 *Georgetown Journal of International Law* 929. The concept of 'financial stability' appears to be notoriously hard to define precisely, or comprehensively. Allen points out that although many international financial instruments mention the concept of financial stability they generally neglect to define this concept. Her proposal is that 'financial stability' should mean 'a state of affairs wherein (i) financial institutions and markets are able to facilitate capital intermediation, risk management, and payment services in a way that enables sustainable economic growth; (ii) there is no disruption to the ability of financial institutions or markets to carry out such functions that might cause harm to persons (wherever they may be resident) who are not customers or counterparties of those financial institutions, nor participants in those financial markets; and (iii) financial institutions and markets are able to withstand economic shocks (such as the failure of other markets and institutions, or a chain of significant losses at financial institutions) so that (x), there will be no disruption to the performance of the functions set forth in (i), and (y), no harm will be caused to the persons set forth in (ii).'

[15] Ellyne & Cheng (2014) *African Development Review* 149.

[16] Ellyne & Cheng (2014) *African Development Review* 149.

intermediation by banks is jeopardised which, as indicated, may then result in bank runs.[17]

1.2 Preventing bank runs and maintaining financial stability

Given the special nature of banks and the risk their business operations may pose to financial stability, the losses that bank failure may occasion to banks' depositors and other creditors, and the implications it may have for financial stability, it is clearly essential that banks must be closely regulated and supervised, both from a prudential and market conduct perspective.[18] On a prudential level, which underlies the focus of this thesis, this has led to the evolution of the concept of a 'financial safety net'[19] as a framework of interactive regulatory measures that can be applied to promote and maintain the safety and soundness of banks.[20] The main gist is that financial system instability should be prevented through certain prudential measures and that there should also be sufficient measures in place to deal appropriately with bank failure in a manner which would least compromise financial stability.

The financial safety net generally comprises of:

[17] De Jager (2010) *De Jure* 229.

[18] The notion that the financial sector can successfully regulate itself has lost credibility in the aftermath of the GFC. The GFC highlighted, among other things, that even if individual financial institutions are able to improve risk management practices, regulators must proactively monitor changes in systemic risk. The key lesson from the GFC was that regulatory action must be swiftly taken to prevent the spread of contagion. See Republic of South Africa: National Treasury. 2011. *A safer financial sector to serve South Africa better.* National Treasury Policy Document 13.

[19] Financial safety net participants are often broadly defined to include all financial institutions, and even depositors and creditors that provide liquidity. However, they are more closely conceptualized to include government-related financial-sector regulatory authorities and their mandates. See Alley "BOFIA 2020 and financial system stability in Nigeria: Implications for stakeholders in the African largest economy" 2022 *Journal of Banking Regulation* 11.

[20] Financial safety nets consist of implicit and explicit guarantees that limit the losses that creditors can experience in the failure of financial institutions covered by the net. See Kane "Financial Safety Nets: The Good, The Bad, and The Ugly," World Scientific Book Chapters, in (2018) Evanoff DD & Malliaris AG & Kaufman GG (ed.) *Public Policy & Financial Economics Essays in Honor of Professor George G Kaufman for His Lifelong Contributions to the Profession* 49.

(a) effective regular bank regulation and supervision as a first layer to keep banks safe and sound and the possibility of emergency liquidity assistance (ELA)[21] by the central bank (that is usually always also the lender of last resort[22]); and

(b) if banks encounter situations that compromise their safety and soundness, they are then expected to self-correct through the application of early intervention measures[23] to prevent their failure;

(c) a framework for orderly bank resolution to optimally deal with bank failure if it nevertheless materializes; and

(d) an appropriate deposit insurance framework to provide effective and efficient depositor protection, on a preventative level by instilling greater market discipline on banks and, when a bank nevertheless fails then either through supporting

[21] Nyberg "The infrastructure of emergency liquidity assistance – what is required in today's financial system?" *Speech presented at the CGFS regional meeting*, Tokyo 22 May 2000 available at https://www.bis.org/review/r000523c.pdf.

[22] A 'lender of last resort' is, simply put, an entity that is prepared to offer loans as a last resort. If a country's central bank of a country acts is the lender of last resort it lends money to banks that are experiencing financial difficulty, or are considered to be very risky or near failure. See Freixas *et al* "Lender of last resort: What have we learnt since Bagehot?" 2000 *Journal of Financial Services Research* 63.

[23] Early identification of weaknesses and threats to banks enables governments to take effective measures for preventing bank failures, such as providing liquidity support, assisting mergers and acquisitions and, in certain cases, recapitalizing a bank at the expense of the deposit insurer or other authorized government agencies. See International Association of Deposit Insurers (IADI). 2013. *General Guidance on Early Detection and Timely Intervention for Deposit Insurance Systems*, Prepared by the Research and Guidance Committee International Association of Deposit Insurers.

resolution actions such as transferring depositors to a bridge bank[24], as explained in more detail later, or facilitating pay-outs to depositors.[25]

1.2.1 Deposit insurance as a mechanism to promote and maintain financial stability and depositor protection

Generally, the regulatory view is that an explicit deposit insurance framework may serve to minimize bank failure by instilling greater market discipline on banks and that the incidence of 'bank runs' by depositors and the threat that bank failures pose to systemic stability can be prevented or at least greatly mitigated, if there is a guarantee from the government of its commitment and capability to deal with bank failures in an orderly and systematic manner. This would, inter alia, require ensuring sufficient depositor protection by guaranteeing speedy repayment of deposits in the event of bank failure that leads to bank liquidation or transfer of such deposits to a 'good' (bridge) bank during the course of the orderly resolution of a failing bank.[26] Therefore, it is suggested by international standard-setting bodies such as the Financial Stability Board (FSB)[27] and International

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[24] Randell "Legal Aspects of Bank Resolution: Designing the Powers and Solutions" *Paper presented at conference on "Operational Aspects of Bank Resolution and Restructuring" at the European Bank for Reconstruction and Development*, London, 19 March 2012 13. Bridge Banks are relevant in the context of orderly bank resolution as envisaged in the Financial Stability Board *Key Attributes of Effective Resolution Regimes for Financial institutions* (2014) available at https://www.fsb.org/wp-content/uploads/r_141015.pdf (accessed 7 June 2020). As explained by Randell, a bridge bank (which has to be a "good bank" with good assets transferred from the bank in resolution) as a resolution tool may be used as a means of transferring the operational part of the business of a failing bank in order to stabilize such operational business with a view to subsequently dispose of it in, for example, a "purchase and assumption" transaction. Alternatively, a bridge bank may be used to take assets of the failing bank out of the insolvent entity so that the failing bank may be wound down in a more stable manner over a longer time period. The idea is that the bridge bank operates as a "good bank" that continues the essential functions and business operations previously rendered by the bank that was put in resolution whilst the residual bank (bad bank) is left with bad assets like non-performing loans and is eventually wound up. See further Avgouleas & Goodhart "Critical reflections on bank bail-ins" 2015 *Journal of Financial Regulation* 3-4.

[25] Cerda, Brewer and Evanof "The financial safety net: Costs, benefits, and implications" 2001 *Chicago Fed Letter* Number 171a.

[26] Polizatto "Prudential regulation and banking supervision: Building an Institutional Framework for banks" 1990 *Background paper for the 1989 World Development Report* Policy, Planning and Research Department Working Papers No WPS 340 1.

[27] The FSB was established in April 2009 as a successor to the Financial Stability Forum (FSF) to make recommendations regarding global financial regulatory reforms to international standard-setting bodies and national authorities aimed at maintaining financial stability. See https://www.fsb.org/history-of-the-fsb/ (accessed 4 May 2022) and https://www.fsb.org/about/fsb-members/ (accessed 4 May 2022). See also

Monetary Fund (IMF)[28], that every country should have a strategy in place to respond to bank failures when they do occur, in a timely and appropriate manner that facilitates the orderly resolution of the failed bank in tandem with measures that provide some form of depositor protection.

Whereas deposit insurance was initially provided on an implied basis during its early development, the incidence of explicit deposit insurance frameworks has increased since the US pioneered it after the Great Depression of 1929, as discussed in more detail in Chapter 3 hereinafter. In fact, the concept of deposit insurance actually goes as far back as 33 AD when the Roman Emperor Tiberius Caesar provided support to "reliable bankers" after fraud; defaults on foreign debt; liquidity draining government policies; sinking of uninsured cargoes; and a slave revolt precipitated a banking crisis – thereby giving birth to an implicit form of depositor protection based on discretion and constructive ambiguity[29] mainly related to the systemic importance of a failing bank.[30] However, as dealt with in more detail in Chapter 2, the notion of a functionally designed EDIS, not only to keep banks safe and sound through greater market discipline but specifically also as an orderly measure to deal with depositor protection during bank failure emerged in the US in 1933, thereafter spreading to many countries over the course of the previous century.

This evolution of a functionally designed EDIS started with the price collapse on the New York Stock Exchange in October 1929.[31] This event was followed by the failure of a vast number of banks during the last few months of 1930, which ultimately triggered widespread attempts to convert deposits to cash.[32] This, in turn, led to insufficient cash being available for the public and placed additional cash demands on banks.[33] To address

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Weber *et al* "Financial Stability Board: mandate and implementation of its systemic risks standards" 2014 *International Journal of Financial Studies* 82.

[28] The IMF was established in 1944 and is responsible for ensuring the stability of the international monetary system and global economic growth by extending various types of support to financially troubled member countries. See the IMF website available at https://www.imf.org/external/index.htm. (Accessed 4 May 2022).

[29] See the discussion in Chapter 2 par 2.2.1.

[30] Carr "Banking on capital punishment" 2001 *Reserve Bank of New Zealand Bulletin* New Zealand 52.

[31] Flood "The Great Deposit Insurance Debate" 1992*The Federal Reserve Bank of St. Louis Review* 53.

[32] Federal Deposit Insurance Corporation (FDIC) *A Brief history of Deposit Insurance in the United States* (1998) 20.

[33] FDIC *A Brief history* (1998) 20.

this situation, the US government introduced the "New Deal"- programme with the aim of providing improved financial security to Americans.[34] In particular, this policy culminated in a complex and formal structure established by the Banking Act of 1933[35] (also referred to as the Glass-Steagall Act) that introduced the Federal Deposit Insurance Corporation (FDIC) to implement and oversee the EDIS in the US. A further measure imposed by the Banking Act of 1933 to limit risk-taking and possible bank failure was the restrictions on combining commercial banking activity and investment banking.[36]

The establishment of the FDIC was a demonstration of the US government's acknowledgment of the profound economic and social consequences of bank failures.[37] Accordingly, the early years of the FDIC's inception were marked by heightened regulation and a reduced risk-taking by banks.[38] Kawadza remarks that in the absence of the federal deposit insurance framework in the US, the number of bank failures would have, without a doubt, increased and the bank population would have been reduced.[39] Almost 90 years since its establishment, the FDIC remains a crucial part of the US financial system and many countries have since followed in its steps by enacting their own EDIS frameworks.

However, Laeven remarks that it was not until the devastating financial collapses of banks and other financial institutions during the 2008 GFC that many countries joined in the trend[40] and started implementing or upgrading their EDIS in an attempt to prevent bank

[34] Golembe "The deposit insurance legislation of 1933: An examination of its antecedents and its purposes" (1960) *Political Science Quarterly* 181.
[35] *Banking Act* of 1933.
[36] Kawadza "The South African financial safety net: In support of the proposed deposit protection framework" 2018 *South African Law Journal* 524.
[37] According to the FDIC, those who survived the Depression were chastened by the events of the Crisis. In particular, the effect of the Depression was seen in the subsequent massive liquidity build-up undertaken by banks. See FDIC *A Brief history* (1998) 33. See also Kawadza (2018) *South African Law Journal* 524.
[38] The prevailing philosophy behind this was that unfettered completion in the past had resulted in excesses and abuses in banking. As a result, the supervisory agencies were willing to follow what the FDIC referred to as a policy of keeping banks and banking practices within the bounds of rightful competition. See FDIC *A brief History* (1998) 36.
[39] Kawadza (2018) *South African Law Journal* 524.
[40] Participation in IADI grew substantially between 2007 and 2008, with 63 participants: 51 members, 6 associates and 6 observers. In addition, IADI had 10 partners. In particular, in 2007, the Société Générale and the Excel Technology International (Hong Kong) joined as observers and the Union of Arab Banks became an IADI Partner. New members included the Barbados Deposit Insurance Corporation, the Bank Guarantee Fund (Poland), the Fondo para la Proteccion del Ahorro, Banco de Guatemala and the Financial

runs as well as to provide liquidity to banks in case bank runs do occur.[41] International standard setting bodies also alluded extensively to the need for jurisdictions to have a well-designed EDIS to appropriately serve the interests of financial consumer (depositor) protection and assist in the maintenance of financial system stability.[42] According to the *Report for the Financial Stability Forum on Enhancing Market and Institutional Resilience,[43]* the events that took place during the 2008 GFC particularly illustrated the necessity for effective depositor compensation arrangements.[44] The Report also emphasized the need for authorities to agree on an international set of principles for an effective EDIS.[45]

Subsequently, the rapid increase in the number of EDIS globally, and the need for improving these deposit insurance systems and providing guidance to countries lacking EDIS, heightened the importance of establishing an internationally agreed set of principles for the effectiveness of EDIS.[46] Hence, in 2009, the International Association

Services Compensation Scheme (UK). At the end of 2007/2008 financial year, there were 119 countries with DIS in operation, pending, planned or under serious study (99 in operation, 8 pending, 12 planned or under study). See International Association of Deposit Insurers (IADI) *Annual Report* 2007/2008 14. Over the year 2009/2010, participation in IADI grew substantially in the wake of the Global Financial Crisis, with 81 participants: 60 members, 6 associates, three observers and 12 partners. At the end of the 2009/2010 financial year, nine new members joined the IADI comprising of: Deposit and Financial Instrument Protection Fund (Belgium); Guernsey Banking Deposit Compensation Scheme; Corporacion del Seguro de Depositos – COSEDE (Deposit Insurance Corporation, Equador); Australian Prudential Regulation Authority (APRA); Azerbaijan Deposit Insurance Fund; Deposit Insurance Fund of the Association of German Banks; Deposit Protection of Swiss Banks and Securities Dealers; Fondo Interbancario di Tutela del Depositi (Interbank Deposit Protection Fund, Italy); and Fondo de Garantia de Depositos, Banco del Paraguay (Deposit Insurance Fund, Central bank of Paraguay). See International Association of Deposit Insurers (IADI) *Annual Report 2009/2010 Working Together to Build More Resilient Financial Systems* 10.

[41] Laeven "Bank risk and Deposit Insurance" 2002 *The World Bank Economic Review* 110.

[42] Jones and Knaack believe the 2008 GFC was a painful awakening that having an inadequate regulation and supervision at the center of the financial system has global consequences. According to them, the Crisis proved to be a clarion call for strengthening international regulatory cooperation. See Jones & Knaack "Global Financial Regulation: Shortcomings and Reform Options" 2019 *Global Policy* 193.

[43] Financial Stability Forum (FSF) *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (2008).

[44] FSF Report (2008) 50.

[45] FSF Report (2008) 51.

[46] According to the FSF Report, these principles were to have a variety of different designs for deposit insurance systems that meet the objectives behind the principles, and therefore, they were to be adaptable to a broad range of country circumstances. See FSF Report (2008) 51.

of Deposit Insurers (IADI)[47] and the Basel Committee for Banking Supervision (BCBS)[48] issued the first set of internationally agreed principles on deposit insurance, titled *Core Principles for Effective deposit insurance systems*, which were later revised in November 2014.[49] These principles serve as a benchmark for countries intending to establish EDIS as well as those intending to reform their existing systems.[50]

An effective EDIS is comprised of a legal framework designed to minimize or eliminate the risk of loss of deposits that depositors face in the event of a bank failure, generally offering protection to the deposits of households and small business enterprises which, may represent life savings or vital transaction balances.[51] The rationale behind a deposit insurance system is, thus, to guarantee the value of depositors' deposited funds – basically to "promise" or guarantee that if a bank fails, the deposit insurer will reimburse the depositors, at least to some extent, for funds deposited with the failed bank.[52] Having such a framework in place promotes confidence amongst depositors that they will not lose their money and serves to minimize the incidence of bank runs.

Therefore, a specially designed EDIS, appropriately captured in legislation to provide sufficient certainty about its application, is perceived as one of the cornerstones of the "financial safety net", protecting both depositors and the financial system from the effects of a bank failure.[53] As observed by Chan, Godwin and Ramsay,[54] EDIS is conventionally understood to be designed to achieve two main policy objectives, namely that of consumer (depositor) protection and financial stability. They point out that the consumer

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[47] The International Association of Deposit Insurers was formed in May 2002 to enhance the effectiveness of deposit insurance systems. See its website at https://www.iadi.org (accessed 4 June 2021).
[48] The Basel Committee on Banking Supervision (BCBS) is the "primary global standard setter" for the prudential regulation of banks and provides a forum for regular cooperation on matters pertaining to banking supervision. See its website at https://www.bis.org>bcbs.pdf (accessed 4 June 2021).
[49] International Association of Deposit Insurers (IADI) *IADI Core Principles for Effective Deposit Insurance Systems* (2014).
[50] IADI Core Principles (2014) 5.
[51] South Africa Reserve Bank (SARB): Financial Stability Department. 2017. *Designing a deposit insurance scheme for South Africa – a discussion paper* 10.
[52] Hubbard (2001) 356.
[53] Ognjenovic *Deposit Insurance Schemes: Funding, Policy and Operational Challenges* (2017) Palgrave Macmillan Studies in Banking and Financial Institutions 49.
[54] Chan, Godwin and Ramsay "Depositor preferences and deposit insurance schemes – challenges for regulatory convergence and regulatory coordination in Asia" 2018 *Law and Financial Markets Review* 71-85.

protection objectives of an EDIS require at least the protection of retail depositors. The rationale behind the financial stability objective is that "by reducing the possibility of loss to depositors, a credible deposit insurance system limits the incentives for covered depositors to precipitate a run on a bank, avoiding the wide-spread public panic that accompanies banks runs and that may trigger further bank runs."[55] Thus, deposit insurance in the form of EDIS contributes to public confidence in the banking system resulting in its significant contribution also to financial system stability.

Diamond and Dybvig,[56] also believe an EDIS is the solution to preventing a bank run without preventing the bank from performing its role as a liquidity provider. According to their model, an EDIS guarantees that 'the promised return will be paid to all who withdraw', thereby preventing a run on the bank.[57] Talley and Mas further observe that the ability of an EDIS to stem bank runs depends on the extent to which depositors feel protected from loss in the event of a bank failure.[58] It follows, therefore, that the presence of an EDIS has the ability to restore depositors' confidence in the banking system and thereby limits depositors' incentive to withdraw their deposits *en masse* at the sign of trouble.

As mentioned, the renewed focus on EDIS was illuminated by the dire events that played out in the financial markets during the 2008 GFC[59]. The spectacular bank failures just before and during the GFC emphasized the need for jurisdictions to actively pursue, promote and maintain financial stability.[60] In particular, the GFC revealed the build-up of

[55] Chan, Godwin and Ramsay 73. Diamond and Dybvig "Bank Runs, Deposit Insurance and Liquidity" 1983 *Journal of Political Economy* 401 refer to this wide-spread panic emanating from a bank run that has the ability to cause other bank runs as a "self-fulfilling" prophecy.
[56] Diamond & Dybvig (1983) *Journal of Political Economy* 402.
[57] Diamond & Dybvig (1983) *Journal of Political Economy* 413.
[58] Talley & Mas 'The role of deposit insurance' in Vittas *Financial Regulation: Changing the Rules of the Game* (1992) 331.
[59] Mishkin "Over the cliff: from the subprime to the global financial crisis" 2011 *Journal of Economic Perspectives* 49.
[60] Financial stability can be defined as the concurrent stability of the financial markets and the key financial institutions that operate in them. See Marcus "The importance of a robust financial system for growth in the South African economy" 2011 *Auditing SA* 5.

moral hazard[61] as a result of government bail-outs[62] that were extended by using taxpayers' money to 'save' "Too-Big-To-Fail"[63] financial institutions as being a regulatory approach that needed to be discarded. The regulatory sentiment post GFC shifted to preferring a new regime where "bail-in",[64] that entails shareholders and creditors bearing the losses during bank failure, is the preferred approach to enforce market discipline in banks.[65] It is within the broader notion of financial stability and orderly bank resolution that the aspect of an EDIS as a measure to achieve depositor protection and preserve financial stability, has thus come into renewed regulatory focus post-GFC.

1.3 The evolution of deposit insurance in South Africa

As with most financial sectors, South Africa's financial sector has become more globally connected and concentrated, potentially exposing the country to significant financial risks.[66] The 2008 GFC was a systemic failure of global proportions which not only revealed the shortcomings in the financial regulatory frameworks and policies of the most advanced economies around the world, but also exposed the fundamental weaknesses

[61] According to *The Handbook for the Assessment of Compliance with the Core Principles for Effective Deposit Insurance systems* moral hazard occurs when parties have incentives to accept more risk because the costs that arise from the risk are borne, in whole or in part, by others. See International Association of Deposit Insurers (IADI) *The Handbook for the Assessment of Compliance with the Core Principles for Effective Deposit Insurance systems* (2016) 7.

[62] A bail out refers to the "rescue" of a failing institution by means of the provision of public funds (taxpayers' money), for example to recapitalize the failing bank. Bail-outs are not only costly, but are associated with moral hazard, where banks are incentivised to take excessive risks as they know they will be rescued if they encounter failure. See Klimek *et al* "To Bail-out or to bail-in? Answers from an agent-based model" 2014 *Journal of Economic Dynamics and Control* 144.

[63] Cetorelli and Traina postulate that the 'Too-big-to-fail' refers to the principle that large financial institutions enjoy implicit government guarantees to prevent them from failing. According to them, these institutions are sufficiently large, complex and extremely interconnected that their failure may have disastrous effects on the financial system through negative spill-overs. See Cetorelli & Traina "Resolving Too Big to Fail" 2018 *Federal Reserve Bank of New York Staff Rep ort No 859* 3.

[64] Bail-in refers to any process through which losses are applied to selected liability holders and shareholders in order to recapitalize an institution. See also Republic of South Africa: National Treasury. 2015. *Strengthening South Africa's resolution framework for financial Institutions* 19.

[65] The degree to which depositors actually engage in market discipline and the extent to which such behavior is actually curtailed by explicit deposit insurance are questions that must be resolved empirically. See Karas, Pyle & Schoors "The Effect of Deposit Insurance on Market Discipline: Evidence from a Natural Experiment on Deposit Flow" 2010 *BOFIT Discussion Papers* 5.

[66] Demirguc-Kunt & Kane "Deposit Insurance: Handle with care" 2003 *Central Bank of Chile Working Paper* No 227.

of globalization and of economic models and assumptions.[67] The aftermath of the GFC saw governments reviewing their country's financial regulation frameworks in an attempt to create a more robust banking system for the future, and South Africa, as a G20-member that committed itself to the post-GFC international financial reform agenda,[68] joined in the momentum to adopt an EDIS.

As set out in more detail in in Chapter 5 of this thesis, South Africa has operated on the basis of implicit deposit protection for many decades but this position was reconsidered after the 2008 GFC. Although South African banks remained resilient throughout the GFC mainly because they were not as exposed to trading in derivatives as many other countries[69], the effects of the GFC could still be felt in the loss of jobs by many South Africans. Notably the 2008 GFC, although not causing systemic financial system collapse in South Africa, nevertheless revealed a gap in South Africa's financial safety net which needed to be closed. In particular, the GFC revealed that the absence of an explicit and privately funded deposit insurance system in South Africa represented a gap in the design of the financial safety net required to better promote financial stability.[70]

Consequently, the South African National Treasury and the South African Reserve Bank, as central bank, took a principled decision in 2015 to establish an EDIS in South Africa to close the existing gap in its financial safety net and to bring South Africa in line with international best practice and the level of deposit protection in other G20 countries.[71] The regulatory journey towards establishing an EDIS framework in South Africa commenced with position and discussion papers setting out the intention to move towards deposit insurance, namely: "*Strengthening South Africa's Resolution Framework,*[72] issued in 2015, and a follow-up paper titled "*Designing a deposit insurance scheme for*

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[67] Tettey *Managing Bank Resolution in South Africa* (Master of Management dissertation, University of Witwatersrand, 2014).
[68] The G20 Seoul Summit Leaders' Declaration available at http://www.g20.utoronto.ca/2010/g20seoul.html accessed (4 April 2020).
[69] Republic of South Africa: National Treasury. 2011. *A safer financial sector to serve South Africa better.* National Treasury Policy Document 13.
[70] SARB *Designing a deposit insurance scheme for South Africa* (2017) 8.
[71] *Ibid*.
[72] Republic of South Africa: National Treasury. 2015. *Strengthening South Africa's resolution framework for financial Institutions.*

South Africa- a discussion paper”,[73] issued in May 2017.[74] Subsequently, the main framework of the South African EDIS was captured in the *Financial Sector Laws Amendment Bill* 2018 which was tabled in Parliament in August 2018, thereafter further amended in 2020 and issued as the *Financial Sector Laws Amendment Bill* B15 of 2020 and eventually enacted as the *Financial Sector Laws Amendment Act* 23 of 2021, which at the time of finalising this thesis, was yet to be put into operation**.**

1.4 The link between deposit insurance and bank resolution

1.4.1 A brief overview of bank resolution

As the IADI Core Principles make several references to aspects of bank resolution, it is necessary to have a fundamental understanding of what bank resolution entails for purposes of appropriately contextualizing the discussion of the IADI Core Principles that follows in Chapter 2 of this thesis, and the critical interaction between deposit insurance and bank resolution.

In recent decades, and especially during the 2008 GFC it has become evident that, not only are banks “special” in view of their critical role in the financial system, as pointed out by Corrigan[75], but their insolvency is also “special” given the impact that bank failure may have on financial stability. It has further become evident that normal commercial insolvency procedures, which may be subject to appeals and reviews, may be too protracted and can lead to loss of value hence they are not best suited to dealing with failing banks.[76]

[73] South Africa Reserve Bank (SARB): Financial Stability Department (2017) *Designing a deposit insurance scheme for South Africa – a discussion paper.*
[74] Both documents are available at www.treasury.co.za accessed on 16 August 2017.
[75] See par 1.1 above.
[76] Randell “Legal aspects of bank resolution: designing the powers and solutions” *Paper presented at conference on “Operational Aspects of Bank Resolution and Restructuring” at the European Bank for Reconstruction and Development*, London, 19 March 2012 at 1. See also Nyaude *Regulatory Measures to address bank failures in Zimbabwe* (LLD Thesis, University of Pretoria, 2021). See further Nyaude and Van Heerden ‘Recent developments in bank resolution in South Africa’ (Submitted to the International Insolvency Law Review for publication) 1.

Dealing with bank failure thus requires a *sui generis* approach that entails swift action, preferably by the bank supervisor who is deeply aware of the special character and role of banks and who can take appropriate, calculated actions to prevent loss of value and maintain financial stability whilst also protecting depositors. On the question of why bank failure merits a *lex specialis,* Hupkes points out that: "the common answer is that banks play a special role in a country's economy in that, collectively, their functions are as important as to constitute a type of public service."[77]

It is submitted, therefore, that the post-GFC regulatory paradigm shift, which focuses on financial stability as a core pursuit, consequently seeks the 'orderly resolution' of financial institutions as the final part of a financial safety net arrangement that includes robust prudential regulation and supervision and timely and self-corrective early intervention, and also a well-conceptualized explicit deposit insurance framework to minimize the potential for bank failure and where banks do fail, to operate in tandem with a comprehensive orderly resolution framework.

Where a failing bank is not eligible for resolution, the bank will be liquidated in which event the deposit insurer will be responsible for timeous pay-outs to protected depositors to prevent a situation that may compromise financial stability.[78] However, where the bank resolution authority is of the view that the bank should rather undergo resolution to conserve critical functions and equity, the deposit insurer's role is quite different,[79] as will be explained later hereinafter.

As generally described by Randell, orderly bank resolution entails "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."[80] These powers may exist within insolvency legislation or by adaptation of insolvency processes,

[77] Hüpkes 'Insolvency – why a special regime for banks?' (2005) 3 *Current Developments in Monetary and Financial Law* 3.
[78] See SARB: Financial Stability Department *Ending too big to fail: South Africa's intended approach to bank resolution* (2019) 19.
[79] *Ibid.*
[80] Randell "Legal aspects of bank resolution: designing the powers and solutions" *Paper presented at conference on "Operational Aspects of Bank Resolution and Restructuring" at the European Bank for Reconstruction and Development*, London, 19 March 2012 at 4.

but often they take the form of special administrative powers that can be exercised by the authorities without, or alongside, normal insolvency proceedings.[81] Thus, resolution may, for example, result in a bank being recapitalized and continuing to operate viably in the market, or it may see certain critical functions of a failing bank being transferred to a bridge bank whereas the 'residual' bank is wound down.[82] The gist is that bank resolution entails a well-planned execution of a strategy, devised well in advance, comprising a variety of measures that aims to deal with a failing bank in an orderly manner that seeks to prevent disruption of financial stability and loss of depositor confidence.

The international best practice benchmark for orderly bank resolution frameworks is the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, issued in 2011 and subsequently updated in 2014.[83] The 12 Key Attributes set out the design features of an optimal bank resolution regime, covering the following aspects: scope; resolution authority; resolution powers; set-off, netting, collateralisation, segregation of client assets; safeguards, resolution funding; legal framework conditions for cross-border cooperation; institution-specific cross-border cooperation agreements; resolvability assessments; recovery and resolution planning; and access to information and information sharing.[84] It introduces new tools such as the 'bail-in' tool that requires recapitalization of the failing bank by its shareholders and which seeks to avoid having to bail out a failing bank with taxpayers' money as well as the 'bridge bank' tool that can be used for continuing certain critical functions of the failing bank and to which deposits can for example be transferred.[85]

As a last resort measure, temporary government ownership of a failing bank is also a resolution option. For purposes of this thesis and for contextualising the role of deposit insurance during bank resolution, a sufficient understanding of bank resolution can be gained from a brief consideration of the role of the resolution authority; resolution powers;

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81 *Ibid.*
82 See SARB: Financial Stability Department *Ending too big to fail: South Africa's intended approach to bank resolution* (2019) 19.
83 Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October 2014 available at https://www.fsb.org/wp-content/uploads/r_141015.pdf (accessed 12 August 2022).
84 FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2014) 5.
85 *Ibid.*

resolution safeguards; resolution funding; resolvability assessments and *ex ante* recovery and resolution planning.

Key Attribute 1 requires that the scope of a country's resolution framework should cover any financial institution that could be systemically significant or critical if it fails.[86] Key Attribute 2 requires the designation of an operationally independent administrative resolution authority to implement the bank resolution regime.[87] According to the Key Attributes, the resolution authority's objective should be, inter alia:[88]

> "to pursue financial stability and ensure continuity of systemically important financial services and payment, clearing and settlement functions; protect, where applicable and in coordination with relevant insurance schemes and arrangements, depositors, insurance policyholders and investors covered by such schemes and arrangements; avoid unnecessary destruction of value and aim to minimise the overall costs of resolution in home and host jurisdictions and losses to creditors; and duly consider the potential impact of its resolution actions on financial stability in other jurisdictions."

Bank resolution, being the execution of a well-planned strategy is thus not a 'knee-jerk' reaction to bank failure as is evident from the requirements in the Key Attributes regarding recovery and resolution planning that underscores a pro-active, forward-looking approach to bank resolution.[89] Recovery plans are self-corrective measures drafted by the banks themselves and should identify options to restore financial strength and viability and avert failure when the bank encounters severe stress.[90] Resolution plans are drafted by the resolution authority, assisted by the bank concerned, and sets out a credible resolution strategy to be applied should the bank in future fail and have to be resolved.[91] These plans must be regularly updated to ensure that they provide optimal strategies for dealing with bank recovery and if recovery is no longer an option, bank resolution.[92] In particular,

[86] *Ibid.*
[87] *Ibid*.
[88] *Ibid.*
[89] Key Attribute 11.1.
[90] Key Attribute 11.5.
[91] *Ibid*.
[92] *Ibid.*

the Key Attributes indicate that that resolution plans "must facilitate the effective use of resolution powers to protect systemically important functions, to make the resolution of any bank viable without severe disruption and without exposing taxpayers to loss."[93]

Key Attribute 3 indicates that resolution should be initiated when a bank is "no longer viable or likely to be no longer viable and has no reasonable prospects of becoming so."[94] It is paramount that the resolution regime provides for timely and early entry into resolution before a bank is balance sheet insolvent and before all equity has been fully wiped out.[95] This is facilitated by having clear standards or suitable indicators of non-viability in the resolution framework to enable the resolution authority to decide whether the conditions for entry into resolution have been met.[96]

The Key Attributes further indicate that an effective resolution framework must provide the resolution authority with a broad range of resolution powers, including the power to:[97]

(a) take control of the failing bank, remove and replace directors and senior management and recover monies from persons responsible for the bank's failure, including claw-back of variable remuneration;
(b) appoint an administrator to manage the failing bank for purposes of restoring the bank or at least parts of its business to ongoing and sustainable viability;
(c) attend to operating and resolving a failing bank, which must include powers for terminating, continuing or assigning contracts, purchasing and selling assets, writing down debt, or taking any other action necessary to restructure or wind down the bank's operations;
(d) ensure continuity of essential services and functions by, for example, 'requiring other companies in the same group to continue providing essential services to the bank in resolution, any successor or acquiring entity; and ensuring that the residual bank in resolution can temporarily provide such services to a successor or an acquiring entity; or procuring necessary services from third parties';

93 Key Attribute 11.6.
94 Key Attribute 3.1.
95 *Ibid.*
96 Ibid.
97 Key Attribute 3.2 (i) to (xii).

(e) override shareholder rights, including overriding a requirement that shareholder approval is needed for specific transactions, or to allow a merger, acquisition, sale of substantial business operations, recapitalisation or other measures to restructure and dispose of the bank's business or its assets and liabilities;

(f) do a transfer or sale of the failing bank's assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, to a solvent third party;[98]

(g) establish a temporary bridge bank for taking over and continuing to operate certain critical functions and viable operations of the failing bank;[99]

(h) establish a separate asset management vehicle to which non-performing loans or difficult–to–value assets can then be transferred to be managed and run-down;

(i) execute "bail-in within resolution" to achieve continuity of essential functions. Bail-in entails either recapitalising the failing bank or capitalising of a new bridge bank to which the failing bank's essential functions have been transferred after such bank was closed. In such event the residual business of such a failing bank would then be wound up and the residual bank would be liquidated);[100]

(j) temporarily stay the exercise of early termination rights that may otherwise be triggered when a bank enters into resolution or that may be triggered when certain resolution powers are applied;[101]

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[98] Key Attribute 3.3.

[99] Key Attribute 3.4. As explained in the Key Attributes, a bridge bank is a new bank, publicly owned and established by the resolution authority or another relevant agency that acquires the critical business functions and services of a failing bank. It is capitalized through the transfer of assets to the bridge bank and by the bail-in of liabilities of the failing bank or by funds obtained from a resolution fund or the government.

[100] Key Attribute 3.5. Bail-in entails shifting the funding for resolution from public funds to the private market by the conversion of unsecured creditor rights or uninsured deposits and other convertible contingent securities into capital. Bail-in is applied in the inverse order of the ranking of liabilities in a liquidation meaning that the lowest ranked liabilities in a liquidation would be bailed-in first, followed by the next lowest ranking. Statutory bail-in is generally only a viable option if a bank has reasonably significant tranches of subordinated debt or non-deposit unsecured senior liabilities. It is unlikely to be an attractive option if a bank is funded only by deposits. The above-mentioned bail-in powers may be applied in conjunction with other resolution powers such as transfer of problem assets. See Lugulu *Addressing the moral hazard through Explicit Deposit Insurance: a comparative appraisal of the Kenya Deposit Insurance* Act, 2012 (LLD Thesis, University of Pretoria, 2019) 69. See also The World Bank Group, Financial Safety Nets and Bank Resolution Frameworks in Southern Africa: Key Issues and Challenges (2019) 6.

[101] Key Attribute 4.3.

(k) impose a moratorium with a suspension of payments to unsecured creditors and customers and a stay on creditor actions against the failing bank, while protecting the enforcement of eligible netting and collateral agreements; and

(l) effect a closure and orderly liquidation of the whole or part of a failing bank with a timely pay-out or transfer of insured deposits and prompt access to transaction accounts and segregated client funds.[102]

The resolution regime must further provide that the aforesaid resolution powers may be applied alone or in combination, with resolution actions being either combined or applied sequentially. The resolution authority should also have the power to apply different types of resolution powers to different parts of the failing bank's business.[103]

The Key Attributes also require that, subject to adequate safeguards, a bank's entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights or present an early termination trigger that could compromise resolution efforts.[104] However, where contractual acceleration or early termination rights are exercisable, it is indicated that the resolution authority should have the power to impose a temporary stay of such rights where they are triggered purely as a result of the bank entering into resolution or in connection with the exercise of any resolution powers by the resolution authority.[105]

Property rights of shareholders and creditors are safeguarded by the requirement in Key Attribute 5 that resolution powers should be applied in a manner "that respects the creditor hierarchy in insolvency." This rule is however not inflexible and permits deviation from the general principle of equal treatment of creditors of the same class (*pari passu* treatment) if such deviation is necessary "to contain the potential systemic impact of a [bank's] failure

[102] Closure and wind-down involves withdrawing the operating license of a non-viable bank and payout of insured depositors by the deposit insurance agency. The bank's assets are typically auctioned in tenders or similar processes and, after the deposit insurer has been reimbursed for all expenses, non-insured creditors are paid based on the realized value of the assets. See The World Bank Group, Financial Safety Nets and Bank Resolution Frameworks in Southern Africa: Key Issues and Challenges (2019) 6.

[103] Key Attribute 3.8

[104] Key Attribute 4.1 and 4.2.

[105] Key Attribute 4.3.

or to maximise value for the benefit of the whole group of creditors."[106] The Key Attributes also introduces the "No creditor worse off than in liquidation" safeguard (NCWOL) which entails that creditors are entitled to compensation "if they do not receive in bank resolution, at a minimum, what they would have received in liquidation under the applicable insolvency regime."[107]

Another necessary safeguard required by the Key Attributes are legal protection for directors and officers of the bank in resolution from lawsuits by shareholders or creditors for actions that such directors and officers took in compliance with resolution decisions of the resolution authority.[108] Notably, the Key Attributes recommend against making provision in the resolution framework for judicial actions such as appeals or reviews that could impede the swift implementation of, or lead to a reversal of, good faith resolution measures taken by resolution authorities, acting within their legal powers.[109] It is thus suggested that, where justified, the resolution regime should rather provide for compensation as a means of redress.[110]

To make sure that resolution plans remain up to date and credible, Key Attribute 10 imposes an obligation on the resolution authority to undertake regular resolvability assessments to evaluate the 'viability and credibility' of resolution plans.[111] During such an assessment, the resolution authority must inter alia assess the extent to which critical financial services and payment, clearing and settlement functions can continue to be performed; the nature and extent of intra-group exposures and their impact on resolution if they need to be unwound; and robustness of cross-border cooperation and information sharing arrangements.[112]

As pointed out by Croitoru, Dobler and Molin, a key element of the international reform agenda post GFC has been "to strengthen resolution regimes and make government

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[106] Key Attribute 5.1. Such departure should be motivated by transparency regarding the reason for the departure.
[107] Key Attribute 5.2.
[108] Key Attribute 5.3.
[109] Key Attribute 5.5.
[110] *Ibid*.
[111] Key Attribute 10.1.
[112] Key Attribute 10.2.

bailouts the last, not first resort."[113] They further point out that "effective resolution regimes need effective funding arrangements."[114]

They observe that for resolutions tools to work effectively and efficiently, they need readily available and sufficient funding.[115] At the point when a systemically important bank fails, its liquidity and capital buffers typically will have been eroded. To be effective when deployed, resolution tools may need additional funding to buttress the internal resources of the failed bank; replace illiquid, encumbered, or impaired assets and 'grease the wheels" of resolution.[116] Additional funds may be needed, for example, to back a transfer of deposits to another bank or a bridge bank, to purchase impaired assets or to inject liquidity after a bail-in of creditors.[117]

1.4.2 Deposit insurance and resolution funding

Croitoru, Dobler and Molin further point out that "resolution funding should be understood within the context of a well-designed financial safety net."[118] Resolution funding refers to financing that can be used to support the use of resolution powers and achieve resolution objectives.[119] They indicate that a sound financial safety net entails a comprehensive legal, institutional, and operational framework for maintaining financial stability while mitigating the risk of government bailouts.[120] The safety net mechanisms are operationally independent, but their objectives and uses are intertwined.[121] This means that the bank supervisor, central bank (if not the bank supervisor), the deposit insurance authority, the resolution authority, and the Ministry of Finance are expected to take measures that are

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[113] Croitoru, Dobler and Molin "Resolution Funding: Who Pays When Financial Institutions Fail?" 2018 International Monetary Fund, Monetary and Capital Markets Department, Technical Notes and Manuals, available at https://imf.org/en/Pu;lications/TNM/Issues/2018/08/16/Resolution-Funding-Who-Pays-When-Financial-Institutions-Fail-46124 (accessed 18 January 2022).
[114] *Ibid* at 5.
[115] *Ibid*.
[116] *Ibid.*
[117] *Ibid.*
[118] *Ibid.*
[119] *Ibid.*
[120] *Ibid.*
[121] *Ibid.*

consistent with their own mandates, but coordinated and commensurate to the financial stability concerns.[122] When problems in a bank are detected early enough, corrective measures required by supervisors may then be financed through the internal (capital and liquidity) resources of the bank. When banks experience temporary liquidity problems, it is possible for viable banks to seek emergency liquidity assistance from the central bank.[123] However if a bank's viability is compromised, it may be necessary to put such bank in resolution to ensure its orderly market exit and /or continuity of critical functions.[124]

Croitoru, Doblin and Molin indicate that the resources required to fund resolution vary significantly, depending inter alia, on the systemic risk of the potential failure.[125] They point out that resolution can take various forms which can range from simple deposit transfers to bridge banks and bail-ins and from small banks to systemic clearing parties.[126] In each instance, resolution funding may be necessary to preserve financial stability, for example because the failing bank's assets are illiquid or impaired, and insufficient to repay systemic creditors at the point of failure.[127] In the event of an isolated failure of one or some systemic banks, it will usually be possible to meet the objective to preserve financial stability by just protecting insured deposits through transfer to an entity that is viable ("purchase and assumption") or in a liquidation by having the EDIS promptly reimbursing them.[128] Where banks of systemic importance fail, there may be a need for additional resources to fund resolution so that capital or liquidity needs are met and continuity of critical functions are ensured.[129]

As pointed out by Croitoru, Dobler and Molin, "building firm-specified, loss absorbing capacity is crucial; but the internal resources of a [bank] may prove insufficient at the point of failure"[130] thus the international reform agenda focused on building firm-specific, loss absorbing capacity at systemic banks. For example, global systemically important banks

[122] *Ibid.*
[123] *Ibid.*
[124] *Ibid.*
[125] *Ibid.*
[126] *Ibid.*
[127] *Ibid.*
[128] *Ibid.*
[129] Croitoru, Dobler and Molin (2018) *IMF Technical Notes* 5 to 6.
[130] *Ibid.*

(G-SIBs) have to build 'total loss-absorbency capacity' (TLAC) which comprises regulatory capital, subordinated debt and long-term liabilities that would facilitate the orderly resolution of these banks.[131] It is however difficult to establish in advance the quantity and quality of resources necessary to have sufficient loss absorbency for resolution purposes.[132] Croitoru, Dobler and Molin explain that liquid assets may have been sold or encumbered, financial assets may need to be revalued, using significant lower 'gone concern' rather than 'going concern' methodologies, and contagion risk may impair the loss absorbency of liabilities.[133]

For these reasons, they indicate that a country's resolution authority should be able to access or promptly mobilize additional resources that are needed for orderly bank resolution.[134] They point out that Key Attribute 6.1 require setting up resolution funding arrangements in advance so that "resolution authorities are not constrained to rely on public ownership or bail-out as a means of resolving firms."[135] The KAs accordingly acknowledge three broad types of arrangements that can facilitate effective resolution:

(a) privately (industry)-financed deposit insurance funds;
(b) privately funded resolution funds; or
(c) temporary access to funding by government within a system that permits ex post recovery from industry of the resolution costs paid by government.[136]

These options have in common their recourse to industry funding and would be readily available for use during resolution, but they differ in important respects. Further, Key Attribute 6 allows countries' flexibility on key aspects of arrangements for resolution

131 *Ibid.*
132 *Ibid.*
133 Croitoru, Molin and Dobler (2018) 6. They indicate that, for example, 'using up the loss-absorbing capacity through a bail-in may increase the risks of a run of wholesale creditors on the wider financial system. Whether TLAC proves loss absorbing at times of severe stress is yet to be tested and will depend on its quality, including contractual terms and investor base. For example, if banks face extended periods of stress, long term debt could roll (after a year) and TLAC sold to other institutions [what do you mean by 'TLAC sold to other institutions?] could trigger cross-contagion, etc'.
134 *Ibid.*
135 *Ibid.*
136 Ibid. See Key Attribute 6.

funding, including whether the funding should be ex ante or ex post and what their 'optimal size' should be.[137]

Croitoru, Dobler and Molin point out that it is possible to use central bank funding in resolution by having the central bank provide ELA.[138] They also address the arguments in favor of using deposit insurance funds in resolution, subject to certain safeguards, and not only for payouts to depositors in liquidation.[139] In particular they observe[140]

> "The closely aligned roles of deposit insurance and resolution in preserving financial stability and reducing the risk of deposit runs, along with potential economies of scale, suggest that the funds collected and available to pay out deposit insurance in bank liquidation should be available to also support a bank resolution, which obviates the need for a liquidation and payout."

In addition to preserving depositor confidence and the continuity of depositor services, a resolution which, for example, transfers retail deposits from a resolved entity to a healthy bank, may realize efficiency gains through maximizing value and reducing disruption.[141] For example, a transfer of deposits and good assets might secure higher 'going concern' values for the assets of a failed bank in liquidation, and a premium for the deposit books (as banks incur costs to attract retail depositors).

The use of the deposit insurance funds in resolution can however only occur if the legal framework for the EDIS permits it. Croitoru, Dobler and Molin explain that this may be the case where the deposit insurer has a dual mandate that includes deposit insurance and resolution (i.e a 'risk or loss minimizer'-mandate) or where the deposit insurer's funds are available to fund resolution by a separate resolution authority (i.e. 'a pay box plus-mandate').[142] IADI Core Principle 9, essential criteria 8 indicate that a deposit insurer that is not the resolution authority, should have 'the option, within its legal framework, to

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[137] Croitoru, Dobler and Molin (2018) 6 to 7.
[138] Croitoru, Dobler and Molin (2018) 8.
[139] Croitoru, Dobler and Molin (2018) 9.
[140] *Ibid.*
[141] *Ibid*.
[142] For an explanation of the concepts of 'risk minimizer and paybox plus' see the discussion of the IADI Core Principles in Chapter Two hereinafter.

authorize the use of its funds for member institutions other than liquidation' up to the net cost it would have incurred if the bank had otherwise undergone liquidation. In addition to a 'least cost' test, other safeguards may be applied to using deposit insurance funds in resolution, for example, that depositors of the resolved banks have continued access to their insured deposits and potential caps.[143]

Given that the primary purpose of an EDIS is to cover insured deposits either by means of a payout during liquidation or covering those deposits during a bank resolution, Parker points out that they are 'normally calibrated to cover losses in a fraction of the insured pool and not to deal with the failure of a large systemic bank or a generalized banking crisis'.[144] He indicates further that such events would usually require significantly more resources than the resources available in a paid-up deposit insurance fund and an EDIS thus has to be protected from such evets by safeguards that are built into the legislation establishing the EDIS. Such safeguards should thus be put in place, including a 'net least cost'[145] test and a 'back-up' credit line from the government. Croitoru, Dobler and Molin mention further that another safeguard could be the introduction of a cap, to prevent the paid-in deposit insurance funds from dropping below a certain level, for example 50% of the target ratio.[146] These safeguards will avoid too excessive reliance on the deposit insurance fund for resolution purposes and will thereby maintain depositor confidence.[147]

1.5 Research statement

The main aim of this thesis is to interrogate the essential features of the new South African explicit deposit insurance scheme as introduced by the *Financial Sector Laws Amendment Act* 23 of 2021, which incorporates the provisions relating to the new EDIS

[143] Croitoru, Dobler and Molin (2018) 9.
[144] Parker *Closing a failed Bank; Resolution Practices and Procedures* (2011) IMF.
[145] See Croitoru, Dobler and Molin (2018) 9, Box 2 where this concept is explained as follows: "A net least cost test ensures that costs to the deposit insurance fund (DIF) of contributing to a resolution event are no higher than the DIF would otherwise have incurred in a payout of insured depositors of the entities being resolved, net of expected recoveries. The test can be made operational simply by adopting/mandating a cap that prevents the DIF from contributing more than the estimated net cost it would have incurred if the troubled entity had been liquidated."
[146] *Ibid.*
[147] *Ibid.*

into the Financial Sector Regulation Act 9 of 2017, for purposes of establishing whether this scheme complies with international good practice and whether further reforms in this context may be necessary. As the new EDIS is not in operation yet and will foreseeably only come into operation in two or three years from now as it would require various resources to put up the necessary institutional infrastructure, it is hoped the that thesis can contribute to augmenting certain features of the new South African EDIS and facilitate its improved implementation.

1.6 Research Hypothesis

A properly designed explicit deposit insurance system in which the incidence of moral hazard is appropriately mitigated will not only serve to protect depositors in the event of bank failure but is an essential component of the wider prudential regulatory framework that serves to maintain financial system stability. Consequently, it is vital that the South African EDIS comply with the *IADI Core Principles for Effective Deposit Insurance Systems,* also bearing in mind country-specific aspects that may impact on the South African EDIS.

1.7 Research questions

The following research questions are sought to be addressed in this thesis:

a) What is the rationale for deposit insurance and why is explicit deposit protection to be preferred above implicit deposit protection?
b) What are the international standards (good practice) for efficient explicit deposit insurance schemes and how can the issue of moral hazard be addressed optimally?
c) What is the legislative framework and design features of the explicit deposit insurance schemes that are in place in the USA and Australia?
d) What is the legislative framework and design features of South Africa's new explicit deposit insurance scheme?

e) Is the new South African EDIS compliant with good practice and if not, in which respects can it be reformed and what guidance can be taken from the IADI Core Principles, the US and Australia in this regard?

1.8 Research Methodology

This research mainly consists of academic, desk-based research based on the review of existing literature on deposit insurance schemes. The literature review comprise of policy documents, standards and guidelines, legislation, case studies as well as the opinions of academic writers.

1.9 Comparative Study

In the modern global economy, it is essential to study and compare the approaches of the legal systems of different jurisdictions legal systems to seek guidance in addressing problems experienced in one's own jurisdiction. According to Eberle, taking cognizance of the expansion of the global economy coupled with new developments such as the escalated use of computers and the internet, regulators are obligated to tap into other jurisdictional systems.[148]

For purposes of this research, the deposit insurance frameworks in the United States of America and Australia will be interrogated.

1.9.1 United States of America

It was pointed out above that EDIS as we know it today, originated in the USA when the Federal Deposit Insurance Corporation (FDIC) was established by the *Banking Act* of 1933.[149] The original purposes of the FDIC included the protection of bank depositors, the maintenance of confidence in the banking system and the promotion of safe and sound banking practices.[150] As observed by Vedder, the FDIC, therefore, was designed

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[148] Eberle "The method and role of comparative law" 2009 *Washington University Global Studies Law Review* 451.
[149] Section 12B of the *Banking Act* 1933.
[150] See Chapter 3 for a comprehensive discussion of the US federal deposit insurance system.

not so much to compensate individual depositors after a failure, but to prevent instability through the mass withdrawal of funds from the banking system in the first place.[151] Having taken the lead in introducing EDIS and having had an explicit deposit protection mechanism in place for nearly a century, it is submitted that the USA is the primary jurisdiction to look towards for guidance on appropriate design features of an explicit deposit protection scheme.

1.9.2 Australia

Australia is renowned for its robust financial system and resilient economy and the Australian financial sector managed to remain resilient during the 2008 GFC compared to other jurisdictions. Notably Australia, like South Africa, also operated without a comprehensive EDIS for several decades. However, in early October 2008, depositors started to withdraw their funds from a number of smaller Australian deposit-taking institutions, indicating loss of confidence in these institutions despite the fact that they remained relatively healthy throughout the GFC.[152] Although not significantly financially scathed by the GFC, the Australian government was proactive and introduced several policies to mitigate the impact of the Crisis and to promote economic recovery.[153] Among the measures introduced was the *Deposit and Wholesale Funding Guarantees (DWFG) scheme*,[154] which was established as a temporary measure to restore the confidence of the Australian ADI depositors with deposits of more than $1million Australian dollars which was beginning to deteriorate as a result of the GFC. The Australian government

[151] Vedder "The Impact of the Federal Deposit Insurance Corporation on Banking Stability" 1968 *Papers of the Annual Meeting of the Business History Conference* 89.
[152] Bollen *et al* "The Global Financial Crisis and its Impact on Australian Bank Risk" 2015 *International Review of Finance* 95.
[153] *Ibid.*
[154] The Deposit and Wholesale Funding Guarantee announcement comprised two schemes: one for retail deposits up to a threshold of A$1milllion; and one for wholesale funding to include individual deposits in excess of A$1million and other wholesale funding liabilities. The latter guarantee required a specific individual guarantee and premium payment (paid by the institution or the client), whereas the former had no direct cost or administrative requirements for either the banks or their clients (Australian Government, 2008).

also introduced the *Australian Financial Claims Scheme*,[155] which was later made a permanent deposit insurance scheme (EDIS) for Australian retail depositors. It is submitted that Australia, having been an advocate of implicit deposit insurance system for centuries, provides a good example of the significance of adopting EDIS even in countries where bank failures are a rare occurrence.

1.9 Delineations and limitations

This study makes peripheral reference to other financial safety net mechanisms in the financial system where relevant, but does not interrogate these safety net mechanisms in detail. Such safety net mechanisms are mentioned only insofar as they relate to the argument that is made that deposit insurance is but one component of the financial safety net and thus has to function within a broader context where it is supported by the other components in the financial safety net structure. Specifically also, given the interaction between deposit insurance and bank insolvency and bank resolution, a brief contextualising overview of bank resolution has been provided to indicate how bank resolution and deposit insurance interact but an in-depth discussion of bank resolution is beyond the scope of this thesis.

The focus of this thesis is on EDIS as an effective financial safety net in promoting financial stability and protecting depositors' funds during a bank failure. The thesis appraises the importance of implementing EDIS and its role in a financial system. In particular, the thesis interrogates the design features of the new South African EDIS and its compliance with international good practice as captured in the *IADI Core Principles of Effective Deposit Insurance Systems*. This thesis states the law as at 31 December 2022.

1.10 Chapter overview

[155] The Financial Claims Scheme is an Australian deposit insurance scheme established under the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act* of 2008 to provide protection to deposits in banks, building societies and credit unions, and to policies with general insurers in the unlikely event that one of these financial institutions fails. See https://www.apra.gov.au>financial-claims-scheme-O. Accessed on 3rd November 2019.

Chapter 1 is an introductory chapter setting out general background and theoretical underpinnings of deposit insurance, its evolution and role in a financial system. The 2008 GFC as well as the lessons drawn from it, specifically in relation to the need for EDIS, are briefly discussed. The chapter also highlights the link between deposit insurance and bank resolution. Finally, the chapter further sets out the research problem, research questions, research methodology, research hypothesis, selection of comparative jurisdictions and chapter lay-out.

Chapter 2 explores the concept of deposit insurance, juxtaposing implicit and explicit deposit insurance systems, its general purpose as well as the advantages and disadvantages of both implicit and explicit deposit insurance. The chapter also highlights the problem of moral hazard in both implicit and explicit deposit insurance systems and how it can be mitigated. It further explores in more detail the reasons behind the move in the context of bank regulation post the 2008 GFC from 'bail-out' to 'bail-in' and the influence that this paradigm shift has in the context of deposit insurance. The general design features of EDIS as captured in the IADI Core Principles of Effective Deposit Insurance Schemes are also discussed in this chapter to provide a benchmark for interrogating the new South African EDIS as well as the EDIS in the US and Australia.

Chapter 3 interrogates and critically analyses the development of EDIS in the USA, the design features of the US EDIS and the extent to which it is compliant with the IADI Core Principles. This interrogation will serve to assess whether there are any features in the US EDIS which are lacking in the South African EDIS and which may be used to amplify the South African EDIS.

Chapter 4 interrogates and critically analyses the evolution of explicit deposit insurance in Australia, the design features of the Australian EDIS and the extent to which it is compliant with the IADI Core Principles. Similar to the comparative enquiry into the US EDIS, this interrogation of the Australian EDIS will also serve to take guidance on any features of such EDIS that can be heeded for purposes of amplifying the South African EDIS.

Chapter 5, being the essential focus of this thesis, thereupon interrogates and critically analyses the evolution of explicit deposit insurance in South Africa, focusing on the design features of the new South African EDIS and the extent to which it is compliant with the IADI Core Principles and whether it requires any reform.

Chapter 6 concludes the study with conclusions regarding how compliant the South African EDIS is with the IADI Core Principles and whether any guidance can be taken from the US and Australia to amplify the South African EDIS. Finally, relevant recommendations are made in this regard.

CHAPTER TWO

DEPOSIT INSURANCE SYSTEMS, THE MORAL HAZARD PROBLEM AND THE IADI CORE PRINCIPLES FOR EFFECTIVE DEPOSIT INSURANCE SYSTEMS

2.1 Introduction

As indicated in Chapter one, the role of banks as key providers of liquidity cannot be overemphasised. This critical role of banks and the problems associated with bank failures makes banks a focal point of attention for government regulators.[156] As a result, country authorities employ a combination of strategies to protect investors and ensure the stability of the financial system.[157] As also alluded to briefly in Chapter One, these strategies are known as 'financial safety nets[158] and comprise banking regulation and supervision, early intervention, deposit insurance and bank resolution. Globally, financial safety nets are regarded as the most fundamental part of the financial regulatory architecture and are commended for their ability to assist in the maintenance of stability in the financial sector.[159]

According to Kane,[160] financial safety nets do not only protect, but also incite, financial institutions to accept the risks associated with financing economically productive activities.[161] Their role, therefore, also includes guarding against excessive risk-taking.[162] As evidenced from the 2008 GFC, the optimal design of a financial safety net entails identifying elements that would aid in predicting a future crisis and those that would directly or indirectly affect the fragility of financial institutions.[163] An appropriate financial safety net is, therefore, imperative to minimize the risk of bank failures and banking

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[156] Cecchetti & Schoenholtz *Money, Banking and Financial Markets: Global Edition* (2015) 365.
[157] Cecchetti & Schoenholtz (2015) 365.
[158] See par 1.2.
[159] Folkerts-Landau & Lindgren "Toward a Framework for Financial Stability" 1998 *World Economic and Financial Surveys* 27.
[160] Kane "Designing financial safety nets to fit country circumstances" 2000 *World Bank Policy Research Working Paper* No 2453 3.
[161] Maslowska-Jokinen & Matysek-Jedrych "One size does not fit all – institutional determinants of financial safety net effectiveness" 2016 *Narodowy Bank Polski Working Paper No 240* 37.
[162] Maslowska-Jokinen & Matysek-Jedryck (2016) *Narodowy Bank Polski Working Paper No 240* 37.
[163] *Ibid*.

crises.[164] As also alluded to in Chapter One, in the absence of a properly designed financial safety net, even mere rumours about the solvency or liquidity of a financial institution could trigger a bank run or even a full-blown financial crisis.[165]

This chapter discusses deposit insurance systems as a crucial element of the financial sector safety net and their role in contributing to the stability of the financial system and depositor protection. The difference between implicit and explicit deposit insurance systems is clarified and certain disadvantages inherent in deposit insurance systems, in particular, the moral hazard problem and how it can be mitigated, are considered. Finally, the chapter explores the *IADI Core Principles for effective deposit insurance systems*[166] as an international benchmarking standard for countries who wish to establish EDIS or reform their existing EDIS.

2.2 Deposit Insurance Systems

As alluded to in Chapter One,[167] deposit insurance schemes are usually designed to provide depositors with the guarantee that their deposits will be repaid in the event that a bank fails.[168] The aim of this guarantee is to prevent bank runs and thereby contribute to the stability of the financial system.[169] It was also pointed out in Chapter One that deposit

[164] Schich "Financial Crisis: Deposit Insurance and Related Financial safety net aspects" 2008 *OECD Financial Markets Trends* 4.
[165] According to Anginer and Ata Can, lack of confidence in the banks causes depositors to run to be the first in line to withdraw their deposited funds. He stipulates that if everyone believes that a run will occur, then it becomes a self-fulfilling prophecy as depositors are likely to run to the bank to avoid being last in line. See Anginer and Ata Can "Deposit Insurance" 2019 *ifo DICE Report* 5. See also Schich (2008) *OECD Financial Markets Trends* 4.
[166] The IADI Core Principles for Effective Deposit Insurance Systems were issued by the International Association for Deposit Insurers (IADI) together with the Basel Committee on Banking Supervision (BCBS) in June 2009 to serve as a benchmark for jurisdictions to assess the quality of their deposit insurance systems and to identify gaps in their deposit insurance practices as well as measures to address them.
[167] See paragraph 1.2.
[168] De Lisa *et al* "Modelling Deposit Insurance Schemes losses in a Basel 2 Framework" (2011) *Journal of Financial Services Research* 126.
[169] According to Hoelscher, Taylor & Kluer, the financial stability objective of deposit insurance depends mostly on the system's relatively broad membership and generous coverage limits with the caveat that if the level and scope of coverage are too high, risk taking could be encouraged, thereby exposing the stability of the financial system to danger. See Hoelscher, Taylor & Kluer "The Design and Implementation of Deposit Insurance Systems" 2006 *International Monetary Fund Occassional Paper* 6. See also De Lisa (2011) *Journal of Financial Services Research* 126.

insurance systems can be implicit or explicit. The implicit form of deposit insurance entails a discretionary approach supported by government to bolster a failing financial institution in the absence of an explicit statutory obligation and accompanying structure on the part of government to protect depositors.[170] EDIS, on the other hand, exists where the terms and conditions of the scheme are explicitly stated in a statute and provides a legally enforceable guarantee, generally for insured retail depositors.[171] In the past, depositor protection in many jurisdictions took the form of implicit deposit insurance. However, as indicated in Chapter One[172], this kind of depositor protection was subsequently replaced in most instances by an EDIS.[173]

The issue of deposit insurance has, however, never been plain sailing and has been the subject of extensive debate. For years, economists have been at loggerheads regarding the concept of insuring depositors' funds against loss as a result of bank runs. Researchers like Diamond and Dybvig[174] postulate that financial institutions render a valuable service in creating liquidity and that regulatory framework must be intended to preserve this basic function and protect banks against runs. Other researchers like Benston and Kaufman,[175] however, contend that modern financial systems challenge effective regulation and that the costs incurred from bank failure are not externalities for which government intervention is justified.

Notably, the view of this thesis, which is aligned with the views of international standard setting bodies like IADI and the BCBS, is that a well-designed EDIS is the most appropriate way to ensure depositor protection. To give credence to this view, it is necessary to appreciate the differences between implicit and explicit forms of deposit insurance systems, considering the advantages and disadvantages of both systems. The

[170] Ogunleye *Perspectives on the Nigerian Financial Safety-Net* (2010) 131.
[171] Hawkins "Financial access and financial stability" 2006 *Paper written for Bank for International Settlements* 75.
[172] See par 1.3.
[173] As it shall be seen later, the first model of explicit deposit insurance system was developed in the United States of America under the *Banking Act* 1933.
[174] Diamond & Dybvig "Banking Theory, Deposit Insurance, and Bank Regulation" 1986 *The Journal of Business* 67.
[175] Benston & Kaufman "The Appropriate Role of Bank Regulation" 1996 *The Economic Journal* 688.

section also interrogates the moral hazard problem posed by deposit insurance systems as well as how it can most optimally be mitigated.

2.2.1 Implicit deposit insurance system

Implicit deposit insurance operates on the principle of 'constructive ambiguity' which, simply put, means that there is no legislative framework setting out how depositors will be protected and failing banks generally do not have a guarantee that they will be bailed-out by the government. The rationale underlying such 'constructive ambiguity"' is that, not having a guarantee that they will be rescued will have the result that banks will exhibit better market discipline and refrain from too risky ventures.[176]

Ognejovic explains that, over the years, many governments prevented bank failure by offering financial support to a failing institution and restoring its operations through an implicit deposit insurance system which functioned on a discretionary basis.[177] This kind of discretionary support exists where there is a public assumption that deposits will be protected by governmental intervention in the event of bank failure.[178] In this regard, depositors generally presume that their deposited funds are protected because nobody told them otherwise or because the government intervened in some way in the past.[179] According to Ognejovic, the most notable characteristic of an implicit deposit insurance system is the absence of law and other rules related to deposit insurance, making it more "flexible".[180] This inherent flexibility gives policymakers enough freedom to fashion deposit protection remedies.[181]

[176] *Ibid*. See also Hoelscher, Taylor and Klueth *The Design and Implementation of Deposit Insurance Systems* 2.
[177] Ognjenovic *Deposit Insurance Schemes: Funding, Policy and Operational Challenges* (2017) 6.
[178] Ognjenovic (2017) 6.
[179] *Ibid*.
[180] Ognjenovic (2017) 6.
[181] For instance, the government can control the amount of protection covered or even offer n protection at all. See Talley & Mas "Deposit Insurance in Developing Countries" 1990 *World Bank Policy Research Working Paper No 548* 16.

According to Talley and Mas, in an implicit deposit insurance system, the government can, at its discretion, extend protection in three basic ways namely:[182]

a) The government can make direct payments to depositors when an insolvent bank is closed or arrange for the failed bank's deposits to be assumed by another bank.

b) The government can arrange and financially support the merger of a problem bank with another bank in an attempt to prevent the failure of such bank and thereby protecting depositors.

c) Finally, the government can prevent the failure by rehabilitating the bank in the form of a direct equity capital injection into the bank; or alternatively the government could acquire some or all of the failing bank's non-performing assets at book value.

Talley and Mas further observe that ultimately, in an implicit deposit insurance system, policymakers have more control over the amount, form, timing of the protection offered and obviously also over whether they are going to offer such protection in the first place.[183] However, Ognejovic points out that this also presents challenges in that the government may engage in inconsistent actions and apply different rules in dealing with different bank failures.[184] In turn, this inconsistency may create uncertainty and lead to unequal and preferential treatments for different categories of depositors.[185] This is the type of uncertainty that would typically give rise to banks runs. [186] When this happens, it significantly reduces the effectiveness of an implicit scheme in maintaining confidence and avoiding systemic risk.[187] In the same manner, the constructive ambiguity involved in implicit deposit insurance often leads to customers believing the government will likely protect and reimburse even extremely large amounts of deposits.[188] This belief may, in

[182] Talley & Mas (1992) 9.
[183] Talley & Mas (1990) *World Bank Policy Research Working Paper No 548* 16.
[184] Ognjenovic (2017) 7.
[185] *Ibid*.
[186] Talley & Mas (1990) *World Bank Policy Research Working Paper No 548* 19 indicate that the uncertainty created by an implicit deposit insurance system in covering deposits sometimes leads depositors to withdrawing their funds *en masse* for fear that they might lose their deposits should a bank fail.
[187] *Ibid*.
[188] *Ibid*.

turn, lead to moral hazard.[189] However, as pointed out in Chapter One[190], the drawback is that if depositors are uncertain whether their deposits will be protected because there is no clear legislative framework entrenching their right to be reimbursed in the event of bank failure, it may lead to bank runs that may in some instances even threaten financial system stability.

In any event, with the advent of financial conglomeration and universal banking,[191] many banks became part of the so-called "Too Big to Fail"[192] conglomerates that unabatedly carried on excessive risk-taking ventures, knowing that their size, interconnectedness and importance in the financial system would guarantee them a bail-out in order to prevent the financial system collapse that their failure could trigger.

2.2.2 Explicit deposit insurance system (EDIS)

In principle, an explicit deposit insurance scheme (EDIS) is a fund or scheme to which deposit-taking financial institutions make contribution of premiums.[193] Okeahalam observes that the fundamental basis for these premiums is two-fold: firstly, to reimburse depositors fully up to a pre-set limit in the event of a bank failure; and secondly, to provide uninformed and unsophisticated depositors with a safety net.[194] This, in turn, restores depositors' confidence in the banking system and thereby promotes financial stability.[195]

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[189] Moral hazard [this is another concept that appears to have been defined in multiple places] is said to arise when parties have incentives to engage in risky behavior knowing that the costs arising from those actions will be borne, in whole or in part, by others. See IADI *Mitigating Moral Hazard Guidance Paper* (2013) 3. The problem of moral hazard is discussed in detail later on in this chapter.
[190] See par 1.2.
[191] As explained by Benston, universal banks are banks "that may offer the entire range of financial services. They may sell insurance, underwrite securities, and carry out securities transactions on behalf of others. They may own equity interests in firms …They may vote the shares of companies they own and if they are delegated as proxies for the owners, they may vote the shares of others. In fact, they may elect their employees as members of the boards of directors of those companies." See Benston (1994) *Journal of Economics* 121.
[192] Barth "Too Big to Fail and Too Big to Save: Dilemmas for Banking Reform" 2016 *National Institute Economic Review* 1.
[193] Okeahalam "Deposit insurance and international banking regulation" in Mullineux & Murinde (eds) *Handbook of International Bankin*g (2003) 638.
[194] Okeahalam (2003) 638.
[195] *Ibid*.

The most important feature of an EDIS is that payment arrangements are clearly set out in advance, readily providing adequate funding as the fund is usually built up by the banking sector in good times rather than at the point of bank failure.[196] Thus, it guarantees legal certainty regarding the coverage of insured depositors to avoid any degree of uncertainty that may come with the provision of emergency lending assistance (ELA) by the central bank.[197] Tally and Mas, therefore, comment that a well-designed EDIS framework provides a better administrative process for handling bank failures and protecting depositors as it tends to be faster, smoother and more predictable, and it produces more consistent results than an implicit deposit insurance system.[198] As pointed out in Chapter One,[199] a well-designed EDIS can also serve to prevent bank failure through the promotion of greater market discipline.

However, over the years academic researchers have disagreed on the efficacy of EDIS in protecting depositors and stabilizing the financial system. Some researchers[200] believe that the use of EDIS is an optimal policy to protect a banking sector when its stability is threatened by depositor runs. Other researchers,[201] however, argue that its use may be a source of moral hazard, as the banks under the scheme, (both in the case of implicit and explicit deposit insurance), knowing that their depositors are protected in the event

[196] South African Reserve Bank (SARB) *Financial Stability Review* (2017) 28.
[197] Theoretically speaking, the foundations of the emergency lending assistance by central banks, generally known as the lender of last resort (LOLR) assistance, were first set by Thornton in 1802 and were further refined by Bagehot in 1873. According to Lastra, the classical Bagehot's LOLR doctrine was based upon four pillars namely: the central bank, acting as lender of last resort, should prevent temporarily illiquid but solvent banks from failing; the central bank should lend freely but charge a penalty rate; the central bank should accommodate anyone with collateral, valued at pre-panic prices; and the central bank should make its readiness to lend freely clear in advance. See Lastra "Lender of last resort – an international perspective" 1999 *International and Comparative Law Quarterly* 342. However, in today's world, the "classical" Bagehot's concept of LOLR has been criticized on two grounds namely: first, the distinction between solvency and illiquidity is less than clear-cut because in most cases the banks that seek the assistance of the LOLR are already under suspicion of being insolvent; second, the existence of a fully collateralized repo market allows central banks to provide the adequate aggregated amount of liquidity and leave the responsibility of lending uncollateralized to the banks thus giving them a role as peer monitors and thereby introducing market discipline. See Freixas, Parigi & Rochet "The Lender of Last resort: A 21st Century Approach" 2004 *Journal of the European Economic Association 1086*.
[198] Talley & Mas (1992) 23.
[199] See paragraph 1.3.
[200] Diamond & Dybvig (1983) *Journal of Political Economy* 404.
[201] According to Schich, deposit insurance gives rise to moral hazard both on the part of depositors, who tend to reduce their monitoring and "policing" efforts, as well as on the part of banks, which tend to perceive the lessening of the threat of market discipline. See Schich (2008) *OECD Finance Market Trends* 10.

of their failure, are then encouraged to finance high-risk or high return projects which may lead to additional bank failures, and ultimately, to systemic instability in the banking sector resulting in a widespread banking crisis.[202]

Despite this disagreement, as pointed out in Chapter One,[203] the incidence of EDIS in various countries across the globe has increased. International standard setting bodies also looked deeper into the issue of deposit insurance as an integral part of the financial safety net. In September 2001, the Financial Stability Forum[204] (FSF), being the entity that dealt with financial stability on international level prior to the current Financial Stability Board, endorsed the Report of its Working Group on Deposit Insurance.[205] According to the then Chairman of the FSF, Andrew Crockett, and the Report[206] was built on three general findings:

(a) that an explicit and limited deposit insurance system is preferable to implicit coverage if it clarifies obligations to depositors and creditors and limits the scope for discretionary decisions that may result in arbitrary actions;

(b) that an explicit deposit insurance must be properly designed, well implemented and understood by the public to be credible and to avoid moral hazard; and

(c) to be effective, an explicit deposit insurance system needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced and sound accounting and disclosure regimes.

Demirguc-Kunt and Kane point out that globally, most countries have resorted to adopting EDIS with the aim of augmenting the flow of bank credit by boosting customer confidence

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[202] Khan & Dewan "Deposit insurance scheme and banking crises: a special focus on less-developed countries" 2011 *Journal of Empirical Economics* 155 - 182.
[203] See paragraph 1.3.
[204] The Financial Stability Forum was a group consisting of major national financial authorities such as finance ministers, central bankers, and international financial bodies. It was later, at the 2009 G20 London Summit, succeeded by the Financial Stability Board with an expanded membership and broadened mandate. This information is available at www.fsb.com. Accessed on 17th November 2019.
[205] Financial Stability Board (FSB) *Guidance for Developing Effective Deposit Insurance Schemes* (2001). Available at https://www.fsb.org/wp-content/uploads/r_0109b.pdf. Accessed on 17 December 2020.
[206] FSB *Guidance for Developing Effective Deposit Insurance Schemes* (2001) Preface.

in the banking system and to do it without setting aside or expending current fiscal resources.[207] As evidenced by the 2008 GFC, an EDIS plays an integral part in maintaining financial stability in a country during a crisis. As a matter of fact, Schich points out that countries with EDIS managed to 'mute' the effects of the GFC by remaining resilient throughout the crisis.[208] This ignited a renewed focus on the importance of EDIS and countries who did not yet have EDIS were encouraged to establish an explicit form of deposit insurance while reform was called for in those countries with existing EDIS.[209]

2.3 Challenges presented by explicit deposit insurance systems

2.3.1 The Moral hazard problem

As indicated, over the years, there has been a lack of consensus among scholars regarding the impact of an EDIS on the financial system.[210] One of the main criticisms against an EDIS is that it brings with it the problem of "moral hazard."[211] In general, moral hazard [this has already been defined] is said to arise when parties have incentives to engage in risky behavior knowing that the costs arising from those actions will be borne, in whole or in part, by others.[212] In the context of deposit insurance, moral hazard refers to the incentives that insured banks have to utilize lower insured deposits to partake in higher risk projects than would otherwise be ideal.[213] In this case, depositors and other stakeholders turn a blind eye to the institution's risk-taking behavior because they either believe they are protected from deposit losses in case the bank fails, or they believe the

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[207] Demirguc-Kunt & Kane "Deposit Insurance: Handle with Care" (2003) C*entral Bank of Chile Working Paper No 227* 4.
[208] Schich (2008) *OECD Financial Market Trends* 30-31.
[209] For instance, Australia, which had established an early access facility in June 2008, extended in October 2008 a three-year guarantee on all deposits in the country's banks, building societies and credit unions. In New Zealand, the finance minister announced that the government had introduced an opt-in deposit guarantee. On the other hand, in October 2008, the Federal Deposit Insurance Corporation (FDIC) extended the coverage of its scheme to small business deposits See Schich (2008) *OECD Financial Market Trends* 20.
[210] Jain, Keneley & Thompson "Insuring for a Crisis: Deposit Insurance and the GFC, the Australian and New Zealand Experience" 2012 *The Economic Society of Australia* 359.
[211] Moral hazard refers to the tendency of a party to take risks with the belief that they will not have to bear the consequences of their actions. See IADI *Mitigating Moral Hazard Guidance Paper* (2013) 3.
[212] IADI *Mitigating Moral hazard Guidance Paper* (2013) 3.
[213] IADI *Mitigating Moral Hazard Guidance Paper* (2013) 7.

bank is "too-big-to-fail."[214] Thus, the moral hazard problem applies to both insured banks as well as to their depositors in the sense that the banks undertake more risky ventures while the insured depositors turn a blind eye to such risk-taking behavior.

Okeahalam thus submits that offering protection to depositors against the risk of loss of deposits through an EDIS appears to be a double-edged sword.[215] On the one hand, the absence of an EDIS may force depositors to run on the bank and withdraw their deposits at the first sign of trouble, thus causing instability in the financial system.[216] On the other hand, the same depositors, when the bank is a member of an EDIS, may lose interest in monitoring the risk-taking behavior of their banks when they believe their deposits are protected against loss in the event of a bank failure.[217] For this reason, the IADI state that whenever depositors and liability holders are offered protection, effective tools for mitigating moral hazard must of necessity also be considered.[218] Some of the ways recommended to mitigate the moral hazard problem are discussed below.

2.3.2 Mitigating moral hazard

Bretschneider and Benna remark that an EDIS, like any other insurance, should be designed in a way that mitigates the impact of moral hazard on the behavior of shareholders, management and creditors, including depositors.[219] They argue that such mitigation can only be achieved when the overall design of a deposit insurance system is designed to reduce incentives for risk-taking.[220]According to the IADI Core Principles, the problem of moral hazard should be mitigated by ensuring that a country's deposit

[214] Basically, the principle underlying the "too-big-to-fail" is that once a bank has reached a particular size, if it experiences any difficulties in meeting its liabilities, it should receive all the financial support available to make sure it does not fail. More importantly, all obligations to depositors, whether insured or uninsured will be protected by a government guarantee. See Okeahalam "The Political Economy of bank Failures and Supervision in the Republic of South Africa" 1998 *African Journal of Political Science* 33.
[215] Okeahalam (2003) 640.
[216] *Ibid.*
[217] *Ibid*.
[218] IADI *Mitigating Moral Hazard Guidance Paper* (2013) 8.
[219] Bretschneider & Benna "Risk-based premium models for deposit insurance systems" 2017 *World Bank Group* 48.
[220] Bretschneider & Benna (2017) *World Bank Group* 48.

insurance system contains appropriate design features and through other elements of the financial system safety net.[221] This entails certain practices that include:[222] setting limits on the amounts insured; excluding certain categories of depositors from coverage; implementing differential or risk-adjusted premium systems where appropriate; and minimizing the risk of loss of equity through timely intervention and orderly resolution of distressed and failed institutions.

Moral hazard can further be mitigated by market discipline[223] exercised by shareholders as well as by larger creditors and depositors who are more vulnerable to the risk of loss from the failure of a bank.[224] However, for market discipline to work effectively, the FSF indicated that information must be readily available and easy to comprehend by the general public; sound accounting and disclosure regimes must be established; as well as ongoing attention must be provided regarding a bank's soundness by ratings agencies, market analysts, financial commentators and other professionals.[225]

The IADI points out that many countries also rely on regulatory discipline to mitigate moral hazard.[226] This means that regulators should not be prone to regulatory forbearance. To be effective, regulatory discipline requires cooperation and that accurate information be shared among financial safety net participants about the state of the insured institution.[227] Regulatory discipline can be exercised through, inter alia:[228] requirements pertaining to the chartering (licensing) and insuring of new institutions; qualifications for managers and directors; regulatory approval of changes of control; risk-management requirements; provisions for internal controls and external audits; and orderly failure resolution.

[221] IADI Core Principles (2014) 11.
[222] *Ibid.*
[223] Market discipline occurs when, given appropriate incentives, the reaction of stakeholders to market forces acts to curtail excessive risk taking. See IADI *Mitigating Moral Hazard Guidance Paper* (2013) 11.
[224] IADI *Mitigating Moral Hazard Guidance Paper* (2013) 11.
[225] FSF Report (2001) 9.
[226] Simply put, regulatory discipline entails intervention by public or private authorities to prevent market forces from producing socially undesirable results, such as bank runs or excessive risk taking. See IADI *Mitigating Moral Hazard Guidance Paper* (2013) 15.
[227] IADI *Mitigating Moral Hazard Guidance Paper* (2013) 15.
[228] IADI *Mitigating Moral Hazard Guidance Paper* (2013) 16.

Importantly, the FSF indicated that moral hazard may be mitigated by creating and promoting appropriate incentives through good corporate governance[229] and sound risk management of individual banks, effective market discipline and robust prudential regulation and supervision frameworks.[230] It is thus pivotally important for policymakers to ensure that deposit insurers and other safety-net participants have the relevant tools and practices in place to mitigate moral hazard.[231] The main take-away here is that an EDIS must be designed in a manner that mitigates moral hazard to the utmost extent possible.

2.4 The 2007/2008 Global Financial Crisis

As alluded to, the 2007/2008 GFC intensified the need for countries to strengthen their financial safety nets.[232] Globally, many banks either failed or received financial aid, which inflicted severe losses on the financial system.[233] A number of weaknesses and gaps were also revealed in the financial regulatory systems.[234] In particular, the inability of government authorities to handle widespread bank failures and deposit losses without

[229] Corporate governance refers to the relationships that ensue between a financial institution's board of directors, management, shareholders and other stakeholders, including the institution's regulators, supervisors as well as the deposit insurer. See IADI *Mitigating Moral Hazard Guidance Paper* (2013) 10.
[230] Good corporate governance as well as sound risk management of individual banks assist in ensuring that business strategies comply with safe and sound operations, thereby acting as the first line of defence against excessive risk taking. See FSF Report (2001) 8.
[231] IADI *Mitigating Moral Hazard Guidance Paper* (2013) 10.
[232] According to Schich, the 2008 GFC was a forceful reminder that financial institutions and markets are exposed to periodic challenges of marked illiquidity and insolvencies which, if not addressed, are capable of prompting system-wide crisis leading to large economic and social costs. See Schich "Challenges associated with the expansion of deposit insurance coverage during Fall 2008" 2009 *The Open Access Open Assessment E-Journal* 2. See also Nolte & Rawlins "Challenges in Building Effective Deposit Insurance Systems in Developing Countries: Lessons Learnt Series" 2017 *The World Bank* 1.
[233] Papanikolaou "To be bailed out or to be left to fail? A dynamic competing risks hazard analysis" 2018 *Journal of Financial Stability* 61.
[234] For instance, a comprehensive review of South Africa's resolution framework in 2009/10 under the auspices of the World Bank's Financial Sector Reform and Strengthening Initiative (FIRST) programme and a thematic peer review by the Financial Stability Board (FSB) in 2012 revealed gaps in a number of areas where South Africa's 'conventional' resolution powers did not comply with the '*Key Attributes for Effective Resolution'*. One of the gaps revealed was the absence of an explicit and privately funded deposit insurance fund that reimburse depositors in the event of a bank failure and could potentially assist in funding the chosen resolution option. See SARB *Designing a deposit insurance scheme* (2017) 14.

exposing taxpayers' funds to risk.[235] As a result, economists were forced to revisit the forces that stabilize or destabilize the financial system globally.[236] This led to a substantial increase in augmenting financial safety nets in most countries in an attempt to restore confidence of depositors and to deter potential contagious runs on their banking sectors.[237]

During the GFC, the significance of depositor confidence in the banking sector was highlighted. In addition, the importance of setting up an effective deposit insurance system as a key element of a financial stability framework was once again emphasized. The GFC in particular, demonstrated the essence of restoring confidence to depositors about access to their funds as payout delays during a crisis seemed to create incentives for preemptive runs by depositors.[238] Thus, the role of an EDIS in promoting financial stability has become a regulatory priority post-GFC.[239]

Not only did the GFC test the design and capacity of existing EDIS in many countries, emphasizing the need for reform but it also led to the establishment of new EDIS in countries that lacked it.[240] Countries with existing systems, one the one hand, responded by quickly increasing deposit coverage levels; making significant changes towards the strengthening of their EDIS; revising their mandates; strengthening funding

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[235] Ellis "Building credible and effective Deposit Insurance Systems' 2016 *Federal Deposit Insurance Corporation Staff Paper* 1.

[236] In the words of Mosley and Singer, the Crisis "prompted much soul-searching among economists and financial experts who failed to anticipate it, or whose warnings were not taken seriously by regulators and investors." See Mosley & Singer "The Global Financial Crisis: Lessons and Opportunities for International Political Economy" 2009 *International Interactions* 420.

[237] Hasan *et al* "Deposit Insurance and the 2008-2009 Global Financial Crisis" 2017 *Financial Stability Studies* 2.

[238] Micajkova "Deposit insurance in times of Financial Crisis" 2013 *South-Eastern Europe Journal of Economics* 172.

[239] The issue of moral hazard [this has previously been defined] has received a great deal of attention in the DIS literature. Simply put, the problem of moral hazard arises from the distortion of incentives induced by deposit protection. The problem of moral hazard, therefore, arises when parties have incentives to engage in risky behavior knowing that the costs arising from those actions will be borne, in whole or in part, by others. See International Association Deposit Insurers (IADI) *Enhanced Guidance for Effective Deposit Insurance Systems Mitigating Moral Hazard - Guidance Paper Prepared by the Research and Guidance Committee International Association of Deposit Insurers* (2013) 3. See also Micajkova (2013) *South-Eastern Europe Journal of Economics* 172. For a detailed discussion on moral hazard, see chapter two of this thesis.

[240] Nolte & Rawlins (2017) *The World Bank* 1.

arrangements; and shortening reimbursing timeframes.[241]

More importantly, the GFC resulted in greater convergence in practices across jurisdictions and an emerging agreement about appropriate features of an effective EDIS which include: higher coverage levels; the elimination of coinsurance; the adoption of ex-ante funding by most jurisdictions; and the strengthening of information sharing and coordination with other safety net participants.[242]

2.5 IADI Key Design Features for Effective Deposit Insurance Systems

2.5.1 Introduction

As clearly demonstrated by the 2008 GFC, a well-functioning financial sector safety net is a critical component for a stable financial sector.[243] Nolte and Khan observes that the GFC revealed, inter alia, a rare exigency for countries to strengthen their safety nets, in particular, by EDIS frameworks to ensure a high degree of depositor confidence in the banking system.[244] In response to the effects of the GFC, the IADI together with the BCBS, issued the first set of internationally agreed principles[245] in 2009 to serve as a benchmark for countries wishing to establish or improve EDIS. These principles were subsequently revised in 2014 and cover a wide range of issues including mandates and powers; funding; payout capacity; and contingency planning as well as crisis management in relation to an EDIS.[246] However an EDIS cannot merely be created *in vacuo* by just focusing on the IADI Core Principles. An important aspect to take note of before one delves into the design features of an effective EDIS, is the supporting financial and regulatory landscape of the country concerned that would optimize the operation and effectiveness of such EDIS.

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[241] *Ibid.*
[242] Micajkova (2013) *South-Eastern Europe Journal of Economics* 166.
[243] Nolte & Khan (Eds) "Deposit Insurance systems: Addressing emerging challenges in funding, investment, risk-based contributions and stress testing" 2017 *World Bank Group* 3.
[244] Nolte & Khan (2017) *World Bank Group* 3.
[245] The IADI Core Principles for Effective Deposit Insurance Systems were first issued in 2009 and later revised in 2014.
[246] Nolte & Khan (2017) *World Bank Group* 3.

2.5.2 Factors to consider before establishing explicit deposit insurance systems

Nolte and Rawlins indicate that, when designing a new EDIS or reforming an existing one, it is imperative for policymakers to ensure that certain preconditions for an effective EDIS framework are met and that critical policy choices relating to its design are made based on the relevant country's unique needs.[247] Accordingly, a number of factors that have a bearing on the effectiveness of EDIS have been identified as set out below.[248]

2.5.2.1 Macroeconomic stability

According to Hoelscher, Taylor and Kluer, the most important factor is the existence of macroeconomic stability, followed closely by the soundness of the particular financial system.[249] Macroeconomic conditions play a critical role in influencing the efficiency of markets, the intermediary function of banks as well as economic growth.[250] Any instability in the macroeconomic conditions can, therefore, delay the operations of markets and distort financial intermediation.[251] Therefore, introducing an EDIS under conditions of macroeconomic instability is considered inappropriate.[252] Accordingly, the IADI Core Principles indicate that, in designing an effective EDIS, policymakers need to analyze the conditions and factors affecting the banking system in the country concerned that may be essential in influencing an effective system including:[253] the level of economic activity ; current monetary and fiscal policies; inflation; housing and financial assets prices; and the condition of financial markets'.

[247] Nolte & Rawlins "Challenges in Building Effective Deposit Insurance Systems in Developing Countries: Lessons Learnt Series" (2017) 1.
[248] Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 6.
[249] It is believed that if the macroeconomic environment is unstable or the banking system is unsound, there is a possibility that a newly established EDIS will fail. See Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 6.
[250] IADI Core Principles (2014) 12.
[251] Basel Committee on Banking Supervision (BCBS) & International Association of Deposit Insurers (IADI) *Core Principles for Effective Deposit Insurance Systems: A methodology for compliance assessment* (2010) 6.
[252] Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 6.
[253] BCBS & IADI *Core Principles: Compliance Assessment* (2010) 6.

2.5.2.2 The soundness of the financial system

The IADI Core Principles further indicate that an important precondition for establishing an EDIS is the existence of a strong and healthy financial sector.[254] As observed, a critical objective of a deposit insurance system is the strengthening of depositors' confidence in the banking sector. Therefore, the establishment of an EDIS in an unsound banking system would reduce or remove incentives for depositors to exercise discipline in relation to placing their deposits in banks that are safe and sound.[255] According to the IADI, elements of consideration regarding the soundness of the banking system include:[256] the assessment of the health of a financial institution, which includes the deposit insurer's ability to recognize emerging threats, its relationship with other safety-net participants as well as its resources; the assessment of the structure of the financial system in terms of the number, type and characteristics of a bank, as well as the types of deposits and depositors covered; and any pre-existing depositor compensation schemes and the effect they will likely have on the introduction of an EDIS.

2.5.2.3 The role of prudential regulation, supervision and resolution

Given the unique role of banks in the economy, Hoelscher, Taylor and Kluer remark that adequate prudential regulation and the legal framework for enforcing such regulation allow authorities to set and enforce limits on risk-taking by banks.[257] As previously indicated, in principle, prudential regulation and supervision are designed to control excessive risk-taking by insured institutions and to ensure that they function in a safe and

[254] IADI Core Principles (2014) 12.
[255] In terms of the definition given by Perla and Schmukler, market discipline in the banking sector refers to a situation in which private sector agents (stockholders, depositors, or creditors at large) face costs that increase as banks undertake risks and take action on the basis of these costs. They believe the presence of an EDIS in a country could affect the extent of market discipline and according to them, a credible EDIS reduces the incentives of depositors to monitor banks, diminishing the degree of market discipline. However, if an EDIS is not credible or if there are costs associated with the recovery of deposits following a bank failure, insured depositors are forced to monitor banks. See Perla & Schmukler "Do depositors Punish banks for bad behaviour? Market Discipline, Deposit Insurance and Banking Cirses" 2001 *The Journal of Finance* 1031. See also Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 7.
[256] IADI Core Principles (2014) 12.
[257] Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 7.

sound manner.[258] Accordingly, a strong framework for regulation and supervision that ensures that weaknesses in a bank are swiftly identified and corrected is essential in influencing the effectiveness of an EDIS.[259]

Robust prudential regulation and supervision, therefore, aids in reducing moral hazard by, inter alia, preventing bank shareholders and managers from engaging in risky activities to the disadvantage of depositors and thereby increases market discipline by banks.[260] Furthermore, a sufficient regulatory framework has the ability to counteract the weakening of market discipline engendered by the existence of an EDIS and to reduce the overall costs to the deposit insurer.[261]

2.5.2.4 The legal and judicial framework

As pointed out in the IADI Core Principles, an effective EDIS requires the existence of a sound legal regime which incorporates a system of business laws, including corporate, insolvency, contract, creditor rights, consumer protection, anti-corruption/fraud and private property laws.[262] Such legal system should be backed by a well-functioning and independent judiciary as well as a legal framework laying out its appropriate powers to enable it to obligate member banks to comply with their agreement with the deposit insurer.[263] Any flaw in the legal framework can undermine the effectiveness of a deposit insurance system and the impact of such flaws may result in the increase of the costs of EDIS.[264]

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[258] The de facto standard for sound prudential regulation and supervision of insured institutions is the *Core Principles for Effective Banking Supervision*, developed by the BCBS in cooperation with fellow supervisors.
[259] IADI Core Principles (2014) 13.
[260] Hoelscher, Taylor and Kluer believe that in the absence of adequate regulatory infrastructure, the authorities would have little means to monitor banking activities or to limit risk taking, thereby exposing the deposit insurer to significant contingent liabilities. See Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 7. See also IADI *Core Principles* (2014) 13.
[261] Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 7.
[262] IADI *Core Principles* (2014) 14.
[263] *Ibid.*
[264] *Ibid*.

2.5.2.5 The Accounting and Disclosure Regime

As pointed out in the FSF Report, an effective EDIS also requires sound accounting and disclosure regimes to effectively assess emerging risks in the financial system.[265] Without accurate and reliable information about an institution's risk profile, it becomes almost impossible for depositors and other stakeholders to make informed decisions about the health of an institution and this can lead to decreased market, regulatory and supervisory discipline.[266] The FSF Report thus indicates that many jurisdictions have, over the years, fostered market discipline by adopting sound and prudent accounting principles and practices as well as methods to ensure compliance with agreed-upon accounting conventions.[267]

2.5.3 Special issues in deposit insurance systems

2.5.3.1 Depositor preference

In setting the scene for the introduction of an EDIS, the IADI Core Principles indicate that treating depositors according to their creditor hierarchy can have a profound impact on the costs incurred by the deposit insurer and the bank failure resolution regime in general.[268] It is pointed out that 'depositor preference', in particular, insured depositor preference, and has the ability to minimize the costs of liquidation and depositor reimbursement.[269] Simply defined, the concept of "depositor preference" means giving

[265] Attributes of a sound accounting regime include accurate and meaningful assessments of information on areas such as asset evaluation, the measurement of credit exposures, loan-loss provisioning, measurement of nonperforming loans, and the treatment of unrealized losses, off-balance-sheet exposures, capital adequacy as well as bank earnings and profitability. See FSF Report (2001) 14.
[266] According to the Financial Stability Forum, comprehensive disclosure regimes can enhance the effectiveness of a deposit insurance system and this can be achieved by requiring banks to provide timely, detailed and useful financial information to allow the market to assess the performance of a bank. See FSF Report (2001) 14.
[267] FSF Report (2001) 14.
[268] IADI Core Principles (2014) 17.
[269] Principle 16 of the IADI Core Principles entails that the deposit insurer should have, by law, the right to recover its claims in accordance with the statutory creditor hierarchy.

priority to the claims of depositors on the assets of an insolvent bank over the claims of other unsecured creditors.[270]

Advocates of depositor preference contend that by protecting depositors against the risk of loss in the event of a bank insolvency, depositor preference supports the financial system safety net in three main ways.[271] Firstly, depositor preference limits the possibility of bank runs.[272] By mitigating the risk of financial panic, depositor preference assists in maintaining public confidence in the financial system, reducing the probability of an outbreak of contagion risk and thereby contributing to the maintenance of stability in the financial system.[273] Secondly, maintaining public confidence can help extend the time available in the implementation of a more efficient official sector response to the insolvency of a bank, more specifically, in the event of the failure of a complex systemically important bank.[274] Thirdly, where a country has established both depositor preference and an EDIS, depositor preference can play a role in reducing the costs incurred by the EDIS through subrogation rights enjoyed by the insurer.[275]

2.6 The IADI Core Principles for Effective Deposit Insurance Systems

2.6.1 Core Principle 1 - Public policy objectives

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[270] Chan *et al* “Depositor preference and deposit insurance schemes – challenges for regulatory convergence and regulatory coordination in Asia” 2018 *Law and Financial Markets Review* 72.
[271] Chan *et al* (2018) *Law and Financial Markets Review* 72.
[272] *Ibid*.
[273] *Ibid.*
[274] *Ibid*.
[275] ‘Subrogation’ is defined in the IADI Core Principles as the substitution of one party (the deposit insurer) for another (the insured depositor) with reference to a lawful claim, demand, or right, so that the party which substitutes succeeds to the rights of the other in relation to the debt or claim, and its rights and remedies. See IADI Core Principles (2014) 10. As a general principle, where an EDIS is subrogated to the claims of covered depositors in insolvency, depositor preference is likely to result in higher recoveries and lower net costs for an EDIS. For instance, of the financial cap or least cost test is calculated net of the expected recoveries of an EDIS in liquidation, depositor preference can therefore significantly reduce the amount of deposit insurance funds that are available to support transactions in insolvency or resolution. See Baudino *et al* “Bank failure management – the role of deposit insurance” 2019 *FSI Insights on Policy Implementation No 17* 14.

IADI Core Principle 1 deals with the public policy objectives underlying the establishment of an EDIS.[276] Such principal policy objectives are to protect depositors and contribute to financial stability. IADI Core Principle 1 accordingly require that these objectives be formally specified and publicly disclosed and that the design of a specific EDIS should reflect the particular system's public policy objectives.[277] In adopting an EDIS or reforming an existing system, regulators are therefore required to identify appropriate public policy objectives and to ensure that they are fully comprehended.[278] It is the role of the policymakers to ensure that they know the public's expectations and attitudes towards the proposed EDIS and that the authorities as well as the public view the components of the EDIS as credible.[279] As observed earlier, a deposit insurance system has two separate but complementary objectives within the overall framework of the financial safety net.[280] First, it should contribute to the stability of the financial system as an adjunct to the central bank's 'lender of last resort'-function.[281] Second, it should afford retail depositors

[276] Principle 1 of the IADI Core Principles (2014) 16.
[277] IADI Core Principle 1.
[278] An inquiry into the role of deposit insurance should commence with determining the objectives of the deposit insurance program, followed by an examination into how these objectives may be implemented in actual practice as well as the extent to which these objectives will serve public interest. See Isaac "The role of deposit insurance in the emerging financial services industry" 1984 *Yale Journal on Regulation* 200. See also FSF *Guidance for Developing effective deposit insurance systems* (2001) 3.
[279] The Financial Stability Forum emphasized the importance of public attitudes and expectations in reinforcing the credibility and effectiveness of a deposit insurance system. See FSF *Guidance for Developing effective deposit insurance systems* (2001) 3.
[280] According to Bernet and Walter, a DIS always has two crucial purposes to achieve: first, a DIS's aim is to prevent a run on illiquid but solvent financial institutions to stop the spread of a crisis in one financial institution to the other financial institutions; and second, to make good the losses incurred by depositors as a result of the illiquid or insolvent financial institution up to a pre-set limit. See Bernet & Walter "Design, Structure and Implementation of a Modern Deposit Insurance Scheme" 2009 *SUERF Studies* 8. See also Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 5.
[281] The classical elements of the doctrine of lender of last resort (LOLR) were first developed by Thornton in 1802 and later refined by Bagehot in 1873. According to their description, the LOLR doctrine holds that monetary authorities in the face of panic should lend unsparingly but at a penalty rate to illiquid but solvent banks. See Bordo "The lender of last resort: Alternative views and historical experience" 1990 *Economic Review* 18. According to Kaufman, the LOLR assistance by the central bank may be provided in one of the two ways namely: through the discount window and through open market operations. He asserts that the discount window was traditionally used as the major tool of central banking before the development of broad financial markets and allowed open market operations to be conducted and hence it had the ability to direct the assistance more precisely to the particular sector under pressure. He further stipulates that the development of financial markets led to the open market operations pre-empting the discount window as the major tool for monetary policy, thereby reducing the need for the central bank to direct its actions at particular sectors. See Kaufman "Lender of Last Resort: A Contemporary Perspective" 1991 *Journal of*

some minimum protection against the risk of loss of their deposits in the event of a bank failure.[282]

Notably, the Financial Stability Forum (FSF) Study Group on Deposit Insurance stated in its Report (2000)[283] that for countries to achieve their public-policy objectives, 'a level of coherence between the objectives and the structure of an EDIS should exist together in a state of balance and consistency in order to achieve the desired results while also minimizing unintended consequences'. International best practice advocates a periodic review of the public policy objectives and that such review must be conducted on a regular basis and on a predetermined timeline.[284]

The essential criteria under IADI Core Principle 1 pertaining to the public policy objectives of an EDIS consequently state that:[285]

(a) the public policy objectives of the EDIS must be formally specified and made public by means of legislation and supporting documents;
(b) the design of the EDIS must be consistent with the public policy objectives of the EDIS;
(c) a review is required of the extent to which the EDIS meets its public policy objectives. Such review, which must take into consideration the views of key stakeholders, comprises both a regular internal review by the governing body and a periodical review by an external body.
If additional public policy objectives are incorporated, it is required that such objectives must not conflict with the two main objectives of depositor protection and contributing to financial system stability.

Financial Services Research 104. See also (Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 5.

282 The most notable characteristic of explicit deposit insurance system is that it guarantees that depositors will receive at least a minimum amount of their deposits in the event that a bank fails, regardless of the quality of the bank's assets available for liquidation. See Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 5.

283 Financial Stability Forum: Working Group on Deposit Insurance *International Guidance on Deposit Insurance - A consultation Process and Background Paper* (2000).

284 Principle 1 of the IADI Core Principles (2014) 18.

285 Core Principle 1 Essential criteria 1 to 4.

2.6.2 Core Principle 2 - Mandates and Powers

Core Principle 2 requires that the mandate[286] and powers of the deposit insurer should support the public policy objectives of the EDIS and be clearly defined and formally specified in legislation.[287] Most importantly, the mandate of an EDIS has to be closely intertwined with that of other financial safety net participants such as the particular country's central bank.[288]

As explained in the IADI Core Principles, the mandates of deposit insurers can be classified into four categories:

(a) A 'pay box mandate' which entails that the deposit insurer is only responsible for reimbursing insured deposits; or
(b) a 'pay box plus mandate' which places additional responsibilities on the deposit insurer such as certain functions pertaining to bank resolution; or
(c) a 'loss minimizer mandate' which requires the insurer to actively engage in selecting least cost resolution strategies; or
(d) a 'risk-minimizer' mandate which gives the deposit insurer comprehensive risk minimization functions that include risk assessment or risk management; early intervention powers as well as resolution powers, and in some instances also include prudential oversight responsibilities.[289]

Thus, a deposit insurer's mandate could be strictly limited to merely reimbursing depositors in the event of a bank failure - which would then be a 'pay box' mandate.[290] Alternatively, it could be more comprehensive and include separating the failed bank's

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[286] A mandate has been defined as a set of official instructions or a statement identifying the purpose. See FSF *Guidance for Developing effective deposit insurance systems* (2001) 17.
[287] Principle 2 of the *IADI Core Principles* (2014) 19.
[288] Adema, Hainz & Rhode "Deposit Insurance: System Design and Implementation across countries" 2019 *ifo DICE Report* 45.
[289] IADI Core Principles 19 footnote 9. The US FDIC is an example of a deposit insurer with such an extended mandate.
[290] Paybox systems are usualy limited to paying the claims of depositors after a bank has been closed, with no prudential regulatory, supervisory responsibilities or intervention powers. See FSF *Guidance for Developing effective deposit insurance systems* (2001) 17. See also Adema, Hainz & Rhode (2019) *ifo DICE Report* 45.

assets; creating a bridge bank; providing open bank assistance[291]; performing bail-in or even terminating failed banks' licenses.[292] Furthermore, an EDIS could also have the direct mandate to limit loss or minimize risk to the deposit insurer, which would then constitute a "risk-minimizer" or "loss-minimizer" mandate.[293]

According to Nolte and Rawlins,[294] each country should select its own mandate for its deposit insurer based on its own circumstances and in consultation with other safety net participants. They indicate that in most countries, the initial policy dialogue on the mandate starts with policymakers aspiring to have larger mandates with more powers.[295] However, they caution that it is imperative that the EDIS does not duplicate mandates already allocated to other financial safety net participants.[296] Therefore, Nolte and Rawlins also caution that countries should consider starting with a simpler mandate and then over time, as capacity is built and it is reasonably sensible to do so, they can enhance their mandate and let the deposit insurer take over other functions such as participating in bank resolution.[297]

The Essential Criteria to IADI Core Principle 2 accordingly require that:[298]

(a) the mandate and powers of the deposit insurer must be formally and clearly specified in legislation and they must be consistent with stated policy objectives.

[291] This entails assistance by the central bank to a troubled bank to prevent its failure. See Mingo 'Open-bank assistance transactions and prompt corrective action' (1994) *Journal of Financial Services Research* 313.
[292] This mandate is known as 'paybox-plus' mandate and most countries with bigger banks or the so-called 'Too-Big-To-Fail' banks prefer this kind of mandate because it tends to support alternative resolution strategies with certain constraints and conditions. See Financial Stability Board (FSB) *Thematic Review on Deposit Insurance Systems – Peer Review Report* (2012) 4.
[293] A loss-minimizer DIS seeks to minimize the costs of resolution in the event of a bank failure while a risk-minimizer aims at minimizing the risks for the financial system. See Adema, Hainz & Rhode (2019) Adema, Hainz & Rhode (2019) *ifo DICE Report* 46.
[294] Nolte & Rawlins "Challenges in Building Effective Deposit Insurance Systems in Developing Countries" 2017 *FIRST Lessons Learned, no. 5. World Bank, Washington, DC. © World Bank.* Available at *https://openknowledge.worldbank.org/handle/10986/27321.* Accessed on 20 October 2021.
[295] Nolte & Rawlins (2017) 4.
[296] Basically, the distribution of powers should be done in such a way that it reflects the capacity of the country as well as the size and complexity of the banking sector and this consideration is particularly important in developing countries with fewer technical personnel to manage the safety nets. See Nolte & Rawlins (2017) 4.
[297] Nolte & Rawlins (2017) 4.
[298] Core Principle 2 Essential criteria 1 to 4.

(b) the deposit insurer's mandate needs to clarify its roles and responsibilities and must be aligned with the mandates of the other safety-net participants,

(c) the deposit insurer's powers must support its mandate and enable the insurer to fulfill the roles and responsibilities assigned to it.

(d) the deposit insurer's powers should include, but not be limited to: assessing and collecting premiums, levies or other charges, transferring deposits to another bank, reimbursement of insured depositors; obtaining from banks such timely, accurate and comprehensive information as is required to fulfill the deposit insurer's mandate; receipt and sharing of such information within the financial safety net as well as with applicable safety net participants in other jurisdictions; compelling banks to comply with their legally enforceable obligations to the deposit insurer (such as providing access to information regarding depositors), or requesting that another safety net participant comply with such obligation on behalf of the deposit insurer; setting operating budgets, policies, systems and practices; and entering into contracts relevant to its functions as deposit insurer.

2.6.3 Core Principle 3 - Governance

According to the IADI Core Principle 3, an EDIS should be independent, transparent, accountable and free from undue political and industry influence.[299] For an EDIS to be effective and independent, it needs to operate within a clear and distinguishable legal framework that clearly sets out its mandate, powers, responsibilities and accountabilities.[300] It is widely believed that a separate, operationally independent,[301] and

[299] Principle 3 of the *IADI Core Principles* (2014) 21.

[300] According to Norton, many jurisdictions have their deposit insurers housed in a separate organization from that of the supervisor/regulator. See Norton "Global financial sector reform: the single financial sector regulator model based on the United Kingdom FSAS experience – a critical revaluation" 2005 *The International Lawyer* 52.

[301] Operational independence means that an organisation can use the powers and means assigned to it without undue influence from external parties. This, however, does not mean that an operationally independent organisation controls its objectives and mandate as these are set by a higher authority. The level and degree of operational independence determines the effectiveness of a deposit insurer in fulfilling its mandate with less potential conflicts. See International Association of Deposit Insurers (IADI): Research and Guidance Committee International Association of Deposit Insurers *Governance of Deposit Insurance Systems – Guidance Paper* (2009) 4.

accountable,[302] deposit insurance system working within the financial system safety net may be the best practice model available to provide the most effective incentives for the control of moral hazard affecting the deposit insurer; the greatest protection of the interests of depositors; more balanced and effective decision-making; and the promotion of more extensive monitoring of potential conflicts than entities lacking such independence.[303]

However, the IADI acknowledges that achieving operational independence of an EDIS can be difficult.[304] On the one hand, to be operationally independent means that a deposit insurer must achieve its mandate in a way that best limits the possibility of conflicts arising from undue political, industry, or other external influence.[305] On the other hand, the deposit insurer must seek to fulfil its responsibilities and be accountable to the organization from which it receives its mandate.[306] It is submitted that finding a balance between being operationally independent and being accountable may be quite problematic in countries where the governing body of an EDIS is appointed by the same organization that the deposit insurer is accountable to.[307]

Moreover, an EDIS should have a governance framework which covers the frequency of meetings, internal controls, duties and responsibilities, communication processes, transparency, disclosure arrangements and transparent processes for the appointment and removal of Board members.[308] In appointing the Board of directors, the procedures

[302] According to the IADI, an accountable deposit insurer is one that is responsible for its actions and for fulfilling its objectives. A deposit insurer should, therefore, promote accountability and assist in reinforcing its operational independence by demonstrating that it can meet its mandate as well as acknowledging areas in which it could improve. See IADI *Governance of Deposit Insurance Systems* (2009) 5.
[303] The World Bank-IMF Financial Sector Assessment Program embodies the standards that hold the view that operationally independent and accountable deposit insurers with clearly specified mandates and which are insulated from undue political influence provide greater integrity, credibility and legitimacy than deposit insurers which lack such independence. See Canada Deposit Insurance Corporation (CDIC) *APEC Policy Dialogue on Deposit Insurance: Policy Conclusions Paper* (2004) 3.
[304] IADI *Governance of Deposit Insurance Systems* (2009) 8.
[305] *Ibid.*
[306] *Ibid*.
[307] According to the IADI, in most cases, governing body members are selected by the authority from which the deposit insurer receives its mandate or the authority to which it is accountable. IADI *Governance of Deposit Insurance Systems* (2009) 10.
[308] It is recommended that the governance framework for deposit insurers should reflect the mandate and structure, with transparency and clear oversight accountability, as well as transparency, oversight and accountability. See Norton, Lastra and Arner "Legal Aspects of Depositor Protection Schemes:

for appointment of heads, their terms of office, and criteria for removal of directors should be such that the integrity of the board-level appointees be safeguarded.[309] Furthermore, the integrity of the deposit insurer's day-to-day operations should also be ensured.[310] Also, a public policy objectives review must be included in this governance framework to establish whether or not the objectives have been met.[311]

The IADI recognizes that, just as the mandates, roles and responsibilities of deposit insurers differ from one country to another, so can the governance structures.[312] However, they recommend there should be certain common characteristics that are shared such as: a higher authority from which they receive their mandates and to which they are accountable; a governing body as well as a management team.[313]

The essential criteria to Core Principle 3 thus require that:[314]

(a) The deposit insurer is operationally independent and able to use its powers to execute its mandate without interference from third parties. The deposit insurer's operational independence is not compromised by any interference from government, the central bank, the bank supervisor or banking industry;
(b) The deposit insurer's governing body is held accountable to a higher authority;
(c) The deposit insurer has the "capacity and capability" (which includes sufficient human resources, operating budget; remuneration to obtain qualified personnel) to support its operational independence and the fulfilment of its mandate.
(d) The deposit insurer is governed well and must comply with sound governance practices which includes appropriate accountability, internal controls, and transparency and disclosure regimes. The deposit insurer's institutional structure

Comparative Perspective" 2002 *A Paper presented at the International Seminar on Legal and Regulatory Aspects of Financial Stability* 12. See also IADI Core Principles (2014) 21.
309 APEC *Policy Dialogue on Deposit Insurance* (2004) 9.
310 This is because fundamental decisions are reserved for the board, regardless of their nature. In particular, the governing board is responsible for monitoring the exposure to risk of the deposit insurance fund, setting the premiums to be paid by the individual insured institutions, choosing the appropriate calculation method as well as the procedure for determining these premiums. See Bernet & Walter (2009) *SUERF Studies* 34. See also APEC *Policy Dialogue on Deposit Insurance* (2004) 9.
311 *IADI Core Principles* (2014) 21.
312 IADI *Governance of Deposit Insurance Systems* (2009) 5.
313 *Ibid.*
314 Core Principle 3 Essential criteria 1 to 9.

must be such that it minimizes the potential for real or perceived conflicts of interest;

(e) The manner in which the deposit insurer carries out its operations must be transparent and responsible;

(f) The deposit insurer's governing laws and policies require that the governing body and management are 'fit and proper' persons; that they are subject to staggered fixed terms; that transparent processes exist for their appointment and removal; and that they can only be removed with good cause on grounds specified in law; internal statutes or rules of professional conduct; and that governing body members and employees are subjected to high ethical standards or comprehensive codes of conduct to limit the potential for real or perceived conflicts of interest;

(g) There are regular assessments of the extent to which the deposit insurer meets its mandate and internal and external audits of the deposit insurer is conducted regularly;

(h) The composition of the deposit insurer's governing body limits the potential for real or perceived conflicts of interest and operation independence is maintained by ensuring that representatives of other safety net entities that participate in the governing body do not chair such body or cannot constitute a majority;

(i) Regular meetings are held by the governing body for oversight and management of the deposit insurer's affairs.

2.6.4 Core Principle 4 – Relationships with other safety-net participants

In terms of IADI Core Principle 4, every deposit insurer should have a formal and comprehensive framework in place for the close coordination of activities and information sharing, on an ongoing basis, between the deposit insurer and other financial safety-net participants.[315] The need for coordination and goodwill among the financial safety net participants is attributed to the potential conflicts between them.[316] It is, therefore,

[315] Principle 4 of the *IADI Core Principles* (2014) 23.
[316] APEC *Policy Dialogue on Deposit Insurance* (2004) 9.

important for deposit insurers to promote smooth coordination of activities by clearly putting in place a clear division of powers and responsibilities regarding the intervention of troubled banks.[317]

The essential criteria for Core Principle 4 accordingly provide that:[318]

(a) There is explicit and continuous sharing of information and coordination of actions by means of legislation, regulation, memoranda of understanding, legal agreements or a combination of the aforementioned;
(b) Information confidentiality rules are applicable to all safety net participants and their exchange of information. Information confidentiality is protected by law or through agreements that still enables information sharing within the safety net;
(c) Participants in the safety net exchange information on an ongoing basis, especially when supervisory actions that are material are applied to member banks;
(d) Appropriate arrangements for information sharing and coordination exist in instances where there are multiple deposit insurers operating in the same jurisdiction.

2.6.5 Core Principle 5 – Cross-Border Issues

IADI Core Principle 5 addresses cross-border issues.[319] Guo remarks that the 2008 GFC witnessed the inadequacies of domestic orderly resolution regimes for financial institutions as well as a lack of effective international cooperation mechanism for cross-border issues.[320] In particular, the Crisis revealed that when financial stability is threatened, the interests of shareholders from the home and host countries of cross-border banks often come into conflict.[321] In the aftermath of the Crisis, world leaders thus

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317 A common safety-net information and coordination mechanisms used by most countries include membership of safety net players on the deposit insurance's board of directors, the deposit insurance licensing process, specially designed committees as well as memoranda of understanding and legal agreements. See APEC *Policy Dialogue on Deposit Insurance* (2004) 10.
318 Core Principle 4 Essential criteria 1 to 4.
319 Principle 5 of the IADI Core Principles (2014) 24.
320 Guo "Cross-border Resolution of Financial Institutions: Perspectives from International Insolvency Law" 2018 *Submission for the III Price International Insolvency Studies* 1.
321 Azevedo & Bonfim "Deposit insurance and cross-border banks" 2019 *ifo DICE Report* 15.

called for the reform of resolution tools and frameworks for the effective resolution of financial groups to assist in limiting the disruptions caused by failures of financial institution as well as to mitigate moral hazard.[322]

Given the heterogeneity in the design of deposit insurance systems, there are key implications for cross-border banks.[323] As such, the IADI Core Principles recommend that where a deposit insurer is responsible for deposits coverage in a foreign jurisdiction, or where there is more than one deposit insurer responsible for the reimbursement process, bilateral or multilateral agreements should exist to determine which deposit insurer is responsible for the reimbursement process, setting levies and premiums, and public awareness.[324]

According to the IADI, cross-border differences in deposit insurance rules and regulations as well as depositor protection can immensely affect markets, financial stability or consumer protections in a number of ways, namely:[325] lack of convergence and harmonization in deposit insurance rules and regulations can create externalities including potential conflicts of interest and competitive/regulatory arbitrage; unilateral adoption of emergency deposit insurance measures and full guarantees during a crisis can exacerbate such externalities and add to financial instability; and home and host issues stemming from cross-border banking present concerns for depositor protection and these concerns can be particularly troubling in a systemic crisis.[326]

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[322] The IADI believe it is important that potential risks such as moral hazard issues associated with cross border banking are studied and evaluated by international financial institutions as well as appropriate regional authorities on a regular basis. See International Association of Deposit Insurers (IADI) *Discussion Paper on Cross Border Deposit Insurance Issues Raised by the Global Financial Crisis – Full Report* (2011) 10. See also Guo (2018) *Submission for the III Price International Insolvency Studies* 1.
[323] Azevedo & Bonfim (2019) *ifo DICE Report* 14.
[324] IADI *Core Principles* (2014) 24.
[325] IADI *Discussion Paper on Cross-Border Deposit Insurance Issues* (2011) 15.
[326] Jurisdictions with deposit insurance systems that extend beyond national borders due to cross-border banking are, therefore, urged to develop pre-crisis coordinated crisis management arrangements that specifically address situations where deposit insurance coverage is provided by a deposit insurer in different jurisdictions. More specifically, appropriate bilateral or multilateral arrangements should be put in place in circumstances where cross-border banking operations provide for depositor coverage or where home or host issues are present. According to the IADI, these arrangements should, among other things: include all appropriate home authorities; provide for ongoing close coordination and information sharing where necessary; clearly clarify which deposit insurer will be responsible for reimbursement; should promote public awareness of issues raised by cross-border banking; and should also be subject to peer review

The essential criteria to Core Principle 5 thus requires that:[327]

(a) If there is a material presence of foreign banks subsidiaries or branches in a country then formal information sharing and coordination agreements, subject to provisions on confidentiality, must be in place among relevant deposit insurers and safety net participants;

(b) In instances where a deposit insurer has responsibility to cover deposits in a foreign jurisdiction, or where multiple deposit insurers are responsible for such coverage, there must be bilateral or multilateral agreements to determine their respective responsibilities for reimbursement, setting of levies and premiums and creating relevant public awareness.

2.6.6 Core Principle 6 – Deposit Insurer's role in contingency planning and crisis management

According to Core Principle 6, a deposit insurer needs to have effective contingency planning[328] and crisis management policies[329] and procedures[330] in order to respond efficiently to risks and potential bank failures. The most crucial prerequisite for a contingency planning framework is that deposit insurers should have in place the necessary tools to perform their normal operations according to its mandate.[331] These

regarding the capacity of systems and funds to respond to a cross-border failure. See IADI *Discussion Paper on Cross Border Deposit Insurance Issues* (2011) 8.

[327] Core Principle 5 Essential criteria 1 and 2.

[328] Contingency planning has been described as a process through which an institution outlines policies, procedures and actions that it plans to follow in the event of an unexpected developments and significant shocks. See International Association of Deposit Insurers (IADI) *Deposit Insurers' Role in Contingency Planning and System-wide Crisis Preparedness and Management – Guidance Paper* (2019) 6.

[329] These are a set of policies and procedures that financial safety-net authorities employ to respond promptly, decisively and effectively when a financial crisis having system-wide implications materialises. This assists in building on advance preparation and requires comprehensive tools and powers, sufficient funds, and communication policies for both domestic and foreign entities. See IADI *Deposit Insurers' Role in Contingency Planning and System-wide Crisis Preparedness and Management – Guidance Paper* (2019) 4.

[330] IADI Core Principles (2014) 25.

[331] IADI *Deposit Insurers' Role in Contingency Planning and System-wide Crisis Preparedness and Management – Guidance Paper* (2019) 6.

contingency planning and crisis management plans need to be developed and tested on a regular basis.[332]

The essential criteria to Core Principle 6 therefore state that:[333]

(a) the deposit insured is required to have its own effective contingency planning and crisis management policies and procedures to ensure its ability to effectively respond to the risk of bank failures as well as actual bank failures and 'other events';
(b) The deposit insurer attends to the development an regular testing of its own contingency and crisis management plans;
(c) The deposit insurer has membership in any institutional framework pertaining to ongoing communication and coordination between safety net participants regarding system-wide crisis preparedness and management;
(d) There is participation by the deposit insurer in regular contingency planning and simulation exercises concerning system-wide crisis preparedness and crisis-management by all safety net participants;
(e) The deposit insurer takes part in developing pre and post-crisis management communication plans by all safety net participants, to ensure comprehensive and consistent public awareness and communication.

2.6.7 Principle 7 - Membership

In terms of IADI Core Principle 7,[334] membership in a deposit insurance scheme should be compulsory. As indicated, a compulsory membership affords all members the benefit of having a more stable financial system with reduced fears of depositor runs.[335] According to Okeahalam, if membership is not compulsory, loopholes may be created and the possibility of some banks free riding on others and thus undermining the entire

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332 *Ibid.*
333 Core Principle 6 Essential criteria 1 to 5.
334 Principle 7 of the IADI Core Principles (2014) 26.
335 See Chapter one, para 1.2.3. See also Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 12.

system may also be increased.[336] In addition, non-compulsory membership can lead to a reluctance by some well-capitalized members to participate.[337] IADI Core Principle 7, therefore, recommends that all conditions, processes and timeframes for attaining membership should be clearly stated and transparent.[338]

Core Principle 7 thus sets the following essential criteria:[339]

(a) It is compulsory for all banks, as well as state owned banks, to be members of a deposit insurance system and such banks must be subject to sound prudential regulation and supervision;
(b) in the instance where there is a newly established deposit insurance system and a bank that enters such system does not comply with all the supervisory or membership requirements but is nevertheless permitted to enter such system, it must have a credible plan to address any deficiencies within a specified time frame;
(c) The conditions, process and timeframe for becoming a member are stated explicitly and are transparent;
(d) If the deposit insurer is not responsible for granting membership in a deposit insurance system, a clear and reasonable time frame must be prescribed by the law or administrative procedures within which the deposit insurer is consulted or informed in advance, and provided with sufficient information regarding an application for a new license;
(e) in the event that a ban's membership is cancelled because its license is revoked or surrendered, immediate notice must be given to depositors to inform them that existing deposits "will continue to be insured up to a specified deadline';

[336] Okeahalam (2003) 653.
[337] This is per the findings of Wheelock & Khumbakar in "Which banks choose deposit insurance? Evidence of adverse selection and moral hazard in a voluntary insurance system" 1995 *Journal of Money*, *Credit and Banking*. According to Hoelscher, Taylor and Kluer, membership criteria should try to avoid adverse selection and limit risk taking. In order words, compulsory membership prevents the possibility that only the weakest institutions may join the deposit insurance system, thus ruining the financial viability of the system. See Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 12.
[338] Principle 7 of the IADI Core Principles (2014) 26.
[339] Core Principle 7 Essential criteria 1 to 7.

(f) when the deposit insurer terminates a bank's membership, there are arrangements in place for coordinating the immediate withdrawal of the bank's license to take deposits by the responsible authority and, upon termination, depositors are immediately informed that 'existing deposits will continue to be covered up to a specified deadline'.

2.6.8 Core Principle 8 – Coverage

IADI Core Principle 8 deals with coverage by an EDIS.[340] Traditionally, the scope and level of deposit insurance coverage were set to balance the deposit insurer's public policy objectives with incentives for depositors to exercise market discipline to limit the risks to banks.[341] However, the 2008 GFC revealed that there were substantial challenges to this approach.[342] First, where depositors feel they are not adequately protected, they can indiscriminately run from both sound and weak banks.[343] Second, most depositors are unable to exercise market discipline.[344]

In light of this, a more nuanced approach to deposit insurance coverage has emerged where the key function of coverage is to promote confidence, contribute to the stability of the financial system as well as prevent disruptive depositor runs.[345] It is recommended,

[340] Principle 8 of the IADI Core Principles (2014) 27.
[341] International Association of Deposit Insurers (IADI) *Enhanced Guidance for deposit insurance systems: Deposit Insurance Coverage – Guidance Paper* (2013) 3.
[342] IADI *Deposit Insurance Coverage – Guidance Paper* (2013) 3.
[343] This suggests that if the level and scope of coverage is too low, it can create incentives for pre-emptive depositor runs that can ultimately undermine the stability of the financial system. See IADI *Deposit Insurance Coverage – Guidance Paper* (2013) 3.
[344] This is problematic because moral hazard is best mitigated by the behaviour of depositors and by the incentives affecting bank management and directors, shareholders and unsecured creditors. IADI *Deposit Insurance Coverage – Guidance Paper* (2013) 3.
[345] Generally, a deposit insurance system whose objective is to protect small-scale depositors provides a relatively low level of coverage, created with the primary purpose of compensating unsophisticated depositors with transaction balances and modest savings. Conversely, a deposit insurance system whose objective is to preserve the financial system may cover a larger portion of deposits. See Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 14. See also IADI *Deposit Insurance Coverage – Guidance Paper* (2013) 3.

therefore, that a deposit insurance system should fully cover the majority of depositors and ensure that a significant portion of the value of deposits are not fully covered.[346]

According to Hoelscher, Taylor and Kluer, there are a number of structural features which countries need to consider before setting the level and scope of coverage for the deposit insurance system namely:[347] that coverage is consistent with the objectives of the deposit insurance system and the funds available; that the level and scope of cover takes into account the incentives for wealthy and sophisticated investors to participate in monitoring activities and exert market discipline; and that the possibility of excessive coverage[348] is prevented.

In addition to this, another important issue to consider in designing a coverage scheme is the treatment of foreign deposits which includes deposits paid in foreign currencies, deposits held in domestic branches of foreign banks as well as deposits in foreign branches of domestic banks.[349] In determining the level and scope of deposit insurance, policymakers thus need to find the right balance between establishing a coverage that is too low and a coverage that is too high.[350] In other words, coverage must be enough to prevent destabilizing banks runs, but not too extensive so as to eliminate market discipline on the bank's risk-taking.[351]

Most importantly, the coverage limit should apply equally to all member banks of the deposit insurance system to avoid competitive distortions that could ultimately limit the efficiency of the deposit insurance system in contributing to the stability of the financial

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[346] IADI *Deposit Insurance Coverage – Guidance Paper* (2013) 3.
[347] Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 14.
[348] Excessive coverage can be prevented by establishing limit on "double coverage" arising from holding several accounts in the same bank which are all below the coverage limit. See Hoelscher, Taylor & Kluer (2006) *International Monetary Fund Occasional Paper* 14.
[349] Ketcha "Deposit insurance system design and considerations" 1999 *BIS Policy Paper No 7* 230.
[350] Ketcha (1999) *BIS Policy Paper No 7* 229.
[351] The sufficiency of coverage is relatively a function of the proportion of covered deposits and depositors rather than of the absolute coverage level. In other words, a level of coverage that is considered low can sometimes be conducive to financial instability. See Financial Stability Board (FSB) *Thematic Review on Deposit Insurance Systems – Peer Review* (2012) 20. See also Ketcha (1999) *BIS Policy Paper No 7* 229.

system.[352] Policymakers should explicitly define the level and scope of deposit coverage.[353]

Mikajkova observes that, as a result of the GFC, most countries resorted to increasing their deposit insurance coverage. However, this increase in deposit insurance coverage presented three basic problems namely:[354] high deposit insurance coverage can initiate moral hazard; increase of the deposit insurance coverage can increase the premium assessment base; and increase of the deposit insurance coverage can increase the potential financial commitment of the deposit insurance institution. Thus, a cautionary approach to coverage that is aligned with Core Principle 8 is advisable.

The essential criteria to Core Principle 8 accordingly provides that: [355]

(a) Deposits that are insured by the EDIS must be clearly and publicly defined, including in respect of the level and scope of coverage, in law or regulation and reflect the public policy objectives of the EDIS. If applicable, it must be clearly specified and easily determined which types of deposits and depositors are not eligible for deposit protection and the speed at which insured depositors are reimbursed must not be affected thereby;
(b) To minimize bank runs and so as not to compromise market discipline, the level and scope of coverage must be limited and credible. Such level and scope must be set so that the large majority of depositors across banks are protected and a substantial portion of the value of deposits is not protected. Where a substantial portion of the value of deposits is indeed protected, strong regulation and supervision together with other design features, are applied to mitigate moral hazard;
(c) The level and scope of coverage is applied equally to all the banks that are members of the EDIS;
(d) The deposit insurer does not incorporate co-insurance;

352 Financial Stability Board (FSB) *Thematic Review on Deposit Insurance Systems – Peer Review* (2012) 20.
353 Principle 8 of the IADI Core Principles (2014) 23.
354 Micajkova (2013) *South-Eastern Europe Journal of Economic* 168.
355 Core Principle 8 Essential criteria 1 to 10.

(e) There is a periodical review, at least every five years of the level and scope of coverage provided by the EDIS to ensure that its public policy objectives are met;

(f) In the case of, or before, a merger or amalgamation of separate banks that have membership in the same EDIS, the depositors of the merged or amalgamated banks enjoy separate coverage (up to the maximum coverage limit) for each bank for a limited, publicly disclosed period indicated in law or regulation. The merging banks are responsible for notification to the affected depositors and this includes notifying them of the date on which the separate coverage will expire;

(g) Coverage is not affected by a depositor's residency status or nationality;

(h) In the event that multiple deposit insurers operate within the same national jurisdiction, any differences in coverage across banks that have operations in such jurisdiction not negatively affect overall deposit insurance system effectiveness and efficiency;

(i) Where foreign currency deposits are widely used in a jurisdiction they are insured;

(j) Where a blanket guarantee applies, there must be a credible plan to transition to a limited coverage EDIS, including: a pre-transition assessment of the economic environment as it affects the financial system; the pace of transition to limited coverage must be 'consistent with the state of the financial industry, prudential regulation and supervision, the legal and judicial framework, and accounting and disclosure regimes; there must be effective communication strategies applied by policymakers to limit negative public reaction to the transition; and if there is a high level of capital mobility and /or regional integration policy, the effect of different jurisdictions protection levels and related policies must be considered when deciding to decrease coverage limits and/or scope of coverage.

2.6.9 Core Principle 9 - Funding

According to IADI Core Principle 9, the deposit insurer should have readily available funds and all the funding mechanisms to ensure prompt reimbursement of depositors' claims, including assured liquidity funding arrangements.[356] For this to happen, banks are usually assessed an annual premium that is based entirely or in large part on the amount of their insured deposits.[357] This is because the costs of establishing and managing a deposit insurance system should be primarily borne by its member banks.[358]

Globally, deposit insurers have various ways of financing their deposit insurance systems.[359] This variety of options ranges from an *ex-ante*[360] to an *ex-post* basis[361] or a combination of both.[362] In an *ex-ante* system, the deposit insurance fund is built up in advance so that financial resources are readily available when a bank fails.[363] In principle, *ex-ante* funding requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure actually occurring.[364] This means that an *ex-ante* funding system spreads the cost of insurance losses over time since

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356 Principle 9 of the IADI Core Principles (2014) 28.

357 The typical practice in most countries is to cover current expenses and build up a permanent fund out of which losses can be paid. See Demirguc-Kunt & Kane "Deposit insurance around the Globe: Where does it work?" 2002 *Journal of Economic Perspectives* 180.

358 Nolte & Rawlins (2017) 5.

359 Adema, Hainz and Rhode (2019) *ifo DICE Report* 48.

360 An ex-ante funding refers to the regular collection of premiums, with the aim of accumulating a fund to meet future obligations and cover operational and related costs of the deposit insurer. See International Association of Deposit Insurers (IADI) *Deposit Insurance Fund Target Ratio* Technical Committee, Core Principles and Research Council Committee (2018) 2.

361 The IADI define an ex post funding as a system in which funds to cover deposit insurance obligations are only collected from surviving banks after a bank failure. See IADI *Deposit Insurance Fund Target Ratio* (2018) 2.

362 This is often referred to as a hybrid funding mechanism and features both ex ante and ex post funding. It incorporates an ex-ante fund financed by premiums and contributions and includes both a mechanism to obtain funds ex post from member institutions, through special premiums, levies or loans, should they be needed. See IADI *Funding of Deposit Insurance System* (2009) 8. See also Financial Stability Forum (FSF) Working Group on Deposit Insurance *International Guidance on Deposit Insurance – A Consultative Process* (2000) 8.

363 The most important feature of an ex-ante system is that banks contribute to the deposit insurance system by paying premiums before their demise. Ex-ante schemes seeks to underpin the credibility of the deposit insurance system by providing reassurance to depositors on the ability of the deposit insurance system to make a fast pay-out, while also reducing the pro-cynical impact of levying 'surviving' banks only after a disbursement, and contributes towards a perceived fairness by securing contributions from the bank before it fails. See International Monetary Fund (2015) *Financial Sector Assessment Program: Financial Safety Net, Bank Resolution, and Crisis Management Framework – Technical note* (2015). See also FSF Working Group on Deposit Insurance (2000) 8.

364 International Association of Deposit Insurers (IADI): Research and Guidance Committee *Funding of Deposit Insurance System – Guidance Paper* (2009) 4

insurance premiums are collected taking into regard expected losses over the long run.[365] Most importantly, as pointed out by the IADI, the *ex-ante* funding mechanism contains an anti-cyclical feature and buffer for the banking industry because the fund continues to accumulate premiums during stronger economic conditions, when losses may be low, thereby hedging against future needs when economic circumstances may be less favorable and losses higher.[366] The most notable characteristic of an ex-ante funding mechanism is that it improves public confidence in the banking sector as the fund is built up ahead of a bank failure.[367]

However, deposit insurance systems that are funded on an ex-post basis rely on the ability of surviving banks to fund losses after they have been incurred.[368] Basically, ex post systems often do not have explicit responsibilities with regards to the sharing of costs for reimbursing depositors.[369] However, the IADI acknowledges that an ex post system is, on the plus side, less burdensome during periods when there are no or few failures because premiums are not being collected continuously.[370]

[365] The IADI cautions, however, that when consideration is made from the perspective of a member institution, compared to an ex post system, an ex-ante system may at first glance appear more costly since it entails an explicit up-front business expense as opposed to an uncertain one and the ex-ante payments required from member institutions may reduce the resources they have available to absorb losses on their own. See IADI *Funding of Deposit Insurance System* (2009) 6.

[366] IADI *Funding of Deposit Insurance System* (2009) 4.

[367] Depositor confidence depends, for the most part, on the knowledge that the deposit insurance fund has sufficient funds to ensure the prompt reimbursement of depositors' claims after the bank failure. See O'Keefe & Ufier "Determining the target deposit insurance fund: Practical Approaches for data-poor deposit insurers" 2017 *World Bank Group* 8.

[368] FSF Working Group on Deposit Insurance (2000) 8.

[369] IADI *Funding of Deposit Insurance System* (2009) 7.

[370] Although this may be an advantage at a time when there are no bank failures, when failures do occur, the government may come under pressure from a variety of quarters, including from surviving banks, to provide financial assistance. According the IADI, this pressure could be more intense at a time of economic weakness when government finances are lacking, the surviving banks could also argue that they did not contribute to the failure and that making large pay-outs under the circumstances could unduly jeopardize their position as well as the financial system as a whole. Apart from that, prompt reimbursement of depositors may be difficult under an ex post system because the systems, procedures and qualified personnel may not be in place to collect and distribute the required funds, and authorities may lack commitment and credibility to collect funds from surviving banks following a failure. See IADI *Funding of Deposit Insurance System* (2009) 8.

Nevertheless, the IADI Core Principles recommend the use of an ex-ante funding mechanism.[371] The main advantages of an ex-ante funding mechanism are, inter alia: the ability to provide prompt payout of deposits after the bank has failed; the ability to reassure depositors that the deposit insurer will be able to meet its payout commitments; and the contribution towards perceived fairness by imposing a cost burden on the failed bank.[372] Unfortunately, the greatest disadvantage of ex-ante funding is that it comes at the cost of lost capital to banks that may otherwise have put it to better use outside the insurance fund.[373]

In particular, an essential design feature for ex-ante funding is the relative rate at which banks pay premiums.[374] According to Ketcha, a simple and easy-to-implement method to assess deposit insurance premiums is to assess all insured banks at a given rate per unit of deposits or per unit of another assessment base[375] that reflects the total coverage provided.[376] Deposit insurance premiums can, therefore, be paid on a 'flat rate'-basis[377] or a 'risk-based'-basis.[378] When considering implementing a differential risk-adjusted

[371] The events of the 2008 GFC revealed the significance of having an unambiguous and immediate access to reliable funding sources. See FSF *Thematic Review on Deposit Insurance Systems* (2012) 32. See also *IADI Core Principles* (2014) 29.
[372] FSB *Thematic Review on Deposit Insurance Systems* (2012) 32.
[373] O'Keefe & Ufier (2017) *World Bank Group* 9.
[374] Adema, Hainz & Rhode (2019) *ifo DICE Report* 48.
[375] The assessment base refers to the basis on which the deposit insurer charges premiums to a member bank or calculates the levy needed to compensate the insured depositors. See IADI *Deposit Insurance Fund Target Ratio* (2018) 2.
[376] Ketcha believes such pricing system can maintain adequate financial capacity for the insurer while leaving the task of controlling moral hazard to the supervisory process as well as the market. See Ketcha (1999) *BIS Policy Paper No 7* 232.
[377] In a flat rate premium system, all member banks are charged the same premium while in a risk-based method, the premium that member banks are charged varies based on each bank's risk profile. See Lukhele *A critical assessment of the Funding structure of South Africa's proposed bank deposit insurance scheme* (MBA dissertation, University of Cape Town, 2017) 43. See also SARB *Designing a deposit insurance scheme in South Africa* (2017) 25.
[378] Under risk-based method, contributions to the deposit insurance system are based on the amount of insured deposits and the risk level assumed by each bank. See Lakstutiene *et al* "The importance of systemic risk assessment in a risk-based common European Union Deposit Insurance System: case of Lithuania" 2018 *Economic Research – Ekonomska Istrazivanja* 75. According to Cummins, risk-based premiums reduce the potential for distortions in deposit insurance system asset and liability portfolios as well as provide a potentially more effective and less expensive means of monitoring solvency and providing information to deposit insurers. See JD Cummins "Risk-based Premiums for Insurance Guaranty Funds" 1988 *The Journal of Finance* 826.

premium system, measures should be taken to ensure that the necessary sources of information are available to fully support the operations of the system.[379]

The essential criteria to Core Principle 9, therefore, requires that:[380]

(a) Funding for the EDIS must be provided on an ex-ante basis with clear funding arrangements set out in the law or regulation;

(b) The banks that are members of an EDIS are responsible for its funding;

(c) It is permissible for a donor, for example the government, to provide initial 'start-up' or 'seed funding' to establish a deposit insurer but any 'start-up' funding provided by the Government must be fully repaid before the deposit insurer decreases any or all bank premiums;

(d) Law or regulation must make explicit provisionsn for emergency funding arrangements for the EDIS such as government funding or central bank funding or market borrowing. However, market borrowing may not be the only source of funding. The emergency liquidity funding arrangement must be set up in advance to facilitate effective and timely access when needed;

(e) After an ex ante EDIS is established the target fund size must be determine by means of clear, consistent and transparent criteria that are periodically reviewed; and a reasonable time frame must be set for achievement of the target fund size;

(f) The deposit insurer is responsible for sound investment and management of its funds. It must have a defined investment policy in this regard that seeks to ensure that fund capital is preserved and liquidity is maintained; and there is adequate risk management policies and procedures and reporting systems in place;

(g) It is permissible for the deposit insurer to hold funds in the central bank and the deposit insurer is obliged to establish and comply with rules to limit significant investments in banks;

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379 IADI *Funding of Deposit Insurance System* (2009) 4.
380 Core Principle 9 Essential criteria 1 to 10.

(h) Where the deposit insurer is not the resolution authority, it has the choice, within its legal framework to provide authorization for the use of its funds to be applied for resolution of member banks by measures other than liquidation. However, it must meet the following conditions: the deposit insurer must be informed that a bank will be put into resolution and it must be involved in the decision-making process regarding resolution; the use of its funds must be transparent and documented and clearly and formally specified; where a bank is resolved by other resolution measures than liquidation, the result of such resolution must be a viable, solvent and restructured bank that limits the deposit insurer's exposure to contribute additional funding towards such resolution; contributions must be limited to the costs which the deposit insurer would otherwise have incurred "in a payout of insured depositors in a liquidation net of expected recoveries' (the 'least cost–test); contributions may not be used to recapitalize resolved institutions unless the interests of shareholders are reduced to zero and uninsured (i.e. via bail-in) and unsecured creditors are subjected to *pari passu* losses in accordance with the priority of legal claims; The use of the funds of the deposit insurer must be subjected to an independent audit and the results of the audit must be reported to the deposit insurer; and there must be an ex post review of all actions and decisions to use the deposit insurer funds.

(i) If the deposit insurer is taxed by the government, for example on the premiums it receives or recoveries it has made from banks that failed or on interest that accrues on funds that were invested such tax rate must not be punitive and it must also not be disproportionate to other corporate taxation and must further not unduly hinder the accumulation of the deposit insurance fund. Any remittances by the deposit insurer to the government must be limited to repayment of 'start-up' funding and liquidity provided by the government;

(j) In the event that the deposit insurer uses differential premium systems the system whereby premiums are calculated must be transparent to all member banks; the scoring /premium categories must be differentiated significantly and the ratings and rankings of individual banks that result from the system must be kept confidential.

2.6.10 Core Principle 10 – Public Awareness

To protect depositors and contribute to financial stability, IADI Core Principle 10 recommends that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.[381] In general, deposit insurance authorities must, at the time of introduction of a deposit insurance system, educate the public about the role of the deposit insurance system in the safety net and what it brings to the depositors and non-depositors, as well as regularly informing the public about the benefits and limitations of deposit insurance.[382]

As pointed out in the FSB *Thematic Review of Deposit Insurance* that was conducted in 2012, the need for public awareness is particularly acute in cases where depositors are simultaneously protected by multiple deposit insurance systems and where the same banking group operates under different franchises whose deposits fall within a single maximum aggregate protection limit.[383]

The essential criteria for Core Principle 10 accordingly state that:[384]

(a) The deposit insurer has the responsibility for promoting public awareness of the EDIS and must use various communication tools on a continuous basis as part of a comprehensive communication program;

(b) if a bank fails, the deposit insurer must notify depositors in an appropriate manner as indicated in the law, by means of media such as press releases or websites of the following: where how, and when insured deposits will be given access to their deposits; which information they must provide to get payment; whether advance or interim payments will be made and whether any depositors will lose funds as well as of procedures in terms whereof uninsured depositors can claim the uninsured portion of their deposits from the liquidator of the failed bank;

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[381] Principle 10 of the *IADI Core Principles* (2014) 31.
[382] Many jurisdictions with established deposit insurance systems have widely publicized the terms and conditions of deposit insurance coverage to ensure that depositors are aware of coverage limitations regarding amounts and account types to avoid assumptions that all deposits are protected as well as to minimize the possibility of bank 'run' in the event of a bank failure. See Safakli & Guryay "A Research on Designing an Effective Deposit Insurance Scheme for TRNC with Particular Emphasis on Public Awareness" 2007 *International Research Journal of Finance and Economics* 204.
[383] FSB *Thematic Review on Deposit Insurance Systems* (2012) 6.
[384] Core Principle 10 Essential criteria 1 to 8.

(c) The public awareness program or activities must include information about the scope of coverage (i.e. which types of financial instruments and depositors are covered by the EDIS and which are not covered); a list of member banks and how they can be identified; the coverage level limits of the deposit insurance; and the mandate of the deposit insurer;

(d) The target awareness program's objectives (for example target awareness levels) must be clearly defined and consistent with the public policy objectives and the mandate of the EDIS; (e) The deposit insurer must set a long-term strategy to meet its public awareness objectives and must make budget allocations to establish and maintain a target level of public awareness of deposit insurance;

(f) The deposit insurer must work closely with banks and other participants in the safety net to ensure that the information that is provided to depositors is consistent and accurate and to maximize awareness on a continuous basis. Banks must be required by law or regulation to provide information regarding deposit insurance in a format or language that the deposit insurer prescribes;

(g) The deposit insured is required to monitor its public awareness activities on a continuous basis and to arrange independent evaluations of its public awareness program or activities on a periodic basis;

(h) Depositors in jurisdictions that are affected by cross-border banking arrangements conducted through foreign bank branches or subsidiaries must be provided with clear information regarding the existence and identification of the deposit insurer legally responsible for reimbursement as well as regarding the limits and scope of coverage.

2.6.11 Core Principle 11 – Legal Protection

Core Principle 11 states that an effective EDIS should provide for the legal protection[385] of its staff and seek to shield them from incurring liability for the actions they took in good

[385] The IADI defines legal protection as a set of lawful mechanisms by means of which persons participating in bank resolution processes, including the deposit insurer, current and former employees, directors, officers and lawfully delegated agents, are covered from the effects of claims and procedures initiated against them for alleged acts and omissions executed in good faith, that occur within the scope of such

faith in the performance of their duties.[386] To function efficiently, all the protected parties must adhere to the relevant codes of conduct and disclosure regimes to avoid conflicts of interests and to ensure their accountability.[387] In this regard, the IADI recommends that the governing body, officers and employees of an EDIS should be judged on the decisions they make and the integrity of those decisions, and thus, they must be able to make decisions in good faith without unnecessary fear of legal reprisal.[388]

According to the *Asia-Pacific Economic Cooperation (APEC) Policy Conclusions Paper*:[389]

> "Individuals working for deposit insurers and other safety net participants should be protected against civil liability for their decisions, actions or omissions taken 'in good faith' while discharging their mandates. Legal protection should be codified in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified."

Given the scope of action of deposit insurers, the decisions taken during the course of a bank resolution process have the potential to affect a country's macroeconomic environment, as well as the legal and economic spheres of various persons including depositors, creditors and shareholders.[390] In addition to this, the nature and significance of the powers conferred upon decision makers and on the members of the governing bodies, officers and employees as well as specialized third parties who partake in

persons' mandates. Legal protection can include the provision of statutory immunity, legal counsel and defense, and indemnification policies. See International Association of Deposit Insurers (IADI): Research and Guidance Committee *Guidance for the Establishment of a Legal Protection Scheme for Deposit Insurance Systems – Guidance Paper* (2010) 2.

[386] Principle 11 of the IADI *Core Principles* (2014) 34.

[387] According to the IADI, persons involved in resolutions should be required to follow appropriate oaths of office, conflict of interest rules, and codes of conduct to ensure they remain accountable. See IADI *Guidance for the Establishment of a Legal Protection Scheme* (2010) 4.

[388] The IADI emphasises, however, that legal protection should only extend to actions or decisions made in good faith while discharging the mandate of the deposit insurance system. This means that individuals who stand to benefit from legal protection should be subject to conflict of interest codes and codes of conduct as well as ethical behavior. Protection should not be extended to actions taken in bad faith or actions which are not related to the deposit insurer's mandate or fraudulent and criminal actions. See IADI *Governance on Deposit Insurance Systems* (2009) 15-16.

[389] APEC *Policy Dialogue on Deposit Insurance* (2004) 2.

[390] See IADI *Guidance for the Establishment of a Legal Protection Scheme* (2010) 5.

resolution processes exposes these persons to possible claims related to the decisions, actions and omissions that occurred while performing their roles.[391]

In this regard, the IADI believes that, without such protection, governing body members, officers and employees are likely to be hesitant in making decisions about interventions into failed or troubled banks.[392] The APEC *Policy Conclusions Paper,* therefore, proposed four elements for a legal protection regime namely:[393] granting statutory immunity to individuals in the EDIS; holding the EDIS, rather than individuals, liable for actions or omissions; including indemnification provisions in employees' contractual arrangements; or combining these mechanisms.[394]

The essential criteria to Core Principle 11 accordingly require that:[395]

(a) Legal information must be specified in legislation and given to the deposit insurer as well as directors, officer and employees currently or formerly in its employ and also to any individual that the deposit insurer currently or previously retained or engaged, for decisions made and actions or omissions taken in good faith in the normal course of their duties.

[391] As a result of this, the IADI believes it is imperative to have a system of legal protection that provides certainty to the decision making process and to the exercise of conferred powers in order to execute banking resolution processes without affecting the government officials or the personnel involved in such processes, as long as their acts take place within the applicable legal framework. See IADI *Guidance for the Establishment of a Legal Protection Scheme* (2010) 5.

[392] According to the IADI, lack of legal protection potentially maximizes the likelihood of undue external influence on the deposit insurer's decision-making process, and thereby limits operational independence. See IADI *Governance of Deposit Insurance Systems* (2009) 15

[393] APEC *Policy Dialogue on Deposit Insurance* (2004) 2.

[394] The most important aspect of this protection is personal protection from civil and criminal liability of senior staff members and other officials or agents of the banking authorities who are involved in the declaration of a bank's insolvency and in the administration of its restructuring, liquidation or both, other than for intentional wrongdoing. This protection can be extended by, inter alia: granting express statutory immunity from liability for actions and omissions that the persons concerned have taken in discharge of their legal responsibilities; by making their agency vicariously liable for their faults; by including appropriate indemnification provisions in their contracts of employment; or by a combination of the three mechanisms, depending on the specific legal position of the officials concerned. See International Monetary Fund & World Bank *Financial Sector Assessment: A Handbook* (2005) 152.

[395] Core Principle 11 essential criteria 1 to 4.

(b) Legal protection precludes awards for damage or other awards against the aforementioned individuals and covers costs, including the cost of funding of defenses as incurred (and not only reimbursement after a successful defense).

(c) The operating policies and procedures of the deposit insurer require individuals with legal protection to disclose real or perceived conflicts of interest as well as adherence to relevant codes of conduct, to ensure their continued accountability.

(d) Legal protections do however not prevent depositors and other individual claimants or banks from legitimately challenging the deposit insurer’s acts or omissions in public or administrative (civil) review

2.6.12 Core Principle 12 – Dealing with Parties at fault in a bank failure

In terms of Core Principle 12, the deposit insurer or any other relevant authority should have the power to investigate all the officers, directors, auditors, managers and all the relevant parties involved in the running of a failing bank.[396] Where fault is found, the relevant authority must take the appropriate action against all parties liable for the bank failure and relevant sanctions must be imposed.[397]

The essential criteria to Core Principle 12 state that:[398]

(a) The conduct of persons (for example directors and bank managers or shareholders) that are responsible for, or contributed to, a bank’s failure as well as the conduct of related parties and professional service providers (for example auditors) must be investigated. Such investigation may be undertaken by the deposit insurer or regulatory authority, criminal or investigative authorities, or any other professional or disciplinary body.

(b) Suitable steps must be taken by the relevant authority for purposes of pursuing persons identified as having been to blame for the failure of the bank and such parties must be sanctioned and /or subjected to redress. Such sanction or redress may include

[396] Principle 12 of the IADI Core Principles (2014) 35.
[397] *Ibid*.
[398] Core Principle 12 Essential Criteria 1 to 3.

personal or professional disciplinary measures (which include fines or penalties), criminal prosecution as well as civil proceedings wherein damages are claimed.

(c) The deposit insurer, or other relevant authority, must have policies and procedures that ensure that insiders, related parties, and professional service providers who act for the bank are appropriately investigated for wrongdoing and for possible culpability in a bank failure.

2.6.13 Core Principle 13 – Early detection and timely intervention

The IADI Core Principle 13 deals with early detection and timely intervention.[399] An effective deposit insurer is part of a framework within the financial safety net which provides for the early detection of, and timely intervention in, financially distressed banks before they become non-viable.[400] This framework should include a set of clearly defined qualitative[401] and/or quantitative[402] criteria which are used to trigger timely intervention and corrective action and such criteria must; inter alia:[403] be clearly defined in law, regulation or arrangements; include safety and soundness indicators such as the institution's capital, asset quality, management, earnings, liquidity and sensitivity to market risk; and be reviewed periodically, and the procedure for the review must be formalized.

Core Principle 13 has the following essential criteria:[404]

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[399] Principle 13 of the IADI Core Principles (2014) 36.
[400] *Ibid.*
[401] The quantitative ratios should, according to the IADI, include measures such as regulatory capital and asset quality. See International Association of Deposit Insurers (IADI) *General Guidance for the Resolution of Bank Failures* (2005) 46.
[402] The IADI recommends that the qualitative indexes should include measures of management quality and any material breaches of standards of sound business and financial practices, violations of regulatory requirements, or the inability of a bank to fulfil its obligations resulting from the claims of depositors. See IADI *General Guidance for the Resolution of Bank Failures* (2005) 46.
[403] The deposit insurer or other financial safety-net participants should set up a rule-based or statutory trigger mechanism for early intervention into the affairs of a troubled bank and for determining whether a bank has failed. See IADI *General Guidance for the Resolution of Bank Failures* (2005) 46
[404] Core Principle 13 Essential criteria 1 to 3.

(a) The deposit insurer is part of an effective framework within the financial safety net that enables early detection of, and timely intervention in banks that are experiencing financial difficulties before such bank becomes non-viable.

(b) Safety-net participants have the necessary operational independence as well as the power to perform their roles in the framework for early detection and timely intervention.

(c) The aforesaid framework includes quantitative and /or qualitative criteria that are clearly defined and are applied to trigger timely intervention or corrective action. Such criteria are: clearly defined in law, regulation or agreements; include indicators pertaining to safety and soundness such as the bank's capital, asset quality, management, earnings, liquidity and how sensitive it is to market risk; and is subject to review on a periodic basis, which review procedure is formalized.

2.6.14 Core Principle 14 – Failure Resolution

The IADI Core Principle 14[405] requires deposit insurers to provide for the protection of depositors and contribute to financial stability during a bank resolution and an EDIS legal framework should include a special resolution regime. In essence, the resolution[406] of a failing bank should end in viable, solvent and restructured bank in order to limit the EDIS's exposure to unnecessary funding contributions for the same bank.[407] The resolution

[405] *Principle* 14 of the IADI Core Principles (2014) 37.

[406] The term resolution is defined as a disposition plan for a failed or failing bank, which is directed by the responsible safety-net authority and is generally designed to fully compensate or protect insured deposits while also limiting costs to the deposit insurer. Typically, resolutions involve costs to the deposit insurer because the deposit insurer's obligation to insured deposits exceeds net recoveries on the institution's assets. See International Association of Deposit Insurers (IADI): Research and Guidance Committee International Association of Deposit Insurers *General Guidance for the Resolution of Bank Failures* (2005) 8.

[407] IADI Core Principles (2014) 37.

authority[408] must have effective resolution tools designed to help preserve critical bank functions and to resolve banks.[409]

In principle, the IADI recommends that deposit insurers should have appropriate policies and standard operational procedures (SOPs) for their bank resolution procedures.[410] This should include reimbursement of depositors, purchase and assumption transactions,[411] open bank assistance,[412] and use of bridge banks.[413]

Core Principle 14 is accompanied by the following essential criteria:[414]

[408] A resolution authority refers to a public agency responsible for the resolution of an insolvent financial institution. Depending on a country's mandates, powers and legal framework, deposit insurers may or may not be the resolution authority in a given jurisdiction. See International Association of Deposit Insurers (IADI) *Purchase and Assumption Research Paper* (2019) 3.
[409] IADI Core Principles (2014) 37.
[410] To operate efficiently, reliably and incredible in handing individual bank failures, the deposit insurer should set up effective resolution policies and procedures which should include, inter alia: how to apply least cost resolution methods; how to handle systemic repercussions of the failure of large bank; how to avoid the disruption of banking services in a particular market or region; and kind of emergency alternatives should be used if conditions deteriorate more rapidly than expected. See IADI *General Guidance for the Resolution of Bank Failures* (2005) 44-46.
[411] The IADI defines a purchase and assumption (P&A) as a resolution method in which a healthy bank or group of investors assume some or all of the obligations, and purchase some or all of the failed bank. Together with the liquidation method, P&A has become the most widely used method around the world since the 1980s. For a P&A to succeed, several factors need to be considered such as: proper due diligence to develop accurate asset value assessment; the availability of a sufficient number of qualified bidders; as well as the solicitation of sufficiently high bids. See IADI *General Guidance for the Resolution of Bank Failures* (2005) 3. See also International Association of Deposit Insurers (IADI): Core Principles and Research Council Committee International Association of Deposit Insurers *Purchase and Assumption Research Paper* (2019) 3.
[412] Under certain very limited circumstances, it may be necessary to provide financial assistance to an operating bank determined to be in danger of failing. In those circumstances, the government authority can make loans to, purchase the assets of, or place deposits in a troubled institution. This kind of assistance is the least costly of all possible methods of resolving an institution and government funds should not be used to benefit any shareholder of the institution of its management. There are a number of ways to provide open bank assistance including capital or other debt instruments as well as capital forbearance. See McGuire "Simple tools to assist in the resolution of troubled banks" 2012 *The World Bank* 10.
[413] A Bridge institution refers to an institution established by the resolution authority to temporarily take over and maintain certain assets, liabilities and operations of a failed bank. In the event where the resolution authority fails to find an acquirer for a failed institution as a result of poor market conditions, the bridge institutions assists in providing time to arrange a permanent transaction. It is also helpful in maintaining banking services and ensuring continuity of the failed institution's critical functions. According to the IADI, the establishment and operation of bridge institutions is subject to less stringent requirements than those of commercial banks in many jurisdictions. See IADI *Purchase and Assumption Research Paper* (2019) 3.
[414] Core Principle 1 Essential criteria 1 to 9.

(a) The deposit insurer must have operational independence as well as sufficient resources so that it can exercise its resolution powers consistently with its mandate;

(b) The resolution regime must ensure that all banks are 'resolvable' by means of a broad range of powers and options;

(c) In the event that multiple safety-net participants are responsible for bank resolution, the legal framework must provide for a clear allocation of objectives, mandates, and powers of such participants and there must be no material gaps or overlaps or inconsistencies. There must also be clear arrangements for coordination.

(d) Procedures for resolution and protection of depositors must not be limited to reimbursement of depositors. The resolution authority or authorities should be given effective resolution tools that are designed to help preserve critical bank functions and to resolve banks. These functions include powers to replace and remove senior managers, terminate contracts, conduct transfer and sale of assets and liabilities, undertake writing down or conversion of debt into equity, and/or establish a temporary bridge bank but it is not limited to these mentioned examples.

(e) One or more of the methods that can be applied for bank resolution must allow the flexibility for a resolution to be undertaken at a lesser cost than otherwise expected 'in a liquidation net of expected recoveries.'

(f) Resolution procedures must follow a defined creditor hierarchy wherein insured deposits are protected against sharing losses and shareholders of the bank must take the first losses.

(g) The resolution regime must not discriminate against depositors on the basis of their nationality or residence.

(h) The resolution regime must be insulated against legal action that seeks to have decisions of the resolution authority pertaining to the resolution of failing banks, reversed. No court may reverse those decisions and the legal remedy for successfully challenging those decisions must be limited to monetary compensation.

(i) The resolution regime must ensure that the time that transpires from the moment that depositors lose access to their funds and the implementation of the selected resolution option (for example reimbursement of depositors) is as short as possible.

2.6.15 Core Principle 15 – Reimbursements

According to the IADI Core Principle 15, one of the key functions of a deposit insurance system is to reimburse depositors' insured funds promptly in order to contribute to financial stability.[415] As such, an EDIS protects depositors by providing them with a quick access to their insurance payouts after a bank has failed.[416] Accordingly, Core Principle 15 indicates that a credible EDIS should be able to reimburse depositors' funds swiftly to promote financial stability.[417] To be considered credible, the reimbursement plan must, among other things:[418] have a clear time frame for implementation;[419] be supported by relevant laws, regulations, systems and processes;[420] and have a clear and measurable deliverable.[421]

Following a bank failure, there must be a review performed to determine and analyze the elements of the reimbursement process and a periodic audit of the reimbursement period

[415] Principle 15 of the IADI Core Principles (2014) 39.

[416] One of the most important instruments in ensuring the protection of depositors is an accurate and prompt payment of insurance payouts to depositors. According to Zilinskas and Skyrius, if the payment of insurance payouts is delayed or paid out incorrectly, this may induce public dissatisfaction which may ultimately lead to a destabilised financial market. See Zilinkas and Skyrius "The Universal information Technology model for deposit insurance payouts" 2014 *Ekonomika* 147-148.

[417] Principle 15 of the IADI Core Principles (2014) 39.

[418] *Ibid*.

[419] It is recommended that an efficient and effective depositor reimbursement procedures should, inter alia: prioritize shortening, as much as possible, the period between the revocation of a bank's license and the actual reimbursement process; continuously disclose information to the public during the reimbursement process and liquidation including keeping depositors informed about the details and timeframe of their reimbursement; and audit the data-processing systems to assess deposit records and gain access to the failed bank's depositor records before bank closure to speed up the reimbursement process. See *General Guidance for the Resolution of Bank Failures* (2005) 48.

[420] The IADI requires deposit insurers to have clearly defined legal rules regarding objects and items to be withheld and set-off, as well as guiding subrogation. See *General Guidance for the Resolution of Bank Failures* (2005) 48.

[421] According to the IADI *General Guidance for the Resolution of Bank Failures*, the deposit insurer should set up partial payment procedures in cases where insured depositors need their funds urgently before the actual reimbursement. See *General Guidance for the Resolution of Bank Failures* (2005) 48.

must be conducted to confirm that appropriate internal controls are in place.[422] Finally, where the deposit insurer is not a liquidator, the authorized liquidator is compelled by law to cooperate with the deposit insurer to facilitate the reimbursement process.[423]

The law should grant the deposit insurer the right to recover its claims in accordance with the statutory creditor hierarchy.[424] The deposit insurer's role in the recovery process must be clearly defined in law and clearly recognized as a creditor of the failed bank by subrogation.[425] In its role as a creditor, the deposit insurer has the right to access information from the authorized liquidator to enable it to monitor the liquidation process.[426]

The essential criteria to Core Principle 15 state that:

(a) The deposit insurer must be able to reimburse most insured depositors within a period of seven working days. Where a deposit insurer is not able to current meet this target, it must have a credible plan to do so;

(b) To be credible the reimbursement plan must have a clear timeframe for when it will be implemented (for example two years); must be supported by relevant laws, regulations, systems and processes (for example manuals for intervention and resolution); and must have clear and measurable deliverables;

(c) In instances where reimbursement is triggered and there may be protracted delays in reimbursement, the depositor can make advance, interim or emergency partial payments.

(d) To enable depositors to promptly access their funds , the deposit insurer must have: access to depositor records at all times, including the authority to require banks to maintain depositor information in a format that the deposit insurer prescribes for purposes of expediting insured depositor reimbursement; the authority to conduct advance or

422 IADI Core Principles (2014) 39.
423 *Ibid*.
424 In principle, the deposit insurer is typically the largest creditor in a failure after subrogation. For this reason, the deposit insurer should seek to maximize its recoveries through tight control mechanism posed on liquidator of failed bank, or selling the assets of the failed banks through appropriate legal means and the use of real estate agents and other market mechanisms including possible recovery mechanisms that will allow the deposit insurer to benefit from the upside. See *General Guidance for the Resolution of Bank Failures* (2005) 47.
425 IADI Core Principles (2014) 39.
426 *Ibid.*

preparatory examinations (for example on-site or in conjunction with the bank supervisor) to determine how reliable depositor records are and it must have tested the IT systems and data of member banks to ensure the capability to produce such records; and it must also have a range of reimbursement options;

(e) The deposit insurer is required to have the capacity and capability to do prompt reimbursement, including adequate resources and appropriately trained personnel dedicated to dealing with reimbursement and there must be documents or manuals to support their functions regarding reimbursement; information systems to process depositor information in a systematic and accurate manner; pre- and post-closing activities specified in closing documentation and manuals; and scenario planning and simulations which include simulations on the closing of banks together with resolution and supervisory authorities;

(f) Reviews must be performed after a bank failure to determine and analyse which elements of the reimbursement process (including, where applicable, the resolution process) were successful or unsuccessful;

(g) The reimbursement process must be subjected to a periodic audit by an independent party to confirm that appropriate controls are in place;

(h) Where set-off of insured deposits against past due claims (for example service debt) or matured loans is applied, that application must be timely and must not delay the prompt reimbursement of insured depositor’s claims or compromise financial stability;

(i) There must be working arrangements and/or agreements in place with relevant clearing and settlement systems agencies and liquidators, to ensure that transit items are dealt with in an appropriate, consistent, and timely manner.

2.6.16 Core Principle 16 - Recoveries

The IADI Core Principle 16 deals with recoveries.[427] According to Principle 16, the deposit insurer should have, by law, the right to recover its claims in accordance with the statutory creditor hierarchy.[428] Accordingly, the deposit insurer's role in the recovery process should be explicitly specified in legislation and the deposit insurer should be clearly recognized as a creditor of the failed bank by subrogation.[429]

The essential criteria to Core Principle 16 state that:[430]

(a) The law must clearly define the deposit insurer's role in the recovery process and the deposit insurer should clearly be recognized as a creditor of the failed bank through the mechanism of subrogation;

(b) The deposit insurer must have at least the same legal creditor rights or the same status as a depositor in relation to how the law treats the failed bank's estate;

(c) In its capacity as a creditor, the deposit insurer has the right to access information from the liquidator of the failed bank, so that it can monitor the liquidation process;

(d) The asset management and recovery approaches applied to the management and disposition of a failed bank's assets are guided by commercial and economic considerations;

(e) Persons working on behalf of the deposit insurer, other safety-net participants, and third-party professional service providers providing resolution services may not purchase assets from the liquidator.

2.7 CONCLUSION

In this chapter, the importance of having a robust financial safety net within the financial system was discussed. In particular, the role of deposit insurance systems in contributing to the stability of the financial system was pointed out. The differences between the

427 Principle 16 of the IADI Core Principles (2014) 41.
428 *Ibid.*
429 *Ibid*.
430 Core Principle 16 Essential criteria 1 to 5.

explicit form of deposit insurance and the implicit form were also identified to contextualize the discussion on the need for the certainty that an EDIS brings which translates to greater depositor protection and greater financial stability. The advantages and disadvantages of both systems and the reasons why the explicit deposit insurance system has become the preferred option for protecting depositors and contributing to the financial system stability were pertinently considered.

The chapter further revealed that given the potential for negative spillovers surrounding EDIS, policymakers need to be cautious of some of the key issues in the design of deposit insurance schemes. In particular, the chapter highlighted that any flaw in the design of EDIS could not only cause moral hazard but could also bring about a bank run. Several ways were also discussed in which moral hazard could be mitigated.

A discussion was further provided of the key design features of effective deposit insurance systems as recommended by the IADI. The IADI Core Principles for Effective Deposit Insurance Systems serve as a benchmark for countries wishing to establish EDIS or those wishing to reform their existing ones. These principles assist in the implementation of effective EDIS and they also ensure that the features chosen are appropriate for the design of the EDIS. It is, therefore, important for each country wishing to introduce an explicit deposit insurance to do so in line with the IADI *Core Principles*. Most importantly, each country must ensure that the features chosen for the proposed implementation of an EDIS are complementary to the conditions of the country because what works in one country might not work in another. Finally, when setting up EDIS it is important to remember the purposes to which it serves, namely consumer protection, promotion of financial stability and prevention of bank runs.

CHAPTER THREE

DEPOSIT INSURANCE IN THE UNITED STATES OF AMERICA

3.1 Introduction

In this chapter, the United States of America (US) framework for deposit insurance is discussed, tracing it back to1933 when it was first introduced. The discussion commences with a general overview of the US banking regulation framework to contextualize the discussion and enquiry that will follow. This chapter discusses the establishment of the FDIC under the *Banking Act* 1933 and its evolution through a series of subsequent legislation. In particular, the chapter outlines the features of the US Federal deposit insurance system and the different stages that helped shape the Federal deposit insurance system to what it is today. The chapter finally explores the extent to which the US deposit insurance system complies with international best practice, in particular, its compliance with the IADI Core Principles.

3.1.1 General Overview of the US banking regulation

To contextualize the evolution of deposit insurance in the US a brief overview of the regulatory framework of the US banking system is critical. *The National Bank Act of 1864* (hereinafter the National Bank Act),[431] introduced the rather unique US dual banking system. It established federally chartered banks, referred to as national banks,[432] which include Federal branches or agencies of foreign banks that are supervised by the Office of the Comptroller of the Currency (OCC), as discussed in more detail hereinafter. Furthermore, as the US is a federal republic comprising of a large number of states, the US dual banking system is also composed of State-chartered banks[433], known as State

[431] The National Bank Act of 1864 – 12 USC 38.
[432] *Ibid*. See also, Pollard *et al* (1988) "Banking Law in the United States" 44-45.
[433] 12 USC § 1813(a) (1) (2) defines a "State bank" as any bank engaged in the business of receiving deposits which is incorporated under the laws of any State.

banks, whose supervision is jointly assigned to a 'State bank supervisor'[434] and the 'relevant Federal banking agency', as defined hereinafter, depending on a bank's membership status.

The OCC, the Board of the Federal Reserve System (Federal Reserve), and the Federal Deposit Insurance Corporation (FDIC), are collectively referred to in section 3(q) of *the Federal Deposit Insurance Act of 1950* (hereinafter the Federal Deposit Insurance Act),[435] as the 'appropriate Federal banking agencies' in the US dual banking system.[436] Notably, this provision was subsequently amended by section 312(c) of the Dodd Frank Act which refers to the 'appropriate Federal banking agencies' in Title III of the Dodd-Frank Act, called *the Enhancing Financial Institution Safety and Soundness Act of 2010*.

The world's first explicit deposit insurance system was pioneered in the US where it was introduced by the *Banking Act* 1933 amid an achingly acute banking crisis.[437] The harsh effects of the Great Depression (1929 – 1933) led to the advent of a convoluted system of laws as part of President Roosevelt's 'New Deal' program.[438] The most important part of the 'New Deal' program was the introduction of the federal deposit insurance system through the establishment of the Federal Deposit Insurance Corporation (the FDIC) in

[434] Section 3(r) of the Federal Deposit Insurance Act defines a "State bank supervisor" as any officer, agency, or other entity of any State which has the primary regulatory authority over State banks or State savings associations in such a State.

[435] The Federal Deposit Insurance Act of 1950 – Pub. L 81-797.

[436] Section 2(2) of the Dodd-Frank Act states that the definition of "Federal banking agencies" is consistent with that of section 3(q) of the Federal Deposit Insurance Act. Section 2(10) of the Dodd-Frank Act stipulates that the term "Federal banking agency" means, individually, the OCC, the Federal Reserve and the FDIC while "Federal banking agencies" is a collective term for the OCC, the Federal Reserve and the FDIC. Section 312(b) of the Dodd-Frank Act transferred the powers and duties of the Office of the Thrift Supervision (OTS) relating to the supervision of Federal and State savings association and savings and loan holding companies (SLHCs) and their subsidiaries to the OCC, the Federal Reserve and the FDIC.

[437] Following the Stock Market crash in 1929, many depository institutions exited from the banking industry. According to Richardson, of the roughly 24 000 institutions in operation in January 1929, only about 14 000 remained when the banking holiday was announced in March 1933. For a general discussion on the causes of bank distress during the great depression, see Richardson "Categories and causes of bank distress during the great depression, 1929 – 1933: The illiquidity versus insolvency debate revisited" 2007 *Explorations in Economic History* 588. See also Federal Deposit Insurance Corporation (FDIC) *The first fifty years: A History of the FDIC 1933-1983* (1984) 4.

[438] The New Deal Program was introduced by the President Franklin Roosevelt and it consisted of an elaborate system of federal securities regulation and oversight of capital markets as well as a system of federal deposit insurance. See Omarova "One Step Forward, Two Steps back? The Institutional Structure of U.S. Financial Services Regulation after the Crisis of 2008" 2014 *Cornell Law School Research Paper* 2.

1933[439] with the aim of preserving depositor confidence in the banking system which had been convulsed by the events of the Great Depression.[440]

The establishment of the FDIC was the response to the economic reduction of the Great Depression which was followed by the collapse of many US banks.[441] These bank failures precipitated widespread attempts to convert deposits into cash, prompting banks to contract credit and, in some cases, liquidate assets in order to accommodate cash demands or increase liquidity.[442] Most banks were not able to meet these withdrawal demands, leading to their closure.[443] This, in turn, frustrated depositors and confidence in the banking system began to deteriorate, leading to more bank runs.[444] Advocates of bank deposit insurance at the time believed that such insurance was crucial for re-establishing the confidence of the US banks' depositors in the US banking sector.[445]

Congress also enacted the *National Housing Act* of 1934 which established the Federal Savings and Loan Insurance Corporation[446] to insure the deposits of federal and state-chartered savings associations.[447] According to Clark *et al*, the overarching purpose for the establishment of the Federal Savings and Loan Insurance Corporation was to assist savings associations in retaining deposits that might otherwise have been withdrawn by

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439 Section 12B of the *Banking Act* 1933 established the Federal Deposit Insurance Corporation.
440 Barth *et al* "Banking Regulation in the United States" 2009 *CESifo Economic Studies Advance Access* 8.
441 Calomiris "The political lessons of Depression-era banking reform" 2010 *Oxford Review of Economic Policy* 541.
442 Federal Deposit Insurance Corporation (FDIC) *A Brief History of Deposit Insurance in the United States* (1998) A Paper Prepared for the International Conference on Deposit Insurance 20.
443 *Ibid.*
444 *Ibid.*
445 Federal Deposit Insurance Corporation (FDIC) *Annual Report of the Federal Deposit Insurance Corporation* for the year ending December 31, 1934 (hereinafter FDIC Annual Report 1934) 7.
446 Established in terms of section 402 (a) of the *National Housing Act* of 1934, the Federal Savings and Loan Insurance Corporation was mandated with the insurance of the accounts of institutions eligible for insurance as provided for under section 403 (a) of the National Housing Act of 1934. In particular, the Federal Loan and Savings Insurance Corporation was to insure, according to section 403(a), the accounts of all Federal savings and loan associations and the accounts of building and loan, savings and loan as well as homestead associations and cooperative banks, organized and operated in accordance with the laws of the State, District, or Territory in which they are chartered or organized.
447 Section 403 (a) of the *National Housing Act* of 1934.

depositors who were concerned about the financial condition of the savings association at which their accounts were maintained.[448]

3.2 The evolution of explicit deposit insurance in the United States of America

3.2.1 The Banking Act 1933

As indicated, explicit deposit insurance was formally introduced for the first time under the US *Banking Act* 1933 (the 1933 Act).[449] The overarching purpose of establishing the FDIC was 'to purchase, hold and liquidate the assets' of national banks which had been closed by the action of the Comptroller of the Currency[450] or by vote of the banks' directors, as well as to insure the deposits of all banks which were entitled to the benefits of insurance under the Act.[451] For the smooth operation of the FDIC, its management vested in a board of directors[452] which consisted of three members, one of whom was Comptroller of the Currency.[453] The other two members of the Board were to be appointed by the President, by and with, the advice and consent of the Senate.[454] One of the appointed members had to be the chairman of the Board of Directors.[455] The Act gave the appointed Board of Directors powers to administer the affairs of the FDIC fairly, impartially and without discrimination.[456]

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448 Clark *et al* "Regulation of Savings Association Under the Financial Institutions Reform, Recovery and Enforcement Act 1989" 1990 *The Business Lawyer* 1017.
449 The 1933 Act established two separate plans of deposit insurance: a temporary plan which was to be initiated on January 1, 1934, and a permanent plan which was to become effective on July 1, 1934. See FDIC *A Brief History of Deposit Insurance* (1998) 27.
450 The Comptroller of the Currency is the chartering authority for national banks – and the counterpart of the chartering authorities in each US state. Established under the *National Currency Act* in 1863, the Comptroller of the Currency is charged with the responsibility to organize and administer a system of nationally chartered banks and a uniform national currency.
451 Section 12B (a) of the *Banking Act* 1933.
452 All reference to the board of directors in this chapter refers to the board of directors of the FDIC.
453 Section 12B (b) of the *Banking Act* 1933.
454 In terms of section 12B (b) of the *Banking Act* 1933, each such appointive member was to hold office for a term of six years and was to be remunerated $10 000 per annum, an amount payable monthly out of the funds of the FDIC with the exception of the Comptroller of the Currency who was not entitled to any additional compensation for his services as a member of the FDIC board.
455 Section 12B (b) of the *Banking Act* 1933.
456 Section 12B (k) of the *Banking Act* 1933.

The 1933 Act authorized the FDIC to appropriate money from the US Treasury in the sum of $150 000 000 and this sum was to be made available for payment by the Treasury Secretary for capital stock of the FDIC.[457] Such stock was to be held in addition to the amount of capital stock required to be subscribed for by the Federal Reserve banks, member banks as well as non-member banks.[458] Subscription to the FDIC membership was to be made in an amount equivalent to one-half of 1 percent of the bank's total liabilities.[459]

Initially, deposit insurance in the US took the form of a temporary insurance plan, and a Temporary Federal Deposit Insurance Fund[460] was established and began operating on 1 January 1934.[461] Under the 1933 Act, all licensed Federal Reserve member banks automatically became members of the Temporary Federal Deposit Fund.[462] According to Hogan and Johnson, the Temporary Federal Deposit Insurance Fund was, at the time, considered a major contributing factor to halting bank failures and thus stabilizing the US banking sector.[463] Therefore, the first major task of the FDIC after the establishment of the Temporary Federal Deposit Insurance Fund was to examine all banks which were not members of the Federal Reserve that applied for admission to the Fund.[464]

For all other banks other than the Federal Reserve member banks, however, the approval for admission as members of the Temporary Deposit Insurance Fund depended on the value of their assets being sufficient to cover all liabilities to depositors and other

[457] Section 12B (c) of the *Banking Act* 1933.
[458] Section 12B (c) of the *Banking Act* 1933.
[459] Section 12B (c) of the *Banking Act* 1933.
[460] The Temporary Federal Deposit Insurance Fund was created under section 12B (y) of the *Banking Act* 1933 to facilitate the actions of the FDIC and was to begin its operations on the 1st January 1934 unless the President decided otherwise. Each member bank licensed before the 1st January 1934 was to become a member of the Fund. It was expected that the Temporary Federal Deposit Insurance Fund would be in operation for six months. This period was, however, extended for one year. See generally FDIC *A Brief history of Deposit Insurance in the United States* (1998) 27.
[461] Section 12B (y) of the *Banking Act* 1933.
[462] See generally FDIC *A Brief history of Deposit Insurance* (1998) 27.
[463] Hogan & Johnson "Alternatives to the Federal Deposit Insurance Corporation" 2016 *The Independent review* 433.
[464] FDIC *Annual Report* (1934) 14.

creditors.[465] Upon receiving an application for membership, the FDIC had to request the Federal Reserve Board, in the case of a State member bank, or the Comptroller of the Currency, in the case of a national bank, to attest, after a thorough investigation of such bank, to the sufficiency of the assets of the bank making the application to enable it to meet all of its liabilities to depositors and other creditors.[466] In the case where such attestation was affirmatory, the FDIC had to grant such application and the applying bank was then expected to pay half of its subscription in full.[467] Conversely, admission into the Fund was denied whenever the applicant bank failed to meet the FDIC's standards for admission to insurance.[468]

When an insured bank was in difficulty, the FDIC had the power to employ several options provided for by the Act.[469] Firstly, in the event that a member bank became insolvent or ceased to be a member of the FDIC, such bank was entitled to the benefits of insurance and the stock held by it in the FDIC was cancelled without any impairment of the liability of such bank.[470] More specifically, if a national bank which was a member bank of the FDIC, was closed by its board of directors or by the Comptroller of the Currency, on account of inability to meet its obligations to depositors, the Act empowered the Comptroller of the Currency to appoint the FDIC as receiver[471] for such bank which

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[465] Section 12B (e) of the *Banking Act* 1933 specifically required every member bank to apply for the FDIC membership in an amount equivalent to one half of 1 per centum of its total deposit liabilities as computed in accordance with regulations prescribed by the Federal Reserve Board.
[466] Section 12B (e) of the *Banking Act* 1933.
[467] Section 12B (f) of the *Banking Act* 1933 stipulated that a bank admitted to membership in the Federal Reserve System at any time after the organisation of the FDIC was expected to subscribe for an amount of class A capital stock equal one-half of 1 per centum of the time and demand deposits it surrendered, no later than the 1st day of January and thereafter, a proportionate amount of its holdings in the capital stock of the FDIC and was to be released from its stock subscription not previously called. The section further required that the shares surrendered be cancelled and the member bank to receive in payment a sum to its cash-paid subscriptions on the shares surrendered and its proportionate share of dividends.
[468] Randall "The Federal Deposit Insurance Corporation: Regulatory functions and philosophy" 1966 *Law and Contemporary Problems* 706.
[469] Miller "The Character of Deposit Insurance in the United States" 1954 *The Review of Insurance Studies* 81.
[470] Section 12B (i) of the *Banking Act* 1933.
[471] The term 'receiver' was defined in section 12B (l) of the *Banking Act* 1933 as a receiver, liquidating agent, or conservator of a national bank, and a receiver, liquidating agent, conservator, commission, person, or other agency charged by State law with the responsibility and the duty of winding up the affairs of an insolvent State member bank.

entailed that the FDIC had to attend to winding up the affairs of the bank.[472] The appointment of the FDIC as receiver of failing banks simplified the procedure by reducing the probability of duplicating records and vesting the responsibility for liquidation in the largest creditor whose interest was to obtain the maximum possible recovery.[473]

After its appointment as receiver of a failing national bank, the FDIC was expected to organize a new national bank (also known as a 'bridge bank')[474] to assume the insured deposit liabilities of the closed bank; to receive new deposits[475] and to provisionally perform all the functions conferred on it.[476] The new bank served as the agency of the FDIC for paying the insured deposits of the closed bank.[477] The FDIC was then expected to promptly make available to the new bank an amount equivalent to the estimated covered deposits of the closed bank together with any amount necessary to cover its operating costs.[478] These funds became available to depositors as their claims were proved and assigned to the FDIC.[479] The 1933 Act did not define the term 'new bank' nor did it provide for how long it would operate. however, section 12B (c)(9) of the *Banking Act* 1935, as discussed below, defined 'new bank' as a new national banking association organized by the FDIC to assume the insured deposits of an insured bank closed on account of inability to meet the demands of its depositors and to perform temporarily the functions prescribed by the *Banking Act*.[480]

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472 Section 12B (l) of the *Banking Act* 1933.
473 FDIC *Annual Report* (1934) 28.
474 See Chapter 2, para 2.5.14.
475 Section 12B (l) of the *Banking Act* 1933 authorized the new bank to accept new deposits, subject to the approval of the FDIC, which together with all the amounts made available to it by the FDIC were to be kept on hand in cash, invested in direct obligations of the US or deposited with the FDIC or with a Federal Reserve bank.
476 Section 12B (l) of the *Banking Act* 1933.
477 In terms of section 12B (l) of the *Banking Act* 1933, the new national banks organized for the purpose of paying the insured portion of depositors' claims in the closed bank were chartered without capital and were under the management of officials designated by the FDIC. See section 12B (l) of the *Banking Act* 1933. See also *Annual Report of the Federal Deposit Insurance Corporation* for the year ending December 31, 1935 (hereinafter FDIC Annual Report 1935) 15.
478 Section 12B (l) of the *Banking Act* 1933.
479 FDIC *Annual Report* (1934) 26.
480 Section 12B (c)(9) of the *Banking Act* 1935.

Initially, the Act guaranteed federal protection of retail deposits up to $2500 in the US depository institutions[481] in the event of failure of a financial institution failure[482] and in October 1934 this amount was increased to $5000.

As receiver of the failed institution, the FDIC had various powers and was authorized, inter alia: to sell the assets of a closed bank, taking into consideration the condition of credit in the district in which such closed bank was located; to enforce the individual liability of the stockholders and directors thereof; and to wind up the affairs of such closed bank in accordance with the legislation relating to the liquidation of closed national banks.[483] Thereafter, the FDIC was expected to retain for its own account such portion of the amount realized from the liquidation of the failed bank as it was entitled to receive on account of its subrogation[484] to the claims of depositors and paying depositors and other creditors the amount available for distribution to them.[485] Where the amount realized by the FDIC on account of its subrogation to the claims of depositors was less than the estimated amount provided for, the remaining balance was charged from the deposit insurance account.[486]

Notably, the *Banking Act* 1933 placed liability on whoever, being connected in any capacity with the FDIC, 'embezzled, abstracted, purloined, or willfully misapplied any moneys, funds, securities, or other things of value, regardless of whether it belonged to him or [was] otherwise entrusted with him.'[487] In the same way, any individual who, with the intention to defraud or deceive the FDIC or any other body, politic or corporate, made any false entry in any book, report or statement of or to the FDIC was liable for a fine not exceeding $10 000 or imprisonment not exceeding five years, or both.[488]

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[481] The term depository institution is defined section 3 (c)(1) of the *FDIC Act* 1950 (As Amended) as any bank or savings association.
[482] Section 12B (l) of the *Banking Act* 1933.
[483] Section 12B (l) of the *Banking Act* 1933.
[484] See Chapter 2, para 2.4.3.1.
[485] Section 12B (l) of the *Banking Act* 1933.
[486] Although the 1933 Act does not define the term 'deposit insurance account', section 12B (k) of the *Banking Act* 1933 authorized the FDIC to open a deposit insurance account as soon as possible after taking possession of any closed national bank in order to debit in it the estimated amount available from all sources for application in satisfaction of the portion of the claims of depositors.
[487] Section 12B (u) of the *Banking Act* 1933.
[488] Section 12B (u) of the *Banking Act* 1933.

At the time the deposit insurance legislation became operative in 1933, it was, however, not possible for banks in all US States to cooperate with the FDIC to the extent contemplated by the federal law.[489] In an attempt to correct this, Congress designed numerous drafts of bills aimed at increasing the effectiveness of the insurance of bank deposits in the US.[490] This process led to the enactment of the *Banking Act* of 1935 as discussed below.

3.2.2 The Banking Act 1935

The enactment of the *Banking Act* 1935 (the 1935 Act) in August 1935 terminated the Temporary Federal Deposit Insurance Fund created under the 1933 Act and inaugurated a Permanent Deposit Insurance Fund.[491] Although the 1935 Act did not entirely change the provisions of the 1933 Act, it substantially altered the character of deposit insurance as enshrined in the 1933 Act.[492] In particular, the 1935 Act changed the requirements for admission to become a member of the FDIC under the permanent plan. Under the 1935 Act, automatic admission to insurance was granted for all banks insured at the close of the Temporary Federal Deposit Insurance Fund with the exception of banks that signified within 30 days of the Act coming into operation, their intention to withdraw from insurance as well as banks that failed to file the required certified statement of deposits and failed

[489] FDIC *Annual Report* (1934) 35.
[490] *Ibid*.
[491] The *Banking Act* 1935 consolidated the Temporary Federal Deposit Insurance Fund and the Fund for Mutuals created under the 1933 Act into a Permanent Insurance Fund to insure deposits and the assets held by the FDIC for the uses and purposes of the Corporation. See section 12B (l)(1) of the *Banking Act* 1935. See also FDIC *Annual Report* (1935) 7.
[492] FDIC *Annual Report* (1935) 7.

to make the necessary payments.[493] Depositors were to be notified in all cases of termination of insurance.[494]

Furthermore, while the 1933 Act provided that the approval of banks for admission into the temporary insurance plan was only dependent on the value of their assets being sufficient to cover all liabilities to depositors and other creditors, the 1935 Act added more factors to be considered by the board of directors before admission of a bank into the permanent plan was granted.[495] These factors included: the financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, and the general character of its management, the convenience and needs of the community to be served by the bank and whether or not its corporate powers were consistent with the purpose of the Act.[496]

The most noteworthy feature of the Federal deposit insurance under the 1935 Act was the power it granted to the FDIC to terminate, after notice and hearing, the insurance of any insured bank which engaged in 'unsafe or unsound practices'.[497] Whenever the FDIC's board of directors found that an insured bank, its directors or trustees had engaged in 'unsafe or unsound' banking practices in conducting the business of such bank, or knowingly or negligently allowed any of its officers or agents to violate any provision of any law to which the insured bank was subject, the board of directors was

[493] Section 12B (f) (1) of the *Banking Act* 1935 provided that every bank which was not a member of the Federal Reserve System which on June 30, 1935, was or thereafter became a member of the Temporary Federal Deposit Insurance Fund or the Fund for Mutuals created pursuant to the provisions of the Act, was to remain and to continue to be, without application or approval, an insured bank and subject to the provisions of the Act. The exception to this was, any State nonmember bank which was admitted to the said Temporary Federal Deposit Insurance Fund or the Fund for Mututals but which failed to file on or before the effective date of October 1, 1934, a certified statement and failed to make payments thereon required by law as well as a bank which was admitted to the said Temporary Federal Deposit Insurance Fund or the Fund for Mutuals before the effective date as an insured bank or had its deposits insured by the FDIC but had permanently discontinued its banking operations before the effective date.
[494] Section 12B (i) of the *Banking Act* 1935 provided, in this regard, that the FDIC publish a notice of termination of insurance and a bank to give notice of such termination to each of its depositors at his last record on the books of the bank in such a manner and at such time as the FDIC's board of directors would deem it necessary and order for the protection of depositors. See also Kress "The Banking Act of 1935" 1935 *The Michigan Law Review* 171.
[495] Section 12B (g) of the *Banking Act* 1935.
[496] Section 12B (g) of the *Banking Act* 1935.
[497] Section 12B (i)(1) of the *Banking Act* 1935.

expected to give to the relevant authority,[498] a statement relating to such practices or violations in order to secure the correction thereof.[499]

Where such correction could not be made within the period of time specified in the statement, the FDIC's board of directors was required, if considered desirable, to proceed to give to the bank a written notice of intention to terminate its status as an insured bank.[500] In such a case the board of directors would also indicate the time and place for a hearing before it or before a person designated by it to conduct such hearing.[501] At such hearing, evidence would have to be produced upon which the FDIC's board of directors would make written findings.[502] Failure by the bank to appear for a hearing or to send a representative to such hearing was deemed to be a consent to the termination of its status as an insured bank.[503] Upon termination, the FDIC was required to publish a notice of such termination and the bank was expected to notify each of its depositors of such termination.[504] After termination, the insured deposits of depositors, less all the subsequent withdrawals, would continue to be insured for a further two years and the bank was to continue to pay to the FDIC levies as in the case of an insured bank during such period.[505]

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[498] Relevant authority in this case refers to the Comptroller of the Currency with respect to insured national banks, Board of Governors in the case of State member banks or a state banking authority in the case of a state non-member bank.
[499] Section 12B (i)(1) of the *Banking Act* 1935.
[500] Section 12B (i)(1) of the *Banking Act* 1935.
[501] Section 12B (i)(1) of the *Banking Act* 1935.
[502] Section 12B (i)(1) of the *Banking Act* 1935.
[503] Section 12B (i)(1) of the *Banking Act* 1935.
[504] Section 12B (i)(1) of the *Banking Act* 1935.
[505] Section 12B (i)(1) of the *Banking Act* 1935 stipulated that during this two-year period, no additions to any such deposits and no new deposits in such bank made after the date of such termination would be insured by the FDIC. The section further provided that the bank was prohibited from advertising or holding itself out as having insured deposits unless in the same connection it would also state with equal prominence that additions to deposits and new deposits made after the termination would not be insured. In terms of the section, the bank would, in all other respects, be subject to the duties and obligations of an insured bank for the period of two years from the date of termination, and in the event that such bank would be closed on account of inability to meet the demands of its depositors within such period of two years, the FDIC would have the same powers and rights with respect to such bank as in case of an insured bank. The 1935 Act does not allude to why deposits would continue to be covered for two years after the termination of deposit insurance. However, it is suspected that this is done to allow depositors time to decide what they would like to do with their deposits. See section 12B (i)(1) of the *Banking Act* 1935.

Another notable provision in the 1935 Act was the power it gave to the FDIC's board of directors to facilitate a merger or consolidation of an insured bank with another insured bank, if in its opinion, such action would reduce the risk or avert a threatened loss to the FDIC.[506] The FDIC's board of directors was also authorized to facilitate the sale of assets of an open or closed insured bank to, and assumption of its liabilities by another insured bank ('purchase and assumption').[507] The FDIC could also upon terms it deemed desirable, make loans secured in whole or in part by assets of an open or closed insured bank.[508]

The 1935 Act retained, to a great extent, the provisions of section 12B of the 1933 Act[509] and effected only minor alterations to it. More specifically, the 1935 Act retained the $5000 deposit insurance coverage which was increased in 1934,[510] as well as the $150 000 000 amount authorized for borrowings from the US Treasury as provided by the 1933 Act.[511]

Compared to the provisions of the 1933 Act, Preston remarks that some very apparent gains were however achieved especially in relation to the FDIC's powers as receiver to deal with banks that failed.[512] Accordingly, the period between the establishment of FDIC in 1933 and the subsequent enactment of the *Federal Deposit Insurance Act* (*FDIC Act*) in 1950 became a time of recovery in the US from the effects of the Great Depression followed by a continuously high level of business activity as a result of the introduction of the federal deposit insurance system.[513] As discussed below, the *FDIC Act* of 1950 brought about further significant changes to the US deposit insurance system.

3.2.3 The Federal Deposit Insurance Corporation Act 1950

506 Section 12B (n)(4) of the *Banking Act* 1935.
507 Section 12B (n)(4) of the *Banking Act* 1935.
508 Section 12B (n)(4) of the *Banking Act* 1935.
509 See para 3.2.1.
510 See para 3.2.1.
511 See para 3.2.1.
512 Preston "The Banking Act of 1935" 1935 *Journal of Political Economy* 760.
513 *Annual Report of the Federal Deposit Insurance Corporation* for the year ending December 31, 1950 (hereinafter FDIC Annual Report 1950) 3.

In 1950, as a result of a decade and a half of administration of a permanent deposit insurance scheme, officials of the FDIC had found various aspects of the law that were in need of reform and this led to a number of proposals for the amendment of the deposit insurance law.[514] The outcome of these proposals was a bill embodying recommendations of the FDIC which culminated in the promulgation of the *Federal Deposit Insurance Corporation Act* (*FDIC Act)* of 1950.[515]

The FDIC Act saw the withdrawal of section 12B of the *Banking Act* as part of that Act and was made a separate standalone Act.[516] After fifteen long years since its establishment, the FDIC Act increased the level of coverage for insured retail deposits from $5000[517] to $10000.[518] The sudden effect of the change in coverage was to provide full protection to three million additional accounts and to increase the amount of insured deposits by $12 billion.[519] The FDIC Act authorized the FDIC to borrow from the US Treasury through the Secretary of the Treasury an amount not exceeding $3 000 000 000.[520] This amount was raised from $150 000 000 which was authorized under the 1935 Act.[521]

The *FDIC Act* 1950 also altered the base for deposit insurance assessment in two ways:[522] first, the semi-annual assessment for each insured bank was to be in the amount of the product of one-half the annual assessment rate multiplied by the assessment base; and second, certain items could be omitted or deducted from deposits in determining the

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[514] FDIC *Annual Report* (1950) 4.
[515] FDIC *Annual Report* (1950) 4.
[516] See the Preamble of the *Federal Deposit Insurance Corporation Act* 1950.
[517] Effective from July 1, 1934, insurance protection was increased from $2500 to $5000. See FDIC *A Brief History of Deposit Insurance in the US* (1998) 30.
[518] Section 3 (m) of the *FDIC Act 1950* defined the term 'insured deposits' as the net amount due to any depositor for deposits in an insured bank less any part thereof which is in excess of $10000. Such net amount was to be determined according to such regulations as the FDIC's Board of Directors may prescribe, and in determining the amount due to any depositor there shall be added together all deposits in the bank maintained in the same capacity and the same right for his benefit either in his own name or in the names of others except funds which were insured in terms of subsection (i) of section 7.
[519] FDIC *Annual Report* (1950) 4.
[520] Section 14 of the *FDIC Act* 1950.
[521] See para 3.2.2.
[522] Section 7 (a) of the *FDIC Act* 1950.

assessment base.[523] An assessment base is defined in terms of section 7(a) (1) of the *FDIC Act* 1950 as 'the amount of the liability of the bank for deposits without any reduction for indebtedness of depositors but includes, *inter alia*: deposit balance due to an insured bank from such insured bank which is subject to immediate withdrawal; trust funds held by the bank in a fiduciary capacity and which are deposited in another insured bank; and cash items as determined by the Act'.[524] However, the bank may exclude, from its assessment base:[525] drafts drawn by it on deposit accounts in other banks which are issued in the regular course of business as well as the amount of any advices or authorizations, issued by it for cash letters received, directing that its deposit account in the sending bank be charged with the amount thereof; and cash funds which are received and held solely for the purpose of securing a liability, and which are not subject to withdrawal by the obligor and are carried in a special non-interest-bearing account designated to properly show their purpose.

Another major change effected by the *FDIC Act* 1950 was granting the FDIC several new powers which included: the power to make loans; to purchase assets as well as to make deposits in any insured bank in danger of closing to prevent it from closing (the so-called "open bank assistance).[526] However, the FDIC was only allowed to exercise any of these powers whenever it had made a determination that an insured bank was in danger of closing, and in the opinion of the FDIC's board of directors, the continued operation of such bank was essential in providing adequate banking service in the community.[527] Notably, under the 1935 Act, the FDIC could make loans to, or purchase assets from, a

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523 In terms of section 7 (a)(2) of the *FDIC Act* 1950, items that may be deducted or excluded include: drafts drawn by it on deposit accounts in other banks which were issued in the regular course of business; cash funds received and held solely for the purpose of securing a liability to the bank but not in an amount in excess of such liability and which were not subject to withdrawal by the obligor and were carried in a special non-interest-bearing account designated to properly show their purpose.
524 Section 7 (a)(1) of the *FDIC Act* 1950. See also Earnest & Andrews "A Comparison of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation" 1962 *The Journal of Insurance* 79.
525 Section 7(a)(2) of the *FDIC Act* 1950.
526 See Chapter 2, para 2.5.14 for a discussion of open bank assistance. Section 13 (c) of the *FDIC Act* 1950 stipulated that tthese powers were to be used by the FDIC at the discretion of the board of directors.
527 Section 13 (c) of the *FDIC Act* 1950. This was done in an attempt to prevent a failing bank from closing and the authorized loans and deposits under subsection 13 (c) could be made in subordination to the rights of depositors and other creditors.

bank in financial distress only when such action would facilitate a merger or assumption of liabilities by another insured bank.[528] These changes brought about by the 1950 Act gave the FDIC a more flexible approach to handling financially distressed banks.[529]

The *FDIC Act* 1950 further extended the FDIC's powers by authorizing it to conduct special examinations of national banks and State banks which were members of the Federal Reserve System when such action was deemed desirable by the FDIC's board of directors in order to determine the insurance risk of the bank concerned.[530] This added power gave the FDIC, for the first time since its inception, the authority to appraise the risks it faced in providing deposit insurance for those banks.[531] Although the power to conduct examinations was granted in the *Banking Act* 1935, the appointed examiners required the written consent of the Comptroller of the Currency, in the case of a national bank or District bank, and alternatively, the written consent of the FDIC's board of directors, in the case of a State bank, to undertake those examinations.[532] The 1950 Act, however, did away with the provision for written requests for permission to conduct examinations, thereby giving the FDIC direct powers in this regard.[533]

Section 8(a) of the FDIC Act 1950 entrusted the FDIC with the responsibility to keep insured banks within the channels of safe and sound banking.[534] Like with section 12B (i)(1) of the 1935 Act, the FDIC Act 1950 empowered the FDIC's board of directors to give an appropriate supervisory authority, a statement with respect to unsafe and unsound practices conducted by an insured bank in order to obtain necessary corrective actions.[535]

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[528] Section 12B (n)(4) of the *Banking Act* 1935. Also see FDIC *Annual Report* (1950) 6.
[529] FDIC *Annual Report* (1950) 6.
[530] Section 10 (b) of the *FDIC Act* 1950 gives more power to the FDIC by adding the power to make examinations of and to require information and reports from banks. In this regard, the board of directors is authorized under section 10(b) of the FDIC Act 1950 to appoint examiners who, on behalf of the FDIC, were to examine any insured State non-member bank excluding District banks, as well as any State non-member bank making an application to become an insured bank, and any closed insured bank, whenever in the opinion of the board of directors an examination of the bank is desirable. In addition, such examiners were also to have the power to make special examinations of any State member bank and any national bank or District bank whenever in the judgment of the board of directors, such special examination was necessary to determine the condition of any such bank for insurance purposes.
[531] FDIC *Annual Report* (1950) 6
[532] Section 12B (k)(2) of the *Banking Act* 1935.
[533] See section 10 (b) of the *FDIC Act* 1950.
[534] FDIC *Annual Report* (1950) 18.
[535] Section 8 (a) of the *FDIC Act* 1950.

As such it thus enabled early intervention to prevent the bank concerned from encountering unmanageable problems. The FDIC was further expected to cooperate with the relevant supervisory authority in an attempt to secure the correct action for the unsound practices or violations of the law.[536] The *FDIC Act* 1950 allowed the FDIC to terminate the insured status of the bank where no corrective action was possible.[537] Alternatively, the FDIC could have the bank absorbed by a healthy bank rather than terminate the bank's insured status where corrective action did not appear to be feasible or likely.[538] This provision is analogous to section 12B (n)(4) of the 1935 Act which allowed the FDIC's board of directors to facilitate the sale of assets of an open or closed insured bank to, and assumption of its liabilities by another insured bank.

Bradley indicates that the US Federal deposit insurance system seemed to operate effectively under the *FDIC Act* 1950 until the latter part of the 1960s when the US banking system experienced a sharp reduction in the flow of funds to depository institutions because of the interest rates offered through securities markets, leading to a number of failures of insured institutions.[539] A large portion of this reduction was the result of the behavior of private households.[540] Congress believed the increase in deposit insurance coverage would encourage members of the public to increase their savings which would, in turn, result in an inflow of funds to the insured institutions.[541] As a result, deposit insurance coverage was increased from $10 000 effected by the *FDIC Act* to $15 000 cover for retail deposits in 1966.[542] Thereafter to $20 000 in 1969.[543] In 1974, deposit insurance coverage was once again increased from $20 000 to $40 000.[544]

According to Gail and Norton, the 1980s began and ended with serious congressional as well as regulatory concern for the financial health and stability of the thrift industry.[545]

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536 Section 8 (a) of the *FDIC Act* 1950. See also FDIC *Annual Report* (1950) 18.
537 Section 8 (a) of the *FDIC Act* 1950.
538 Section 8 (a) of the *FDIC Act* 1950.
539 Bradley "A Historical Perspective on Deposit insurance coverage" 2000 *FDIC Banking Review* 14.
540 Bradley (2000) *FDIC Banking Review* 14.
541 *Ibid.*
542 Section 301 (a) of *the Financial Institutions Supervisory Act* 1966.
543 FDIC *A Brief History of Deposit Insurance in the US* (1998) 45.
544 *Ibid.*
545 Gail & Norton "A decade's journey from "deregulation" to "supervisory reregulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989" 1990 *The Business Lawyer* 1105.

These financial difficulties of the thrift industry increased, leaving cracks in the financial health of the US banking sector.[546] This prompted the Congress to enact the *Financial Institutions Reform, Recovery and Enforcement Act 1989* as a reactive piece of legislation.[547]

3.2.4 The Financial Institutions Reform, Recovery and Enforcement Act 1989

The promulgation of the *Financial Institutions Reform, Recovery and Enforcement Act 1989* (FIRREA) in August 1989 has been said to have been 'the most important restructuring of the US's financial institutions and deposit insurance apparatus in over fifty years'.[548] It was passed as a remedial measure necessitated by the failure of the savings and loan industry and also as an opportunity for lawmakers to change the way in which banks and savings associations were supervised and insured.[549]

As indicated, prior to the enactment of the FIRREA, the Federal Savings and Loan Insurance Corporation was responsible for insuring savings and loan associations.[550] When establishing the FDIC and the Federal Savings and Loan Insurance Corporation, Congress envisioned both agencies to operate as independent deposit insurance companies whose premium collections from commercial banks and savings associations would cover losses in the event that individual institutions failed.[551] In 1988, however, the Federal Savings and Loan Insurance Corporation became insolvent because of the expenses it incurred in rescuing failed thrifts.[552] In response to this, the FIRREA was enacted in 1989.

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[546] Gail & Norton (1990) *The Business Lawyer* 1104.
[547] *Ibid.*
[548] Gail & Norton (1990) *The Business Lawyer* 1106.
[549] Helmer "Banking on solvency: The takings of FIRREA's cross-guarantee provision" 1995 *Valparaiso University Law Review* 234. See also FDIC *Annual Report of the Federal Deposit Insurance Corporation* for the year 1989 (hereinafter FDIC Annual Report 1989) 74.
[550] Para 3.1.
[551] Taylor "The FDIC's Enhanced Powers over savings associations: Does FIRREA make it "SAIF"?" 1991 *Fordham Law Review* S384.
[552] Taylor (1991) *Fordham Law Review* S384.

The key objective for the establishment of the FIRREA was, inter alia: to promote the independence of the FDIC from the institutions whose deposit it insured by providing an independent board of directors,[553] adequate funding and appropriate powers;[554] to put the federal deposit insurance funds on a sound financial footing;[555] to establish a new corporation known as the Resolution Trust Corporation (RTC)[556] meant to contain, manage and resolve failed savings associations;[557] to provide funds from public and private sources to deal expeditiously with failed depository institutions;[558] to strengthen the enforcement powers of federal regulators of depository institutions;[559] and finally, to strengthen the civil sanctions and criminal penalties for defrauding or damaging depository institutions and their depositors.[560]

First and foremost, the FIRREA dissolved the Federal Savings and Loan Insurance Corporation.[561] Upon its abolishment, the FIRREA established the Resolution Trust Corporation,[562] as indicated, to manage and resolve savings associations that were

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[553] Section 203 (e) of the *FIRREA* 1989 sought to enhance the independence of FDIC's board of directors by prohibiting them from holding any office, position, or employment in any insured depository institution or any depository institution holding company during the time such member was in office and the two-year period beginning on the date such member ceased to serve on the FDIC's board of directors.
[554] Section 101 (4) of the *FIRREA* 1989.
[555] Section 101 (5) of the *FIRREA* 1989.
[556] The Resolution Trust Corporation is an agency of the United States established under section 501 (b) of *FIRREA* 1989 to manage and resolve all cases involving depository institutions.
[557] Section 101 (7) of the *FIRREA* 1989. As indicated, the
[558] Section 101 (8) of the *FIRREA* 1989.
[559] Section 101 (9) of the *FIRREA* 1989. As indicated, the 1933 Act granted the FDIC, as the deposit insurer of commercial banks, the authority to terminate the insurance of deposits for institutions that were found guilty of serious offences. However, the power to take deposit insurance away from a financial institution proved to be an inadequate and impractical enforcement tool. FIRREA sought to enhance these powers further. See paragraph 3.2.1. See also Curry *et al* "Financially distressed banks: How effective are enforcement actions in the supervision process?" 1999 *FDIC Banking Review* 1.
[560] Section 101 (10) of the FIRREA 1989. According to Battin, many of the bank failures that occurred were attributed to either fraud of negligent mismanagement by bank directors, therefore, the enactment of FIRREA was meant to strengthen the civil sanctions and criminal penalties for defrauding or otherwise damaging depository institutions and their depositors as well as to strengthen the enforcement powers of Federal regulators of depository institutions. See Battin "Bank director liability under Firrea" 1995 *Fordham Law Review* 2347.
[561] Section 401 of the FIRREA 1989 abolished the Federal Loan and Savings Insurance Corporation established under the National Housing Act of 1934 with effect from the date of the enactment of FIRREA.
[562] The Resolution Trust Corporation was established in terms of section 501 (b)(1) (A) of *FIRREA* 1989 to manage and resolve all cases involving depository institutions. According to Josel, the Congress designed the RTC, among other things: to resolve cases involving insured thrifts placed in conservatorship or receivership between 1 January 1989 and 9 August 1992; to conduct operations in order to maximise

insured by the Federal Savings and Loan Insurance Corporation. The Resolution Trust Corporation was to be deemed to be an agency of the US to the same extent as the FDIC when acting as a conservator or receiver of an insured depository institution.[563] In particular, the Resolution Trust Corporation was authorized, among other things, to manage and resolve all cases involving depository institutions – the accounts of which were insured by the Federal Savings and Loan Insurance Corporation prior to the enactment of the FIRREA.[564] The FIRREA appointed the FDIC as the Resolution Trust Corporation's "exclusive manager", in which capacity the FDIC had the sole responsibility for day-to-day operations of the Resolution Trust Corporation.[565] The FIRREA further established the Resolution Funding Corporation [566] to fund the activities of the Resolution Trust Corporation through bond sales.[567]

With the abolishment of the Federal Savings and Loan Insurance Corporation, the FIRREA introduced some of the most significant changes to the FDIC's primary mission by charging it with the responsibility to, inter alia: insure the deposits of savings associations;[568] examine savings associations and their affiliates under the same circumstances that examinations of banks are permitted;[569] issue regulations barring

recovery on acquired assets; to minimize the impact on local markets; to make efficient use of funds; to minimize losses incurred in resolving as well as to preserve a supply of affordable housing. See Josel "Resolution Trust Corporation: Waste management and the S&L Crisis" 1991 *Fordham Law Review* S342.

[563] Section 501 (b)(1)(B) of *FIRREA* 1989.

[564] Section 501 (b)(3)(A) of *FIRREA* 1989.

[565] Section 501 (b) (1) (C) of *FIRREA* 1989.

[566] The Resolution Funding Corporation (RFC) was established by section 511 (b) of *FIRREA* 1989.

[567] According to Josel, the overarching purpose for the establishment of the RFC was to provide the RTC with funds to pay depositors of failed thrifts. See Josel (1991) *Fordham Law Review* S344.

[568] In terms of *FIRREA* 1989, the term 'savings association' means a savings association as defined in section 3 of the *FDIC Act* 1950, the deposits of which are insured by the Corporation. The *FDIC Act* 1950 defined savings associations in section 3(b) as any federal savings association, any State savings association and any corporation (other than a bank) that the Board of Directors and the Director of the Office of Thrift Supervision jointly determine to be operating in substantiality the same manner as a savings association. Section 205 (2) of *FIRREA* 1989 provided that each savings association the accounts of which were insured by the Federal Savings and Loan Insurance Corporation on the day before the date of the enactment of the *FIRREA* 1989 was to be an insured depository institution without application or approval.

[569] Section 210 (B) of *FIRREA* 1989 gave the board of directors of FDIC the power to appoint examiners and claim agents to examine, on behalf of the Corporation, any savings associations, State non-member bank or State branch of a foreign bank, or other depository institution which had filed an application with the Corporation to become an insured depository institution.

savings associations from engaging in certain activities;[570] and take enforcement actions against savings associations.[571]

The enactment of the FIRREA increased the size of the FDIC's board of directors from three members to five members.[572] Previously, as provided for in the 1933 Act,[573] the 1935 Act[574] as well as the FDIC Act 1950,[575] the FDIC's board of directors consisted of only three members. The FIRREA altered this position by providing for five board members namely: the Comptroller of the Currency; the Director of the Office of Thrift and Supervision; and three US citizens who were appointed by the President with the advice and consent of the Senate.[576]

The FIRREA also expanded the statutory restriction prohibiting the FDIC's board members from serving as officers or directors of any insured bank as well as of a federal reserve bank and barring them from making investments in the stock of any insured bank to bar service as directors or officers of any insured depository institution, depository institution holding company including savings associations and their holding companies, or federal home loan bank.[577]

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570 Section 222 of *FIRREA* 1989 prohibited the savings association from engaging as principal in any type of activity, or in any activity in an amount that was not permissible for a Federal savings association unless the Corporation has determined that the activity would not pose any significant risk to the affected deposit insurance fund and the savings association was and continued to be in compliance with the fully phased-in capital standards prescribed under section 5(t) of the *Home Owners' Loan Act*.
571 Section 902 of *FIRREA* 1989 gave FDIC the authority to issue which required an insured depository institution or any institution-affiliated party to take affirmative action to correct any conditions resulting from any violation or practice with respect to which such order was issued including the power to require such depository institution or such party to reimburse, indemnify or give a guarantee against loss if such depository institution or such party was unjustly enriched in connection with such violation or practice or where the violation or practice involved a reckless disregard for the law or any applicable regulations or prior order of the appropriate Federal banking agency.
572 Section 203 (a) of FIRREA 1989 stipulated that the management of the Corporation would be vested in a board of directors consisting of five members, one of whom would be the Comptroller of the Currency, another would be the Director of the office of Thrift Supervision and three would be appointed by the President with the advice and consent of the Senate.
573 Para 3.2.1.
574 Para 3.2.2.
575 Para 3.2.3.
576 Section 203 (a) of *FIRREA* 1989.
577 Section 203 (e) (2) of *FIRREA* 1989. See also Gail & Norton (1990) 1111.

The enactment of the FIRREA further introduced the provision that non-depositor creditors of a failed institution should share proportionately with the FDIC in the proceeds of the liquidation of an insured institution.[578] In other words, whenever the status of any savings association as a depository institution was terminated by virtue of any provision of section 8 of the FDIC Act 1950[579] and a receiver or other legal custodian was appointed for the purpose of liquidation or winding up the affairs of such savings association, or whenever the FDIC determined that any savings association had to go into liquidation, the FIRREA allowed the FDIC to pay in cash to such institution its pro rata share of the secondary reserve[580] upon the terms and conditions prescribed by the FDIC.[581]

With regard to insuring the deposits of savings associations and banks, the FIRREA created two separate insurance funds: the Bank Insurance Fund[582] and the Savings Association Insurance Fund[583] which replaced the abolished Federal Loan and Savings Insurance Fund. Both funds were maintained and administered by the FDIC separately[584] without being commingled and were utilized by the FDIC to carry out its insurance purposes.[585] To help recapitalize the deposit insurance funds, Helmer indicates that billions of taxpayer dollars were injected to restore the health of the deposit insurance

[578] Section 208 (5) (A), (B) & (C) of *FIRREA* 1989. See also FDIC *Annual Report of the Federal Deposit Insurance Corporation* for the year 1989 (hereinafter FDIC Annual Report 1989) 31.
[579] Section 8 of the *FDIC Act* 1950 allowed for the termination of the insured status of the bank whenever the Board of Directors has found that such insured bank or its directors or trustees have continued unsafe or unsound practices in conducting the business of such bank or had knowingly or negligently permitted any of its officers or agents to violated any provision of any law or regulation to which the insured bank was subject.
[580] Secondary reserves can be defined as non-cash, liquid assets which a bank can easily turn into cash at little risk of loss of value and minimal delay. See Onyiriuba *Bank Risk Management in Developing Economies: Addressing the Unique Challenges of Domestic Banks* (2016) 301.
[581] Section 208 (5)(A), (B) & (C) of *FIRREA* 1989.
[582] The Bank Insurance Fund was established under section 211 (5)(A) of *FIRREA* 1989.
[583] Established under section 211 (6)(A) of FIRREA 1989, the Savings Association Insurance Fund replaced the Federal Savings and Loan Corporation after its abolishment. See also Gail & Norton (1990) *The Business Lawyer* 1114.
[584] The Bank Insurance Fund was used with respect to Bank Insurance Fund members while the Savings Association Insurance Fund was used with respect Savings Association Insurance Fund members.
[585] Section 211 (6)(A), (B) & (C) of *FIRREA* 1989.

funds.[586] The FIRREA further designated the reserve ratio[587] for both the Bank Insurance Fund and the Savings Association Insurance Fund at 1.25% of insured accounts.[588]

The most important provisions of the FIRREA regarding deposit insurance funds were the cross-guarantee provisions[589] it introduced. These cross-guarantee provisions were intended to protect the deposit insurance funds (Bank Insurance Fund and Savings Association Insurance Fund) by creating liability for insured depository institutions in respect of losses incurred by the FDIC in connection with either the default[590] of a commonly controlled insured depository institution[591] or any assistance provided by the Corporation to any commonly controlled depository institution in danger of default.[592] In

[586] Helmer (1995) *Valparaiso University Law Review* 238.
[587] Section 214 (6) of *FIRREA* 1989 provides that the term reserve ratio with respect to Bank Insurance Fund (BIF) means the ratio of the net worth of the Bank Insurance Fund to the value of the aggregate estimated insured deposits held in all BIF members. Section 214 (7) of *FIRREA* on the other hand provides that the Savings Association reserve ratio means the ratio of the value of the net worth of the Savings Association Insurance Fund to the value of the aggregate estimated insured deposits held in all Savings Association Insurance Fund members.
[588] Section 208 of *FIRREA* 1989 required the Corporation to fix the annual assessment rate of BIF members independently from the annual assessment rate for SAIF members at the designated reserve ratio of 1.25 percent of estimated insured deposits or at such higher percentage of estimated insured deposits, not exceeding 1.50 percent, as the board of directors may determine for that year to be justified by circumstances that raised significant risks or substantial future losses to the BIF.
[589] The Cross-guarantee provisions of *FIRREA* 1989 allowed the FDIC to charge off any expected losses relating to the failure of one subsidiary bank of a multi-bank holding company to the capital of a related subsidiary bank. The FDIC exercised this authority for the first in October 1992 when the lead banks of First City Bancorporation were declared insolvent. The insurer expected losses of $500 million and the other 18 subsidiaries only held less than $300 million in primary capital, as a result, these other banks also failed. See Adam "Are Banks really special? New Evidence from the FDIC-induced failure of healthy banks" 2003 *Staff Report No 176 Federal Reserve Bank of New York* 3.
[590] The term 'default' refers, with respect to an insured depository institution, any adjudication or other official determination by any court of competent jurisdiction, the appropriate Federal banking agency, or other public authority pursuant to which a conservator, receiver, or other legal custodian is appointed for an insured depository institution, or, in the case of a foreign bank having an insured branch, for such branch.
[591] The term 'commonly controlled' is defined in terms of section 1815 of the *Bank Holding Company Act* 1956 as an institution, in the case of a depository institution, that is controlled by another depository institution.
[592] An institution is in danger of default if, in the case of an insured depository institution, or in the case of a foreign bank having an insured branch, with respect to such insured branch, the appropriate Federal banking agency or State chartering authority has advised the Corporation that in its opinion, the depository institution or insured branch was not likely to be able to meet the demands of the institution's or the insured branch's depositors or pay its obligations in the normal course of business; and there was no reasonable prospect that the depository institution or insured branch would be able to meet such demands or pay such obligations without Federal assistance. Section 203 (e)(1)(A) *of FIRREA* 1989 provided that any insured depository institution would be liable for any loss incurred by the Corporation, or any loss which the Corporation reasonably anticipated incurring, in connection with the default of a commonly controlled

this regard, the insured depository institution concerned was expected to pay the amount of liability to the FDIC upon receiving a written notice by the FDIC.[593] The cross-guarantee provision was inserted as part of the initiative to augment the FDIC's insurance funds.[594] Helmer points out that since a deposit insurance system cannot function without adequate funds to pay the claims of the depositors of failed financial institutions, the US Government designed the cross-guarantee provision to provide an alternative means of procuring the much needed funds.[595]

The cornerstone of the FIRREA's regulatory reforms was the imposition of higher minimum capital standards for savings associations.[596] In particular, the FIRREA authorized the Director of the Office of Thrift Supervision[597] (the Director) to establish, on a case-by-case, the minimum level of capital for a savings association at such amount or at such ratio of capital-to-assets as the Director determined to be necessary or appropriate for such association in light of the particular circumstances of the association.[598] These minimum regulatory capital requirements required savings associations to maintain adequate capital in accordance with three standards namely: a risk-based capital standard;[599] a leverage standard;[600] and a tangible capital standard.[601]

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insured depository institution or any assistance provided by the Corporation to any commonly controlled insured depository institution in danger of default.

593 Section 203 (e)(1)(B) of *FIRREA* 1989.

594 Helmer (1995) *Valparaiso University Law Review* 238.

595 *Ibid.*

596 Section 301(5)(s) of *FIRREA* 1989.

597 Established in terms of section 301 (3)(a) of *FIRREA* 1989, the Office of Thrift Supervision was an office in the Department of the US Treasury.

598 Section 301 (5)(s)(2) of *FIRREA* 1989.

599 The risk-based capital requirement of savings associations were, according to section 304 (2)(C) of *FIRREA* 1989, to deviate from the risk-based capital standards applicable to national banks to reflect interest-rate risk or other risks, but such deviations were to never, in the aggregate, result in materially lower levels of capital requirement than would be required under risk-based standards applicable to national banks. According to Clark *et al*, the risk-based capital requirements were intended to increase the level of required capital in proportion with the level of risk associated with an association's assets and off-balance sheet items. See Clark *et al* (1990) *The Business Lawyer* 1036

600 In terms of section 304 (2)(A) of *FIRREA* 1989, the leverage limit required savings and associations to maintain core capital in an amount not less than 3 per cent of the savings associations' total assets.

601 Section 304 (2)(B) of *FIRREA* 1989, on the other hand, required savings associations to maintain tangible capital in an amount not less than 1.5 per cent of the savings associations' total assets.

The FIRREA further empowered the Director to treat the failure of any savings association to maintain the minimum capital level required as an unsafe or unsound practice.[602] In such a case, the Director had a discretion to issue out a directive requiring any such savings association to submit and adhere to a plan for increasing capital which would be acceptable to the Director.[603] The required capital plan was expected to provide a detailed explanation of the association's proposed strategy for achieving compliance with the minimum capital standards as well as the types and levels of activities in which the savings association would engage.[604] Failure to comply with the requirements to submit the capital plan was to be treated as an unsafe and unsound practice by a savings association.[605]

The FIRREA also authorized the FDIC to temporarily suspend the deposit insurance of a depository institution, upon finding out that the institution had insufficient tangible capital, as an ancillary proceeding to terminate deposit insurance after consultation with the appropriate federal banking agency.[606] The FIRREA further allowed the FDIC to issue a temporary order suspending deposit insurance on all deposits received by a special supervisory association[607] if, after making a determination, the FDIC's board of directors decided that:[608]

a) the capital of such association, as computed using applicable standards, had materially declined;

b) such association was engaging in an unsafe or unsound practice in conducting the business of the association;

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602 Section 301 (5)(s)(2) of *FIRREA* 1989.
603 *Ibid*.
604 Section 301 (6)(A)(ii) of *FIRREA* 1989.
605 Section 301 (6)(E) of *FIRREA* 1989
606 Section 926 (A) of *FIRREA* 1989. See also Gail & Norton (1990) *The Business Lawyer* 1117.
607 In terms of section 926 (B)(i) of *FIRREA* 1989, any savings association which would otherwise be subject to suspension order but for the consideration given goodwill was to be deemed a special supervisory association. According to Taylor, "savings associations which have no tangible capital, but which have goodwill, were to be considered 'special supervisory associations' for temporary-suspension-of-insurance purposes." See Taylor (1991) *Fordham Law Review* S404.
608 Section 926 (B)(ii) of *FIRREA* 1989.

c) such association was in an unsafe or unsound condition to continue operating as an insured association; or

d) such association had violated any applicable law, rule, regulation or order, or any condition imposed in writing by a Federal banking agency, or any written agreement including a capital improvement plan entered into with any Federal banking agency.

In addition to that, the FIRREA increased the amount of borrowings from the US Treasury, subject to the approval of the Secretary of the US Treasury, from $3 000 000 000 authorized by the FDIC Act to $5 000 000 000.[609]

The FIRREA thus significantly altered the structure and powers of the FDIC and its related adjuncts and granted it expansive powers to restructure troubled financial institutions as well as to dispose of their assets.[610] However, the FIRREA left a number of problems unresolved such as creating two deposit insurance funds which would, according to the FDIC, lead to destabilizing effects if one fund required premiums while the other did not,[611] thereby requiring the US Government to embark on further deposit insurance reforms.[612] [It would be helpful to explain why two deposit insurance funds would lead to destabilizing effects.] To address these unresolved problems, the *Federal Deposit Insurance Corporation Improvement Act*, as discussed below, was enacted in 1991.

3.2.5 The Federal Deposit Insurance Corporation Improvement Act 1991

The most immediate effect of the *Federal Deposit Insurance Corporation Improvement Act* of 1991 (FDICIA) was to buttress the existing deposit insurance system.[613] First and

[609] See para 3.2.3.
[610] Gail & Norton (1990) *The Business Lawyer* 1226.
[611] Federal Deposit Insurance Corporation (FDIC) *Keeping the Promise: Recommendations for Deposit Insurance Reform* (2001) 1.
[612] Hefferman *Modern Banking: The Wiley Finance Series* (2005) 370.
[613] *Annual Report of the Federal Deposit Insurance Corporation* for the year 1991 (hereinafter FDIC *Annual Report* 1991).

foremost, the FDICIA established a system of prompt corrective action[614] with the purpose of resolving the problems of insured depository institutions at the least cost[615] to the deposit insurance fund.[616] For the first time in the history of federal deposit insurance system, the FDICIA authorized the FDIC to charge higher deposit insurance premiums to banks that exposed the Bank Insurance Fund to greater risks.[617] These risk-based[618] deposit insurance premiums were designed to create an incentive for banks to monitor their risks profiles in order to improve their banking conditions.[619] The FDICIA also prohibited the FDIC from charging deposit insurance premiums to banks in the lowest risk category if the Deposit Insurance Fund reserves exceeded the 1.25 percent designated reserve ratio.[620]

The FDIC was expected to obtain private reinsurance covering not more than 10 percent of any loss the FDIC had incurred with respect to an insured depository institution and to base that institution's semiannual assessment on the cost of the reinsurance.[621] In order to be able to carry out these assessments, the FDICIA classified insured depository institutions into five categories according to the adequacy of their capital, namely:[622] well-

[614] Section 131 (a) of the *Federal Deposit Insurance Corporation Improvement Act* 1991 (hereinafter *FDICIA* 1991).
[615] The least cost provisions of the *FDICIA* require the FDIC to resolve failed banks with the least expensive method. See section 38 (1) of *FDICIA* 1991. See also Bank Insurance Fund (BIF) *1992 Bank Resolutions: FDIC Chose Methods Determined Least Costly But Needs to Improve* (1994) Report to the Congressional Committee GAO/GGD-94-107.
[616] In terms of the *FDICIA* 1991, the term 'deposit insurance fund' means the Bank Insurance Fund or the Savings Association Insurance Fund, as appropriate.
[617] Section 302 (b)(1)(A) of the *FDICIA* 1991 authorized the FDIC's Board of Directors to establish a risk-based assessment system for insured depository institutions.
[618] Section 302 (C) defined the risk-based assessment as a system for calculating a depository institution's semi-annual assessment based on the probability that the deposit insurance fund will incur loss with respect to the institution, taking into consideration the risks attributable to, inter alia: different categories and concentrations of assets; different categories and concentrations of liabilities, both insured and uninsured, contingent and non-contingent as well as any other factors the FDIC determines are relevant to assessing such probability.
[619] Cebula "An exploratory empirical analysis of the impact of the Federal Deposit Insurance Corporation Improvement Act of 1991 on bank failures in the United States" 1997 *Applied Financial Economics* 697.
[620] Section 302 (a)(2)(iv) of the *FDICIA* 1991 defined the designated reserve ration as 1.25 per cent of estimated insured deposits or a higher percentage of estimated insured deposits that the FDIC's board of directors determined to be justified for that year by circumstances raising a significant risk of substantial future losses to the fund. See JR Brown *Public Insurance and Private Markets* (2010) 27.
[621] Section 302 (b)(1)(B) of the *FDICIA* 1991.
[622] Carnell "A partial antidote to preserve incentives: The FDIC Improvement Act of 1991" 1993 *Annual Review of Banking Law* 327.

capitalized;[623] adequately capitalized;[624] under-capitalized;[625] significantly undercapitalized;[626] and critically undercapitalized.[627] An institution that fell below the minimum capital standards faced progressively more stringent regulatory restrictions and requirements.[628] As part of the FDICIA's prompt corrective action measures, any insured depository institution that was classified as 'undercapitalized' was required to submit an acceptable capital restoration plan[629] to the appropriate Federal banking agency[630] within the time allowed by the agency.[631]

In general, the capital restoration plan was expected to clearly specify, inter alia: the steps that an undercapitalized insured depository institution would take to become adequately capitalized; the levels of capital it hoped to attain during the year it put its plan in effect; how the institution would to comply with the restrictions or requirements of the FDICIA; the types and levels of activities in which it would engage; and any other information which federal banking authority required.[632] The requirement to submit a capital restoration plan

[623] The *FDICIA* 1991 provided that an insured depository institution was 'well-capitalized' if it significantly exceeded the required minimum level for each relevant capital measure.
[624] An adequately capitalized institution was defined by the *FDICIA* 1991 as an insured depository institution that failed to meet the required minimum level for each capital measure.
[625] According to the definitions section of the *FDICIA* 1991, an insured depository institution was undercapitalized if it failed to meet the required level for any relevant capital measure.
[626] An insured depository institution was described as significantly undercapitalized by the *FDICIA* 1991 if it was significantly below the required minimum level for any relevant capital measure.
[627] An insured depository institution was, in terms the *FDICIA* 1991, 'critically undercapitalized' if it failed to meet any level specified under subsection (c)(3)(A).
[628] According to Aggarwal & Jacques, if a bank fell below the minimum capital requirements, mandatory restrictions were placed on its activities that became increasingly severe as the bank's capital ratios deteriorated. For instance, undercapitalised banks were subject to restrictions that included the need to submit and implement a capital restoration plan in terms of section 38 of the FDICIA 1991, limits on asset growth as well as restrictions on new lines of business. See Aggarwal & Jacques "Assessing the Impact of Prompt Corrective Action on Bank Capital and Risk" 1998 *FRBNY Economic Policy Review* 24. See also Carnell (1993) *Annual Review of Banking Law* 327.
[629] Section 38 of the *FDICIA* 1991 defined the capital restoration plan as a plan submitted under subsection (e) (2).
[630] The appropriate Federal banking agency referred to here is the Comptroller of the Currency in the case of national banks, the Federal Reserve Board in the case of State bank that were members of the Federal Reserve System, the FDIC in the case of State banks that were not members of the Federal Reserve and the Director of the Office of Thrift Supervision in the case of thrift institutions.
[631] Section 131 (e)(2)(A) of the *FDICIA* 1991.
[632] Section 131 (e)(2)(B) of the *FDICIA* 1991.

was, to some extent, analogous to the rules for undercapitalized savings associations in the FIRREA.[633]

Predominantly, through the FDICIA, the US Congress sought to encourage the federal banking agencies to facilitate early resolution of troubled insured depository institutions whenever feasible if such early resolution would have the least possible long-term cost to the deposit insurance fund, consistent with the least-cost and prompt corrective action provisions of section 13 (c) of the *FDIC Act*.[634]

In addition to that, the FDICIA increased the $5 000 000 000 limit on borrowings from the US Treasury to $30 000 000 000.[635] This meant that the FDIC could now borrow $30 000 000 000 from the US Treasury to cover losses in the Bank Insurance Fund.[636] However, before the amount borrowed could be granted by the Secretary of the Treasury, there had to be an agreement in place between the Secretary and the FDIC providing for a schedule for the repayment of the outstanding amount of any borrowing.[637] The schedule also had to demonstrate that the income to the FDIC from assessments was sufficient to amortize the outstanding balance within the period established in the repayment schedule.[638]

Although the FDICIA has been hailed for being the most important banking legislation since the 1933 Act,[639] it did not take long after its establishment before Congress commenced with talks about reforming federal deposit insurance. In this regard, the FDIC issued a policy document in August 2000 with the title '*Deposit Insurance Options Paper'* (the Options Paper)[640] which sought to encourage public dialogue on possible reforms in the deposit insurance system.[641] According to the *Options Paper*, the FDIC had, over the

633 See para 3.2.4. See also Carnell (1993) *Annual Review of Banking Law* 338.
634 As indicated in para 3.2.3, the FDIC Act 1950 limited the FDIC's assistance to not more than the assistance it determined reasonably necessary to save the cost of liquidation and institution unless the continued operation of the institution was essential to provide adequate banking services. See also Gail & Norton "The Financial Institutions Reform, Recovery and Enforcement Act of 1989: Dealing with the Regulators" 1990 *Banking Law Journal* 206.
635 Section 101 of the *FDICIA* 1991.
636 FDIC *Annual Report* (1991) 2.
637 Section 103 (1)(A) & (B) of the *FDICIA* 1991.
638 Section 103 (1)(A) & (B) of the *FDICIA* 1991.
639 Benston & Kaufman "FDICIA after five years" 1997 *Journal of Economic Perspectives* 140.
640 Federal Deposit Insurance Corporation (FDIC) *Deposit Insurance Options Paper* (2000) Washington DC.
641 Kaufman "FDIC Reform: Don't Put Taxpayers Back at Risk" 2002 *Policy Analysis Paper* 1.

decade, stated its desire to merge the two insurance funds administered by the FDIC: the Bank Insurance Fund and the Savings Association Insurance Fund.[642] In FDIC's view, a combined fund would be stronger and more efficient.[643]

Following the policy document, the FDIC issued another proposal in the form of a policy document titled '*Keeping the Promise: Recommendations for Deposit Insurance Reforms*' (the Recommendations Paper)[644] which presented the FDIC's recommended changes to the deposit insurance system.[645] In particular, the *Recommendations Paper* recommended the merging of the Bank Insurance Fund and the Savings Association Insurance Fund to prevent the destabilizing effects that would result if one fund required premiums while the other did not.[646] The *Recommendations Paper* further suggested that the statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions be eliminated.[647] Additionally, the coverage level should be indexed to keep pace with inflation and the sharp premium swings inherent in the deposit insurance system should be eliminated.[648] The result of these documents was the enactment of the *Federal Deposit Insurance Reform Act* 2005 (FDIRA) in 2006.

3.2.6 The Federal Deposit Insurance Reform Act 2005

As observed, the enactment of the FDICIA effectively changed the US deposit insurance system into a privately funded, albeit still a mandatory and government managed system.[649] This system worked reasonably well to preserve the safety and soundness of the banking system as well as to protect taxpayers from funding losses to the FDIC

[642] FDIC *Deposit Insurance Policy Options Paper* (2000) 2.
[643] *Ibid.*
[644] Federal Deposit Insurance Corporation (FDIC) *Keeping the Promise: Recommendations for Deposit Insurance Reform* Washington, April 2001.
[645] Kaufman (2002) *Policy Analysis Paper* 2.
[646] FDIC *Keeping the Promise* (2001) 1.
[647] *Ibid.*
[648] The Recommendations Paper suggested, instead, that if the fund fell below a target level, premiums were to increase gradually and that if it grew above target level, funds were to be rebated gradually. See FDIC *Keeping the Promise* (2001) 1.
[649] Kaufman (2002) *Policy Analysis Paper* 1.

Fund.[650] However, in the early 2000s, the US Congress further sought to reform the US federal deposit insurance system which led to the enactment of the Federal Deposit Insurance Reform Act 2005 (FDIRA).[651]

The FDIRA merged the two deposit insurance Funds, the Bank Insurance Fund and the Savings Association Insurance Fund created under FIRREA 1989[652] into a Deposit Insurance Fund.[653] To give effect to the merger, all assets and liabilities of the Bank Insurance Fund and the Savings Association Insurance Fund were transferred to the Deposit Insurance Fund.[654]

The FDIRA also increased the deposit insurance coverage for retail depositors from $40 000 to $100 000.[655] This increment was to be reconsidered by the FDIC's board of directors after each subsequent 5-year period to determine if it deemed the inflation adjustment to be appropriate and thereafter a new amount would be determined.[656] In making the determination to increase the deposit insurance coverage due to inflation, the FDIRA required the FDIC's board of directors and the National Credit Union Administration Board[657] to jointly consider:[658] the overall state of the Deposit Insurance Fund and the economic conditions affecting insured depository institutions; the potential problems affecting insured depository institutions; or whether the increase would cause the reserve ratio of the Fund to fall below 1.15 percent of estimated insured deposits.

The FDIRA further set the standards for the assessments of insured depository institutions.[659] In particular, the FDIRA required the FDIC's board of directors to set the assessments for insured depository institutions in such amounts as it may determine to

[650] Kaufman (2002) *Policy Analysis Paper* 1.
[651] Para 3.2.6.
[652] Section 211 (5) (A) and section 211(6) (A) of *FIRREA* 1989.
[653] Section 2102 (a)(1) of the *Federal Deposit Insurance Reform Act* 2005 (*FDIRA* 2005).
[654] Section 2102 (a)(2) of the *FDIRA* 2005.
[655] Section 2103 (a)(2) of the *FDIRA* 2005.
[656] Section 2103 (a)(2)(F)(i) of the *FDIRA* 2005.
[657] The National Credit Union Administration is an independent Government agency established under section 102 (a) of the *Federal Credit Union Act* to insure deposits at federally insured credit unions and whose administration is vested under the management of a National Credit Union Administration Board.
[658] Section 2103 (a)(2)(F)(v) of the *FDIRA* 2005.
[659] Section 2104 (a) of the *FDIRA* 2005.

be necessary or appropriate, taking into account:[660] the estimated operating expenses of the Deposit Insurance Fund; the estimated case resolution expenses and income of the Deposit Insurance Fund; the projected effects of the payment of assessments on the capital and earnings of insured depository institutions; the risk factors and other factors taken into account pursuant to the risk-based assessment system, including the requirement to maintain a risk-based system; and any other factors the FDIC's board of directors may determine to be appropriate.

Furthermore, the FDIRA replaced the fixed designated reserve ratio introduced by section 214(6) of the FIRREA with the reserve range.[661] Under the FIRREA, the FDIC was required to maintain the deposit insurance fund balance at a fixed designated reserve ratio of at least 1.25 percent of the estimated insured deposits.[662] The FDIRA changed this position to allow the FDIC's board of directors to designate the reserve ratio[663] applicable with respect to the Deposit Insurance Fund and to publish the reserve ratio so designated.[664] The reserve ratio designated by the FDIC's board of directors for any year was not to exceed 1.5 percent of estimated insured deposits and was not to be less than 1.15 percent of estimated insured deposits.[665] In designating a reserve ratio, the FDIC's board of directors was required, inter alia, to:[666] consider the risks of losses to the Deposit Insurance Fund, including historic experience and potential and estimated losses from insured depository institutions; consider the economic conditions generally affecting insured depository institutions so as to allow the designated reserve ratio to increase during more favorable economic conditions and to decrease during less favorable economic conditions; seek to prevent sharp swings in the assessment rates for insured

[660] Section 2104 (a)(A) and (B) of the *FDIRA* 2005.
[661] Section 2105 of the *FDIRA* 2005.
[662] Para 3.2.5.
[663] Section 2107(4)(b) of the *FDIRA* 2005 provided that "the term 'reserve ratio' when used with regard to the Deposit Insurance Fund other than in connection with a reference to the designated reserve ratio, means the ratio of the net worth of the Deposit Insurance Fund to the value of the aggregate estimated insured deposits."
[664] Section 2105 (a)(3)(A)(i) of the *FDIRA* 2005.
[665] Section 2105 (B) of the *FDIRA* 2005.
[666] Section 2105 (a)(3)(C) of the *FDIRA* 2005.

depository institutions; and take into account such factors as the board of directors may determine to be appropriate.

More importantly, whenever the FDIC projected that the reserve ratio of the Deposit Insurance Fund would, within 6 months of such determination, fall below the minimum amount specified for the designated reserve ratio, the FDIC was expected establish and implement a Deposit Insurance Fund restoration plan within 90 days.[667] The purpose of the 'Deposit Insurance Fund restoration plan' was to raise the ratio back up to 1.15 percent if it ever fell below that amount.[668] The required Deposit Insurance Fund restoration plan had to meet the specified requirements and would meet those specified requirements if the plan provided that the reserve ratio of the Fund would meet or exceed the minimum amount specified.[669]

In addition to that, the FDIRA amended section 7(b) (1) of the FDIC Act in relation to the assessments of premiums.[670] In this regard, the FDIRA provided that in order to determine the risk of losses at insured depository institutions and for purposes of determining the economic conditions generally affecting depository institutions, the FDIC was expected to collect, as appropriate as the FDIC may determiner, all information from all sources of the FDIC's board of directors.[671] These information included, inter alia: reports of condition; inspection reports; and other information from all Federal banking agencies; any information available from State bank supervisors, State insurance and securities regulators; the Securities and Exchange Commission, the Secretary of the US Treasury, the Commodity Futures Trading Commission, the Federal Trade Commission, any Federal reserve bank or Federal home loan bank, and other regulators of financial institutions, and any information available from credit rating entities, and other private economic or business analysts.[672]

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[667] Section 2108 (E)(i)(I) of the *FDIRA* 2005. See also Kim "The FDIC's Special Assessment: Basing Deposit Insurance on assets instead of deposits" 2010 *North Carolina Banking Institute* 382.
[668] Section 2108 (E)(i)(I) of the *FDIRA* 2005.
[669] Section 2108 (E)(ii) of the *FDIRA* 2005.
[670] Para 3.2.3.
[671] Section 2106 of the *FDIRA* 2005.
[672] *Ibid.*

In assessing the risk to the Deposit Insurance Fund with respect to any depository institution, the FDIC was expected to consult with Federal banking agencies.[673] In the case of depository institutions that were well capitalized and that were found to be well managed, such consultation concerning the assessment of the risk of loss posed by the institution was to be made on an aggregate basis.[674]

Although the FDIRA made a few commendable changes to the FDIC and the US deposit insurance system, the 2008 GFC nevertheless occurred, causing a sharp increase in the number of failures of FDIC-insured institutions and a significant depletion of the Deposit Insurance Fund.[675] In response to the effects of the GFC, in 2010, the US Government once again embarked on reforms to the US financial sector to make it more resilient.[676] The result was the enactment of the comprehensive *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.*

3.2.7 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Following the 2008 GFC, Congress promulgated the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank Act). The enactment of the Dodd-Frank Act is said to be the most significant and overarching reform to financial regulation in the US since the regulatory reform that occurred in the wake of the Great Depression of the 1930s.[677] In particular, Title III titled 'The transfer of power of the Comptroller or Currency, the Corporation, and the Board of Governors' of the Dodd-Frank Act addresses the *Federal Deposit Insurance Act*.[678]

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673 Section 2106 (I) of *FDIRA* 2005.
674 Section 2106 (II) of *FDIRA* 2005.
675 Federal Deposit Insurance Corporation (FDIC) *Crisis and response: an FDIC history 2008-2013* (2017) 151.
676 Garcia (2010) *Journal of Banking Regulation* 172.
677 Mason *et al* "Financial Supervision and Regulation in the US: Dodd-Frank Reform" 2018 *Study for the Committee on Economic and Monetary Affairs* 7.
678 CCH Attorney-Editor Staff *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 97.

First and foremost, the Dodd-Frank Act increased the deposit insurance amount from $100 000 to $250 000 for retail deposits other than retirements accounts.[679] This increase in deposit insurance applied retroactively to depositors in the six banks that failed between January 1, 2008, and October 3, 2008.[680] The Dodd-Frank Act also changed the provisions of the *Federal Deposit Insurance Act* relating to the composition of FDIC's board of directors.[681] In particular, the Director of the Office of Thrift Supervision[682] was abolished and replaced with the Director of the newly established Consumer Financial Protection Bureau (CFPB).[683]

The Dodd-Frank Act further changed the definition of the term "assessment base" to mean an amount equivalent to the average consolidated total assets of the insured depository institution during the assessment period, minus: the average tangible equity of the insured depository institution during the assessment period; and in the case of an insured depository institution that is a custodial bank[684] an amount that the FDIC determines necessary to establish assessments consistent with the definition under

[679] Section 335 (a)(1) of the *Dodd-Frank Act* 2010. This $250 000 increase in deposit insurance coverage was first effected by section 136(a) of the *Emergency Economic Stabilization Act* of 2008 which was passed and signed into law in October 2008 in response to the financial collapse of 2008 with the aim of authorizing the US Treasury the power to purchase up to $700 billion of questionable "toxic" mortgage-backed securities under the Troubled Assets Relief Program (TARP). However, the increase was temporary and lasted until December 2013. See *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 168. See also Burton *Intro to Financial Markets and Institutions* (2010) 418.

[680] Federal Deposit Insurance Corporation (FDIC): Division of Insurance and Research *FDIC Quarterly* (2009) 15.

[681] *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 166.

[682] The Office of Thrift Supervision (OTS) was established under *FIRREA* 1989 to replace the Federal Home Loan Bank Board (FHLBB) which was created in 1932 under the *Federal Home Loan Bank Act* 1932 to regulate all S & L [is 'S & L' defined?] that made long-term home mortgage loans and were members of the Federal Home Loan Bank System. See Cooper "The Office of the Thrift Supervision" (1991) *Fordham Law Review* S363.

[683] In order to improve consumer safeguards, the *Dodd-Frank Act* 2010 created the Consumer Financial Protection Bureau (CFPB), an independent bureau housed within and funded by the Federal Reserve. The Dodd-Frank Act requires that in the event of a vacancy being available in the office of the Comptroller of the Currency or the office of the Director of the CFPB, the acting Comptroller of the Currency or the acting Director of the CFPB, as the case may be, should be appointed as the member of the board of directors. See section 336 (a)(1) and (2) of the *Dodd-Frank Act* 2010. See also Noeth "Financial Regulation: A Primer on the Dodd-Frank Act" 2011 *Liber8 Economic Information Newsletter* 1.

[684] In terms of section 331 (b) of the *Dodd-Frank* 2010, a custodial bank is determined by the FDIC based on factors including the percentage of total revenues generated by custodial businesses and the level of assets under custody.

section 7(b)(1) of the *FDIC Act*.[685] More importantly, the Dodd-Frank changed the reserve ratio requirements to reflect the new assessment base.[686] In this regard the Dodd-Frank provides that the reserve ratio designated by the FDIC's board of directors for any year may not be less that 1.35 percent of the estimated insured deposits, or the comparable percentage of the new assessment base.[687]

In addition to the reforms the Dodd-Frank Act makes to the FDIC, Title II (the Orderly Liquidation Authority) of the Dodd-Frank Act establishes a mechanism for the orderly resolution of large failing institutions that threaten financial stability in the US.[688] Prior to the passage of the *Dodd-Frank Act*, the FDIC's powers were limited to federally insured banks and thrifts.[689] This lack of power to resolve the holding company of an insured depository institution or any other nonbank financial entity under the FDIC receivership served as a major source of instability during the 2008 GFC as the US regulators lacked the necessary tools to resolve these entities in an orderly manner.[690]

The overarching purpose for the establishment of the orderly liquidation authority,[691] is to allow for the liquidation of failing financial institutions that pose a significant risk to the financial stability in the US in a manner that limits such risk and reduces moral hazard.[692] The Dodd-Frank Act has, therefore, broadened the resolution powers of the FDIC with

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685 Para 3.2.3.
686 Section 334 of the *Dodd-Frank Act* 2010.
687 Section 333 (a) of the *Dodd-Frank Act* 2010.
688 Section 202 (a) of the Dodd-Frank Act 2010 provides for the commencement of the orderly liquidation process after the Secretary of the US Treasury has made a determination in terms of section 203 that a financial company is in default or in danger of default.
689 See para 3.2.4.
690 Baily, Klein & Schardin "The Impact of the Dodd-Frank Act on Financial Stability and Economic Growth" 2017 *The Russell Sage Foundation Journal of the Social Sciences* 24. See also *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 97.
691 Section 204 of the *Dodd-Frank Act* created the Orderly Liquidation Authority to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the US in a manner that mitigates such risk and reduces moral hazard. In this regard, section 203 authorises the FDIC and the Board of Governors, on their own initiative or at the request of the Secretary, to make a written recommendation in relation to whether the Secretary should appoint the FDIC as the receiver for a financial company. Thereafter, after a determination has been made, section 202 requires the Secretary to notify the FDIC and the covered financial company and if the board of directors (or the body performing similar functions) of the covered financial company acquiesces or consents to the appointment of the FDIC as receiver, the Secretary of the FDIC must then appoint the FDIC as receiver.
692 Section 204 (a) of the *Dodd-Frank Act* 2010. See Chapter 2, para 2.3.1 for a comprehensive discussion of moral hazard.

respect to financial institutions that are considered systemically relevant.[693] In this regard, the FDIC may be appointed as receiver if, upon the written recommendation, the Secretary of the Treasury in consultation with the President, makes a determination that the financial company is in default or in danger of default,[694] or the failure of the financial company and its resolution under applicable laws would have serious adverse effects on financial stability in the US and no viable private sector alternative is available to prevent the default of the financial company.[695]

The court may, confidentially, after giving notice to the covered financial company, make a determination whether the Treasury Secretary's determination that the covered financial company is in default or in danger of default, satisfies the definition of a financial company[696] under section 201(a) (11) and is not arbitrary or capricious.[697] If the court finds that the determination is not arbitrary or capricious, it must issue an order immediately authorizing the Secretary to appoint the FDIC as receiver.[698] However, if the court finds the determination to be arbitrary or capricious, the court has to immediately provide a written statement to the Treasury Secretary, for each reason supporting its determination and give the Treasury Secretary an immediate opportunity to amend and

[693] Section 803 of the *Dodd-Frank Act* 2010 defines systemically important or systemic importance as a situation where the failure of or a disruption to the functioning of a financial market utility or the conduct of a payment, clearing or settlement activity could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the US. See also Deslandes *et al* "Liquidation of banks: Towards an 'FDIC' for the Banking Union" 2019 *IPOL Economic Governance Support Unit* 3.

[694] In terms of section 203 (c) of the Dodd-Frank, a financial company is considered to be in default or in danger of default if: a case been or is likely to promptly commence with respect to the financial company under the Bankruptcy Code; the financial company has incurred or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or the financial company is, or is likely to be, unable to pay its obligations in the normal course of business.

[695] Section 203(b) of the *Dodd-Frank Act* 2010.

[696] A financial company is defined in section 201 of the *Dodd-Frank Act* as any company that is incorporated or organized under any provision of Federal Law or the laws of any state, a bank holding company as defined in section 2 (a) of the *Bank Holding Company Act* 1956, a nonbank financial company supervised by the board of governors or any company that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto.

[697] *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 102.

[698] Section 202 (a)(1)(A)(iv)(I) of the *Dodd-Frank Act* 2010.

refile the petition.[699] Failure by the court to give a determination within twenty four hours of receipt of such petition renders the petition granted by operation of the law (thus *ex lege*), giving the Treasury Secretary the power to appoint the FDIC as receiver, after which liquidation is commenced automatically and without further notice or action.[700]

As a receiver, the FDIC must consult with the primary regulatory agencies of the covered financial company[701] and its subsidiaries to ensure an orderly liquidation.[702] It must also consult with any subsidiaries other than covered subsidiaries[703] to coordinate the treatment of solvent subsidiaries and the separate resolution of insolvent subsidiaries under other governmental authority.[704] The FDIC must further make funds available to the receivership for the orderly liquidation of the covered financial company subject to conditions provided for in section 206 of the *Dodd-Frank Act*.[705] All funds provided have claims priority[706] and may include funds used for:[707]

(a) making loans to or purchasing the debt of the covered financial company or covered subsidiary;

(b) purchasing or guaranteeing against loss, the assets of the financial company or its subsidiary;

(c) assuming or guaranteeing the company's or subsidiary's third-party obligations;

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699 Section 202 (a)(1)(A)(iv)(II) of the *Dodd-Frank Act* 2010.
700 Section 202 (a)(1)(A)(v)(I)(II) & (III) of the *Dodd-Frank Act* 2010.
701 Section 201 of the Dodd-Frank Act 2010 defines a covered financial company as a financial company for which a determination has been made under section 203 (b) with the exclusion of an insured depository institution.
702 Section 204 (c)(1) of the *Dodd-Frank Act* 2010.
703 The term 'covered subsidiary' is defined in section 201 of the Dodd-Frank Act as a subsidiary of a covered financial company, other than: an insured depository institution; an insurance company; or a covered broker or dealer.
704 Section 204 (c)(3) of the *Dodd-Frank Act 2010*. See also *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 110.
705 Section 204 (d) of the *Dodd-Frank Act* 2010.
706 In 1993, the US Government amended the *FDIC Act* through the passing of the *Omnibus Budget Reconciliation Act* 1993 to establish a system of depositor preference in failed bank resolutions. Under this regime, set forth in section 11(d) (11) of the *FDIC Act*, the receiver of a failed bank distributes amounts realized from its liquidation to pay claims in order of priority. See FDIC *Rules and Regulations* (2013) Federal Register 56584.
707 Section 204 (d) of the *Dodd-Frank Act* 2010. See also *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 111.

(d) taking a lien on assets of the company or subsidiary, including a first priority lien on unencumbered assets to secure repayment of any transactions conducted under the provisions of the *Dodd-Frank Act*;

(e) selling or transferring all or any part of the acquired assets, liabilities or obligations of the company or its subsidiary; and

(f) making payments to similarly situated creditors.

Section 210 of the *Dodd-Frank Act* provides for the powers and duties of the FDIC as a receiver. In particular, the *Dodd-Frank Act* provides that the FDIC 'shall upon appointment as receiver for a covered financial company, succeed to all rights, titles, powers and privileges of the covered financial company and its assets, and of any stockholder, member, officer, or director of such company as well as title to the books, records, and assets of any previous receiver or other legal custodian of such covered financial company.'[708]

In addition, the FDIC may take over the assets of, and operate, the covered financial company with all the powers of the members or shareholders, the directors and the officers of the covered financial company, and conduct the business of the covered financial company;[709] collect all obligations and money owed to the covered financial company;[710] perform all functions of the covered financial company;[711] manage the assets and property of the covered financial company;[712] and provide by contract for assistance in fulfilling any function, activity, action or duty of the FDIC as receiver.[713]

According to the FDIC, the most appealing characteristic of receivership as provided for under the Dodd-Frank Act is the express prohibition of the use of taxpayers' funds in preventing the liquidation of any financial institution and the provision that no taxpayer shall bear the costs from the exercise of any authority under Title II (Orderly Liquidation

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[708] Section 210 (a)(1)(A)(i) and (ii) of the *Dodd-Frank Act* 2010.
[709] Section 210 (a)(1)(B)(i) of the *Dodd-Frank Act* 2010.
[710] Section 210 (a)(1)(B)(ii) of the *Dodd-Frank Act* 2010.
[711] Section 210 (a)(1)(B)(iii) of the *Dodd-Frank Act* 2010.
[712] Section 210 (a)(1)(B)(iv) of the *Dodd-Frank Act* 2010.
[713] Section 210 (a)(1)(B)(v) of the *Dodd-Frank Act* 2010.

Authority).[714] Thus, in effect ending bail-outs. In this regard, the Dodd-Frank Act establishes an Orderly Liquidation Fund[715] in the US Treasury Department as a separate fund which the FDIC must utilize to carry out its powers under Title II.[716] The Orderly Liquidation Fund is funded through the risk-based premiums that covered financial institutions pay to the FDIC and through other earnings from investments as well as through the repayments to the FDIC by covered financial institutions.[717]

In order for the funds in the Orderly Liquidation Fund to be made available to the FDIC, the covered financial institution to which the FDIC was appointed as receiver is required to develop an orderly liquidation plan that is acceptable to the Secretary of the US Treasury.[718] The orderly liquidation plan must clearly specify the intended use of funds, taking into consideration actions to avoid or mitigate potential adverse effects on low income, minority or underserved communities affected by the failure of the covered financial institution.[719]

To qualify for approval, the orderly liquidation plan should include an agreement between the Treasury Secretary and the FDIC.[720] Such agreement should contain a specific plan and schedule to achieve the repayment of the outstanding amount of any borrowing.[721] The plan should also demonstrate to the Treasury Secretary that income to the FDIC from the liquidated assets of the covered financial institution as well as the risk-based premiums charged by the Corporation will be enough to cover the outstanding balance within the period established in the repayment schedule.[722]

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[714] *Annual Report of the Federal Deposit Insurance Corporation* for the year 2010 (hereinafter FDIC *Annual Report* 2010).

[715] The *Dodd-Frank Act* 2010 provides for the OLF to serve as a back-up source of liquidity support that would only be available on a fully secured basis where private sector funding cannot be immediately obtained. See US Treasury *Orderly Liquidation Authority and Bankruptcy Reform* (2018) Report to the President of the United States Pursuant to the Presidential Memorandum Issued April 21, 2017 38.

[716] Section 210 (n)(1) of the *Dodd-Frank Act* 2010.

[717] Section 210 (n)(2) of the *Dodd-Frank Act* 2010.

[718] Section 210 (n)(9)(A) of the *Dodd-Frank Act* 2010.

[719] Section 210 (n)(9)(A) of the *Dodd-Frank Act* 2010.

[720] Section 210 (n)(9)(B) of the *Dodd-Frank Act* 2010.

[721] Section 210 (n)(9)(B) of the *Dodd-Frank Act* 2010.

[722] Section 210 (n)(9)(B) of the *Dodd-Frank Act* 2010.

Furthermore, as receiver, or in an anticipation to become receiver for a failing covered financial institution, the FDIC may organize a bridge financial company.[723] The term 'bridge financial company' is defined in section 201 (a) of the Dodd-Frank Act as a new financial company organized by the FDIC in accordance with section 210(b) which authorizes the FDIC to organize a bridge financial company for the purpose of resolving a covered financial company. Upon its creation, a bridge company may, with respect to the covered financial institution, assume liabilities (including liabilities associated with any trust or custody business of such covered institution, with the exception of liabilities that count as regulatory capital of such covered financial institution) as the FDIC may, in its discretion, deem appropriate.[724] The FDIC may also purchase assets, including assets associated with any trust or custody business of such covered financial institution as the FDIC may, in its discretion, deem appropriate.[725]

To fund the operations of the bridge bank, the FDIC may, in its discretion, cause capital stock or other securities to be issued and offered for sale.[726] Alternatively, the FDIC may make funds available in lieu of capital, subject to the orderly liquidation plan.[727] However, the organized bridge financial company may, with the permission of the FDIC, operate with or without capital or surplus.[728]

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[723] Section 210 (h)(1)(A) of the *Dodd-Frank Act* 2010. As its name suggests, a bridge bank [this has previously been defined] is designed to 'bridge' the gap between the failure of a bank and the time when the FDIC can implement a satisfactory resolution of a bank. In a bridge bank transaction, the FDIC itself acts temporarily as the acquirer, taking over the operations of a failing bank and maintaining banking services for the customers. According to McGuire, a bridge bank is designed to operate in a conservative manner, with the aim of preserving the franchise value of the failed bank and preparing the bank or parts of the bank for ultimate sale to a private acquirer. See McGuire "Simple tools to assist in the resolution of troubled banks" 2012 *The World Bank* 9. See also Federal Deposit Insurance Corporation (FDIC) *FDIC Banking Review* (2000) 15.
[724] Section 210 (h)(1)(B)(i) of the *Dodd-Frank Act* 2010.
[725] Section 210 (h)(1)(B)(ii) of the *Dodd-Frank Act* 2010.
[726] Section 210 (h)(2)(G)(iii) of the *Dodd-Frank Act* 2010. See also *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 141.
[727] Section 210 (h)(2)(G)(iv) of the *Dodd-Frank Act* 2010 provides that upon the organization of the bridge financial company, and thereafter as the FDIC may, in its discretion, determine to be necessary or advisable, the FDIC may make available to the bridge financial company, subject to the orderly liquidation plan, funds for the operation of the bridge company in lieu of capital.
[728] Section 210 (h)(2)(G)(i) of the *Dodd-Frank Act* 2010.

In specifying the receiver's rights and duties, the *Dodd-Frank Act* also establishes procedures for claims resolution and priority.[729] The *Dodd-Frank Act* commences by defining the priority of expenses and unsecured claims against the covered financial institution.[730] The FDIC is expected to classify claimants in such a manner that all claimants of a covered financial institution that are similarly situated are treated in the same manner ("no creditor worse off).[731] However, the FDIC may take an action contrary to this equal treatment proscription if the FDIC decides that such action is necessary to:[732] maximize the value of the assets of the covered financial institution; initiate and continue the operations essential to implementation of the receivership or any bridge financial company; maximize the present value return from the sale or other disposition of the assets of the covered financial institution; or minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial institution.

As a receiver, the FDIC has the discretion to pay creditor claims, subject to the availability of funds.[733] However, the discretion is subject to the receiver allowing and approving payments according to a final determination or determined by the final judgment of a

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[729] *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis* (2010) 122.
[730] Section 210 (b)(1) of the *Dodd-Frank Act* 2010 provides that unsecured claims against covered financial company or the FDIC as receiver for the covered financial institution that are proven to the satisfaction of the receiver shall have priority in the following manner:
Administrative expenses for the receiver;
Any amounts owed to the US;
Wage salaries, or commissions, including vacation, severance and sick leave;
Contributions owed to the employee benefit plans arising from the services rendered not later than 180 days;
Any other general or senior liability of the covered financial institution
Any obligation subordinated to general creditors; and
Any obligation to shareholders, members, general partners, limited partners or other persons with interest in the equity of the covered financial company.
[731] Section 210 (b)(4) of the *Dodd-Frank Act* 2010.This provision is similar to the Key Attributes' principle of "no creditor worse off than in liquidation" which stipulates that creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime. See FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2014) 11.
[732] If the FDIC orderly plan intends to treat any claimants or parties in a manner different from similarly situated claimants of the financial company, the intention must be clearly stated in the plan, with a full description of the facts and circumstances of this preference. See section 210 (b)(4)(A) of the *Dodd-Frank Act* 2010.
[733] Section 210 (a)(7)(A) of the *Dodd-Frank Act* 2010.

court.[734] The Dodd-Frank Act also leaves the discretion to the FDIC to decide whether or not to pay dividends on proven creditor claims.[735] Finally, the FDIC may prescribe rules to establish an interest rate for or to make payments of post-insolvency interest to creditors holding proven claims but no interest may be paid until the FDIC has satisfied the amount of all creditor claims.[736]

Although the *Dodd-Frank Act* has been largely successful in stabilizing the US financial sector, some writers believe it still needs to be fine-tuned.[737] To this effect, in April 2017, the President of the United States issued a memorandum directing the Secretary of the Treasury to examine the Orderly Liquidation Authority-resolution regime created by Title II of the *Dodd-Frank Act* and to propose recommendations for reform of the Orderly Liquidation regime as provided under Title II of the Dodd-Frank Act.[738] The Trump Administration also introduced the *Financial CHOICE Act* of 2017[739] with the aim of repealing the orderly liquidation regime in its entirety and replacing it with an amendment to the *Bankruptcy Code*, which in theory, would enable large complex financial institutions to fail safely in a bankruptcy process without using any taxpayers funds.[740]

In February 2018, the US Treasury issued a Report[741] with proposals for reform of the Orderly Liquidation regime. In contrast to the *Financial CHOICE Act*, the Report recommended retaining the orderly liquidation regime as an 'emergency tool for use under extraordinary circumstances'.[742] In particular, the Treasury recommended, inter

[734] Section 210 (a)(7)(A) of the *Dodd-Frank Act* 2010.
[735] Section 210 (a)(7)(C) of the *Dodd-Frank Act* 2010.
[736] Section 210 (a)(7)(A) of the *Dodd-Frank Ac* 2010 provides that the FDIC as receiver may, in its discretion, and to the extent that funds are available, pay creditor claims in such a manner and amounts as are authorised under the Act, which are permitted and approved by the receiver after the final determination of a court of competent jurisdiction.
[737] Baily, Klein & Schardin (2017) *The Russell Sage Foundation Journal of the Social Sciences* 43.
[738] US Treasurer *Orderly Liquidation Authority and Bankruptcy Reform* (2018) Report to the President of the United States -Pursuant to the Presidential Memorandum Issued April 21, 2017 1.
[739] The *Financial CHOICE Act* of 2017 has, however, not been passed as law yet.
[740] Maciuch "Backstop, not Bailout: The Case for preserving the Orderly Liquidation Authority under Dodd-Frank" 2018 *Brooklyn Journal of Corporate, Financial & Commercial Law* 269.
[741] US Treasurer *Orderly Liquidation Authority and Bankruptcy Reform* (2018) Report to the President of the United States -Pursuant to the Presidential Memorandum Issued April 21, 2017, hereinafter OLA Report (2018).
[742] OLA Report (2018) 2.

alia:[743] restricting FDIC's power to treat similarly situated creditors differently on an *ad hoc* basis; providing for the Bankruptcy Court to adjudicate claims against the receivership; clarifying of the standard for commencing a Title II proceeding; and strengthening the judicial review of the decision to invoke Orderly Liquidation Authority.

Against this background, it is possible that the US federal deposit insurance will soon be further reformed to accommodate the recommendations made by the Treasury concerning the orderly liquidation regime as contained in the Dodd-Frank Act.

3.3 Compliance of the US Legal Framework for deposit insurance with the IADI Core Principles

3.3.1 Core Principle 1: Public Policy objectives

From the above overview, it is clear that the EDIS in the US serves a public policy objective. This is apparent from the fact that the system was initially created in response to the dire financial effect of the Great Depression and its detrimental effect on depositors and particularly to avoid depositors losing confidence in the banking sector and causing financial instability through bank runs that lead to the collapse of banks. In fact, it appears that the US actively sought to augment its approach to deposit insurance in response to various other crises that followed such as the Thrift Crisis,[744] and more recently, the 2008 GFC.[745] At the core of its public policy objective lies of course the realization that deposit insurance is an integral part of the safety net that seeks to maintain financial stability as the core regulatory objective.[746] From the beginning, the US deposit insurance has sought

[743] OLA Report (2018) 4.
[744] As observed from above, the US government enacted the *Financial Institutions Reform, Recovery and Enforcement Act* 1989 as an attempt to address the events of the Thrift Crisis as well as to alter the way in which banks and savings associations were supervised and insured. See para 3.1.2.5.
[745] The 2008 GFC clearly revealed that the entire system of the US financial sector regulation and supervision was woefully inadequate to effectively curb the risks posed by the complexity of new financial products and markets. To address these inadequacies, the Dodd-Frank *Wall Street Reform and Consumer Protection Act* 2010 was designed to increase financial stability as well as to prevent future crises. See para 3.2.8.
[746] Chapter 2, para 2.1.

to protect the interests of depositors as well as to promote financial stability in the US and this has explicitly been specified in all the US deposit insurance legislation.

3.3.2 Core Principle 2: Mandates and Powers

From the abovementioned discussion, it is further clear that the FDIC operates a "risk-minimizer" mandate.[747] As such, the FDIC as a risk-minimizer deposit insurer, has comprehensive risk minimization functions including risk assessment/management, a full suite of early intervention and resolution powers.[748] This risk-minimizer mandate entails that the FDIC is also a designated resolution authority and is responsible for the receivership operations for all insured banks and savings institutions.[749] As pointed out, being a designated resolution authority, the FDIC's powers were recently extensively expanded with the enactment of the Dodd-Frank Act and also extended to the resolution of systemically important financial institutions (SIFIs).[750]

3.3.3 Core Principle 3: Governance

The above overview of the US deposit insurance system indicates that the FDIC has, from its inception, always been operationally independent and appropriately governed by a board of directors who were appointed to administer the affairs of the FDIC in an open and fair environment insulated from external interference.[751] The US deposit insurance legislation has always been clear as to who should be appointed in the Board and for how long. Initially, the governing Board had to consist of three members, one of which should

[747] The risk-minimizing DIS is one which has supervisory powers and is able to conduct and impose prudential measures, withdraw banking license related to bank resolution, execute the resolution process, conduct risk assessment in order to minimize risks for the system and for the DIS funds. See Ognjenovic *Deposit Insurance Schemes: Funding, Policy and Operational Challenges* (2017) 57. See also IADI *General Guidance on Early Detection and Timely Intervention for Deposit Insurance Systems* (2013) Prepared by the Research and Guidance Committee International Association of Deposit Insurers, Bank of International Settlements.
[748] See para 3.2.3.
[749] See para 3.2.4.
[750] See para 3.2.7.
[751] See para 3.2.1.

be the Comptroller of the Currency and two of whom had to be the citizens of the US appointed by the President with the advice and consent of the Senate.[752] This position changed with the enactment of the FIRREA in 1989 which increased the number from three to five.[753] Added to the Board was the Director of the Office of Thrift Supervision and one other person who had to be appointed by the President with the advice and consent of the Senate.[754] However, with the abolition of the Office of the Thrift Supervision by the DFA 2010, the Director of the Office of the Thrift had to be replaced by the director of the Consumer Financial Protection Bureau.[755] Apart from appointing the board of directors, the FDIC has, from its establishment been governed by legislation which sets out how the federal deposit insurance should be operating, clearly clarifying the roles and duties of the board of directors.[756]

3.3.4 Core Principle 4: Relationship with other safety-net participants

The FDIC has a productive working relationship with other financial safety net participants. This is apparent from the fact that the FDIC works closely with other banking agencies such as the Federal Reserve and the Office of the Comptroller of the Currency.[757] The FDIC also works closely with the Consumer Financial Protection Bureau whose CEO is a board member, to address consumer protection issues.[758] In this regard, whenever the FDIC identifies a problem that may lead to a financial distress in an institution, it is able to share this information with other federal banking agencies in order to be able to address the problem.

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[752] See para 3.2.1.
[753] Para 3.2.4.
[754] Para 3.2.4.
[755] Para 3.2.7.
[756] Para 3.2.1.
[757] The Comptroller of the Currency forms part of the FDIC board of directors and this position assists in the coordination and sharing of information between the FDIC and the Office of the Comptroller of the Currency. See paragraph 3.2.1.
[758] The Consumer Financial Protection Bureau also forms part of the FDIC board of directors. See para 3.2.7.

3.3.5 Core Principle 5: Cross-border issues

Prior to the promulgation of the *International Banking Act* of 1978 (IBA),[759] US banking offices of foreign banks were not subject to legislation or regulation at the federal level.[760] In essence, foreign bank branches were neither required by federal law to obtain, nor eligible under federal law to receive FDIC insurance.[761] However, the enactment of IBA amended the FDIC Act to allow the US branches of foreign banks to apply for deposit insurance.[762] In particular, the IBA makes it mandatory for foreign bank branches that accept retail deposits to obtain federal deposit insurance and makes FDIC insurance optional for foreign bank branches that do not accept retail deposits.[763]

In light of the above, it is clear that the FDIC appreciates the presence of foreign bank branches in the US and is willing to cooperate with foreign countries to solve cross border issues that may arise. In this regard, the FDIC has entered into multiple cooperation arrangements and cross-border resolution memoranda of understanding (MoU) with foreign authorities.[764] An integral part of these arrangements is that they provide for the exchange of information and the sharing of data and policies concerning coordination of cross-border resolution.[765]

3.3.6 Core Principle 6: FDIC's role in contingency planning and crisis management

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[759] The *International Banking Act* 1978 (IBA) is a landmark piece of legislation which, for the first time, established a framework for federal regulation of foreign activities in the US. The main aim of the Act was to give foreign banking institutions the same rights, duties and privileges as domestic banks while subjecting them to the same limitations, restrictions and conditions. See McMahon "The International Banking Act of 1978: Federal Regulation of foreign banks in the United States" 1978 *Georgia Journal of International and Comparative Law* 159. See also Segala "A Summary of the International Banking Act of 1978" 1979 *Federal Reserve of Richmond Economic Review* 16.

[760] Dugan *et al* "FDIC Insurance and Regulation of US branches of foreign banks" in *Regulation of foreign banks and affiliates in the United States* (2014) 607.

[761] Dugan *et al* (2014) *Regulation of foreign banks and affiliates in the United States* 607.

[762] Section 6 of the *International Banking Act* 1978.

[763] Segala (1979) *Federal Reserve of Richmond Economic Review* 20.

[764] IADI *Deposit Insurers' role in contingency planning and system-wide crisis preparedness and management* (2019) Guidance Paper (Consultation version) International Association of Deposit Insurers.

[765] IADI *Discussion Paper on Cross Border Deposit Insurance Issues raised by the Global Financial Crisis* (2011) Prepared by the IADI Research and Guidance Committee Subcommittee on cross border deposit insurance issues.

Evidence suggests that the US deposit insurance worked effectively from its establishment in 1933 until the 1970s when banks and thrifts started to fail, ultimately leading to the Thrift Crisis in the 1980s.[766] If this is anything to go by, then it is fair to state that the US deposit insurance system's contingency plans and crisis management were not well in place to prevent future crises. Following the Thrift Crisis, the US deposit insurance system developed goals and objectives to prioritize certain crisis readiness planning activities.[767] However, the 2008 GFC events unfolded more quickly and more severely than the FDIC's planning efforts had anticipated.[768] In light of this, it is submitted that the US deposit insurance system must continuously revise its crisis planning efforts in order to be able to remain well prepared with tools that will be able to prevent or mitigate the effects of future crises.

3.3.7 Core Principle 7: Membership

As seen from the above overview, the FDIC insures all banks and savings associations. When it was first permanently established, the FDIC's insurance membership was mandatory for all members of the Federal Reserve that met the FDIC's requirements for admission, which included adequate capitalization, reserve strength and financial stability.[769] This requirement was amended with the enactment of the 1935 Act to extend insurance membership to state-chartered banks that were not members of the Federal Reserve.[770] The enactment of the FIRREA in 1989 further extended deposit insurance to savings associations.[771] In the beginning, the FDIC's membership was only limited to banks registered in the US with the exclusion of foreign banks branches. However, as indicated,[772] the establishment of the International Banking Act 1978 saw the FDIC membership being extended to foreign banks branches which take retail deposits. The

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766 Para 3.2.4.
767 FDIC: Office of Inspector General *Top Management and Performance Challenges Facing the Federal Deposit Insurance Corporation* (2019) 16.
768 FDIC *Top Management and Performance Challenges Facing the Federal Deposit Insurance Corporation* (2019) 16.
769 Para 3.2.1.
770 Para 3.2.2.
771 Para 3.2.4.
772 Para 3.3.4.

US deposit insurance framework is in line with the IADI Core Principles' recommendation for compulsory membership.

3.3.8 Core Principle 8: Coverage

The US deposit insurance system's scope and level of coverage have considerably increased over time and no longer resemble its original intended purpose of covering small-scale depositors only. From the beginning, the US deposit insurance has been limited by statute and remains so even today. Initially, coverage was set at $2500 per retail depositor under the temporary plan created by the 1933 Act.[773] Currently the US deposit insurance system covers deposits up to $250 000 per retail depositor.[774] As indicated, the US deposit insurance coverage has undergone a number of reforms as a result of the different circumstances that the country has but the deposit insurance coverage is clearly in line with the public policy objectives that the FDIC serves.

3.3.9 Core Principle 9: Sources and uses of funds

As seen from the discussion above, the manner in which the US deposit insurance system funds itself has greatly evolved over the years from a relatively simple set of rules to a more sophisticated system where risk is explicitly considered in determining the appropriate size of the fund and the amount of premiums charged on banks.[775] As observed by Ellis, this evolution is a reflection of the experience the FDIC gained from past crises, its greater authority to manage the deposit insurance system and its better analysis of funding requirements.[776] From its inception, the FDIC has always had an explicit, ex-ante fund paid for by the banking industry to satisfy depositors' claims as they arose.[777]

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773 Para 3.2.1.
774 Para 3.2.7.
775 Ellis "Deposit Insurance funding: Assuring confidence" 2013 *FDIC Staff Paper* 2.
776 Ellis (2013) *FDIC Staff Paper* 2.
777 Ellis (2013) *FDIC Staff Paper* 3.

Initially, the US deposit insurance funds were raised from the sale of stock as entailed in section 12B of the 1933 Act as well as the 1935 Act.[778] Additional funds were and continue to be obtained through borrowing from the US Treasury in the amounts limited by statute.[779] Until 1991, the insured banks were charged flat rate premiums when the FDICIA in 1991 introduced a risk-based premium system which required banks to be charged premiums based on their risk profiles.[780] The FDIC also operated without a target fund size from its establishment through to 1989 when instituted, for the first time, a target fund size in the form of a Designated Reserve Ratio (DRR) equal to at least 1.25 percent of the estimated insured deposits.[781]

3.3.10 Core Principle 10: Public Awareness

Part of the FDIC's mission as a deposit insurer is to make sure that accurate information about the FDIC's rules for covering deposits is easily accessible to bankers and consumers.[782] As such, the FDIC promotes public awareness and understanding of deposit insurance rules and coverage through its industry and consumer awareness programs.[783] In cooperation with other federal regulatory agencies, the FDIC also ensures that depository institutions accurately disclose uninsured products.[784] The FDIC further apprises the depositors and financial institutions' staff about the rules relating to deposit insurance and the limits that apply to specific deposit accounts.[785]

3.3.11 Core Principle 11: Legal Protection

The US deposit insurance system has, since 1946, afforded legal protection to the staff of the FDIC against any legal liability arising as a result of an act or omission committed

[778] Para 3.2.1.
[779] Para 3.2.1.
[780] Para 3.2.5.
[781] Section 208 (4)(1)(B) of *FIRREA* 1989. See also Ellis (2013) *FDIC Staff Paper* 4.
[782] FDIC *Annual Report* (2017) 52.
[783] FDIC *Annual Performance Plan* (2019) 8.
[784] *Ibid*.
[785] *Ibid.*

in the course of their duties and responsibilities. The legal protection was further extended under section 806 of the *FIRREA* in 1989, which stipulated that in any case in which the conservator was a Federal agency or an employee of the Government, there would be no liability attached to the actions or omissions of the conservator performed during the course of their duties and responsibilities of the conservatorship.[786]

3.3.12 Core Principle 12: Dealing with Parties at fault in a bank failure

As observed, the US deposit insurance system has, since the enactment of the *FIRREA*, found ways to deal with parties who contributed, through their actions, to the demise of a financial institution.[787] At first, the FDIC was granted the power to have a director, officer or any person involved, suspended or prohibited from further participating in the affairs of the bank where such persons were found to have acted in dishonesty while conducting the business of the bank.[788]

3.3.13 Core Principle 13: Early detection and timely intervention

The US deposit insurance system's early detection and timely intervention powers go back to the early days of its establishment when the 1935 Act granted the FDIC the power to terminate the insurance of any insured bank which engaged in 'unsafe or unsound practices'.[789] These powers were expanded by the *FDIC Act* 1950 which authorized the FDIC to conduct special examinations on banks to determine insurance risks with the aim of enabling the FDIC to appraise the risk it facing in providing deposit insurance.[790]

In 1989, the enactment of the *FIRREA* strengthened these powers by allowing the FDIC to temporarily suspend deposit insurance of any bank whenever it found out that that institution operated without sufficient tangible capital.[791] In 1991, the *FDICIA* introduced

[786] Para 3.2.4.
[787] Para 3.2.4.
[788] Para 3.2.4.
[789] Para 3.2.2.
[790] Para 3.2.3.
[791] Para 3.2.4.

what is known as 'prompt corrective action' in an attempt to encourage the federal banking agencies to facilitate early resolution of troubled insured depository institutions.[792] Having full access to supervisory information and market information, the FDIC continues to utilize this information to build risk detection models, prepare summary and other analytical reports, and assign risk ratings to insured institutions that have the potential to affect both their assessment rates and supervisory actions.[793]

In light of the above, it is clear that the FDIC has made it its mission to keep improving its powers in relation to early detection and timely intervention. However, it appears bank failures and banking crises are inevitable even with the most credible EDIS like the US deposit insurance system and there is really no best way to avoid or prevent them from occurring. The only thing that can be done is find a way to minimize their impact when they do occur and the FDIC has indeed done its best in this regard.

3.3.14 Core Principle 14: Failure resolution

As indicated, one of the primary reasons for the establishment of the FDIC was to resolve failed US banks. In this regard, the Corporation has, from 1933, used different approaches to find the most effective ways of resolving failed depository institutions.[794] Accordingly, the US deposit insurance system's resolution process and tools have, over the years, gone through a series of changes brought by subsequent legislation. The overarching purpose for the establishment of the US deposit insurance as contained in the 1933 Act was to insure deposits and to resolve failing US banks.[795] Over the years, the US deposit insurance system has used several methods to resolve failed banks, among which the purchase and assumption transactions were,[796] open bank

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[792] Para 3.2.5.
[793] IADI *General Guidance on Early Detection and Timely Intervention for Deposit Insurance Systems* (2013) Prepared by the Research and Guidance Committee International Association of Deposit Insurers, Bank of International Settlements.
[794] See para 3.2.1.
[795] Para 3.2.1.
[796] Para 3.2.3.

assistance,[797] as well as bridge banks.[798] However, the US resolution planning process is continuously evolving, and efforts are being made to improve the US resolution framework.

3.3.15 Core Principle 15: Reimbursing depositors

From inception, the US deposit insurance system's mandate has always been the payment of deposit insurance as soon as possible to preserve depositors' confidence in the US banking sector. The 1933 Act specifically ordered the FDIC, in its capacity as receiver of failed bank, to organize a bank which would then facilitate the reimbursements of deposits.[799] Although the Act did not provide for the specific duration for the action of the FDIC through the new bank, it did provide that the FDIC must act promptly in this regard. To this day, the US deposit insurance system realizes the importance of paying insured deposits of a failed bank as soon as claims are proved and keeps working tirelessly [unless you have evidence in support of this assertion – namely, that the US deposit insurance system 'keeps working tirelessly' it would be better to delete this] towards the realization of this objective.

3.3.16 Core Principle 16: Recoveries

From as early as 1933, the US deposit insurance system's recovery process had clearly been specified in law. More specifically, the 1933 Act gave the power to the FDIC to make recoveries through subrogation.[800] Where the amount recovered through subrogation was insufficient, the deposit insurance account was charged a deficiency. As a receiver for failed banks, the FDIC stands first in line of priority claims for all expenses incurred during receivership.[801]

[797] Para 3.2.3.
[798] Para 3.2.1.
[799] See para 3.2.1.
[800] Para 3.2.1.
[801] Para 3.2.6.

3.4 Concluding Remarks

The above overview of the US deposit insurance system has traced the evolution of explicit deposit insurance system in the US during which developments, the FDIC, as the oldest deposit insurer globally, played a pivotal and very active role. Established in the midst of a banking crisis, the FDIC's purpose has always been to protect depositors, to reimburse insured deposits and to maintain the stability of the US financial system. Since its inception in 1933, the FDIC has managed to deter liquidity panics, forestall bank runs and avoid instability in the US economy.

The chapter also revealed that the US deposit insurance system has evolved significantly through a series of subsequent legislation. From its deposit insurance coverage, to membership and governance as well as the resolution processes and tools, the US deposit insurance system has immensely changed from when it was first established. The current model of the US deposit insurance system reflects a strong system that has gone through trials and challenges but has managed to grow through it all. It would be safe to conclude that the US deposit insurance is not only the oldest model but also the most advanced system in the world.

The above discussion further showed that the US deposit insurance system nevertheless has some flaws which have, in the past, contributed to several banking crises (particularly the Thrift Crisis and the 2008 GFC) as well as bank failures that mostly happened in the 1970s and 1980s. However, this could yield a lesson to countries which are still in the process of establishing their own system of EDIS to look at the US deposit insurance from its inception until today and determine what makes an effective EDIS.

Finally, the chapter revealed that the US deposit insurance has, long before the establishment of the IADI *Core Principles for effective deposit insurance systems,* possessed all the features recommended by the IADI Core Principles. Accordingly the IADI Core Principles appear to have largely been modelled on the US approach to deposit insurance.

Since its establishment in 1933, the FDIC has undergone several transformations to address the growing complexity of the US financial system as well as shifting political expectations and demands for public accountability.[802] In a series of learning experiences, which included high-profile failures, the US deposit insurance system has developed an intricate system of checks and balances to help reduce public costs and moral hazard, while maintaining predictability and credibility for deposit protection.[803] For this reason, it is submitted that the US deposit insurance system as an IADI Core Principle–compliant EDIS, can be used as a benchmark to provide guidance to countries wishing to establish explicit deposit insurance systems.

[802] Gelpern & Veron "US Experience and Considerations for EU Reform: Banking Union Scrutiny" (2019*)* *IPOL Economic Governance Support Unit* 6.
[803] Gelpern & Veron (2019) *IPOL Economic Governance Support Unit* 6.

CHAPTER FOUR

DEPOSIT INSURANCE IN AUSTRALIA

4.1 Introduction

In this Chapter, the framework for deposit insurance in Australia is considered. A brief overview of the framework for banking regulation in Australia is first provided in order to contextualize the discussion and analysis pertaining to deposit insurance that will follow. In particular, the evolution of deposit insurance is traced as it developed since the enactment of the Banking Act of 1945 through to the framework currently in place in Australia.

4.1.1 General overview of banking regulation and supervision in Australia

Banking regulation in Australia initially gained momentum under the functions exercised by the Commonwealth Bank of Australia, established in terms of the first *Commonwealth Bank Act of 1911*[804] *as* a publicly owned commercial and savings bank. The Commonwealth Bank gained prominence while providing war financing during the First World War and notes issue was subsequently transferred to the Bank in 1924.[805] The Commonwealth Bank also functioned as lender of last resort to Australian banks in limited instances since early in the twentieth century[806] and acquired various central banking functions over time.[807] Its functions in relation to the administration of monetary and banking policy, and exchange control were formalized by the Commonwealth *Bank Act of*

[804] Act 18 of 1911.

[805] Stevens "A brief history of the Reserve Bank of Australia" *Address to the Reserve Bank of Australia's 50th Anniversary Gala Dinner in Sydney* – BIS Review 27/2010 (8 February 2010). Available at http://www.bis.org/review/r100311b.pdf (accessed 20 September 2020) 1 (hereinafter Stevens (2010)); Reserve Bank of Australia (undated) http://www.rba.gov.au/about-rba/history. (Accessed 20 September 2020) 1 (hereinafter RBA history).

[806] Fitz-Gibbon and Gyzicki "A History of Last Resort Lending and Other Support for Troubled Financial Institutions in Australia" 2008 *RBA Research discussion Paper NO 2001-07* Available at http://www.rba.gov.au/PublicationsAndResearch/RDP/RDP2001-07.html. (Accessed 20 September 2020) 2.

[807] RBA history 1.

1945[808] and the *Banking Act, 1945.*[809] In terms of section 8 of the 1945 *Commonwealth Bank Act*, the objective of the Commonwealth Bank was 'to pursue a monetary and banking policy to the greatest advantage of the people of Australia, exercising its powers in such a manner as to contribute to the stability of the currency, the maintenance of full employment and the economic prosperity and welfare of the people of Australia.'

In terms of the bank regulation and supervision framework established by the 1945 Banking Act, banks had to apply to the Treasurer to carry on banking business and the Governor-General could then grant the bank such authority subject to conditions that were specified in the authority.[810] Banks were required to maintain a Special Account with the Commonwealth Bank[811] for purposes of maintaining reserve deposits and where the Commonwealth Bank was satisfied that it was necessary or expedient to do so in the public interest, it could determine the policy in relation to advances by banks.[812] Banks further had to furnish the Commonwealth Bank with specified balance sheets and statements as part of their supervisory compliance obligations.[813] The Auditor-General was tasked with the periodic investigation of the books, transactions and accounts of bank in respect of which a report was furnished to the Treasurer and Commonwealth Bank, subsequent to such investigation.[814] Banks were further required to furnish the Commonwealth Bank with any information in respect of their business that the Bank directed them to provide[815] and they could not enter into any amalgamation or reorganization without prior consent by the Treasurer.[816] Provision was also made for a penalty regime in respect of non-compliance with the provisions of the *Banking Act 1945*.[817]

[808] Commonwealth Bank Act 13 of 1945.
[809] Commonwealth Bank Act No. 13 of 1945 and Banking Act No. 14 of 1945.
[810] Section 8 of the Banking Act 1945.
[811] Section 16 to 22 of the Banking Act 1945.
[812] Section 27 of the Banking Act 1945.
[813] Section 40 of the Banking Act 1945.
[814] Section 49 of the Banking Act 1945.
[815] Section 50 of the Banking Act 1945.
[816] Section 51 of the Banking Act 1945.
[817] Such penalty regime provided for fines and offences. See for example section 20(4) that set out the penalty for failure to comply with the Special Account (reserve deposit) requirements of the Act and section 39(2) in relation to non-compliance with the interest rate provisions. Section 53 provided that where a bank was convicted of an offence under the Banking Act a court could, upon application by the Attorney-General,

The original body corporate of the Commonwealth Bank was later converted to the Reserve Bank of Australia (RBA) that was formally established as Australian central bank in terms of the *Reserve Bank Act 1959*. The objective of the RBA as central bank was similar to that captured previously in section 8 of the Commonwealth Bank Act.[818] The powers of the RBA, as set out in the Reserve Bank of Australia Act, included the following:[819] to receive money on deposit; to borrow money; to lend money; to buy, sell, discount and re-discount bills of exchange, promissory notes and treasury bills; to buy and sell securities issued by the Commonwealth as well as other securities; to buy, sell and otherwise deal in foreign currency, specie, gold and other precious metals; to establish credits and give guarantees; to issue bills and drafts and effect transfers of money; to underwrite loans; and to do anything incidental to any of its aforementioned powers.

The *Banking Act 1945* was superseded by the *Banking Act 1959,* which incorporated most of the provisions of the 1945 Act.[820] In fact, the *Banking Act 1959* was largely a verbatim re-enactment of the provisions of the Banking *Act 1945* as mentioned above. The *Banking Act 1959*, however, differed from the *1945 Act* in that it contained special provisions pertaining to saving banks that gave the RBA the power *inter alia* to issue regulations on how saving banks should invest their funds; indicating which banks the savings banks could deposit money with or lend money to; setting out classes of persons from whom saving banks were not allowed to accept deposits and defining the classes of persons that savings banks could permit to draw cheques on an account maintained with the bank.[821]

Over the years, Australia maintained a very stable banking sector. However in 1974 Australian banks, as a result of the failure of several property financiers that led to runs

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direct compliance by such bank with the provisions of the Banking Act or the regulations that were not complied with.

[818] Reserve Bank of Australia Act 4 of 1959.

[819] Section 8 of the Reserve Bank of Australia Act 1959.

[820] The Reserve Bank of Australia (RBA) was established under section 26(a) of the *Reserve Bank Act* 1959 as Australia's central bank. See also Fitz-Gibbon & Gizycki "History of last resort lending and other support for troubled financial institutions in Australia" 2001 *Research Discussion Paper 2001-07* 52.

[821] Section 37 of the Banking Act 1959. Savings Banks were defined in the Banking Act as banks that were specified in Part II of the Schedule to the Banking Act and included the Commonwealth Savings Bank.

on various building societies, experienced some deficits in liquidity and had to borrow from the RBA to preserve their Liquid assets and Government Securities ratios.[822] The landscape of financial regulation in Australia changed when the *Campbell Inquiry*, which was appointed in 1979, recommended significant deregulation of the banking system.[823] Subsequently, in the early 1980s there was a period of financial deregulation in Australia in response to the perception that the existing financial system had outdated regulatory structures. [824] Another significant development occurred with the adoption of the *Australian Securities Commission Act* in 1989,[825] that resulted in market conduct regulation of the whole Australian financial sector being entrusted to the Australian Securities Commission whilst the obligation for ensuring consumer protection regulation was divided between various regulators. The model of financial regulation in Australia during the 1990s was thus an institutional model where the RBA, as central bank, had the responsibility for bank supervision, oversight of the payments and settlement system as well as a *de facto* financial stability mandate and a lender of last resort function, and the Australian Securities Commission was the market conduct regulator.[826]

Change was again on the cards in 1996 when Australia, as a pro-active jurisdiction in respect of financial system regulation, embarked on a comprehensive review of its financial system by the *Financial System Inquiry* (the *Wallis Inquiry*).[827] The Wallis Inquiry had to consider an optimal framework for the regulation of the financial sector and was also tasked to recommend ways to improve the regulatory arrangements that existed at the time.[828] The main outcome of the Inquiry was that it recommended that Australia

[822] Fitz-Gibbon & Gyzicki (2008) 51. Fitz-Gibbons and Gyzicki observe that although the RBA did not make loans directly to troubled banks it was de facto acting as lender of last resort.
[823] Australian Government. 1981. *Australian Financial System Final report of the Committee of Inquiry*. Australian Government Publishing Service, Canberra. Available at https://treasury.gov.au/sites/default/files/2019-03/p1981-fsi-Chpt1-12.pdf. Accessed on 20 October 2021.
[824] Tyree "The Australian Payments System" 2001 *Banking and Finance Law Review* 39 at 40.
[825] Act 90 of 1989.
[826] See also Fitz-Gibbon & Gyzicki 1 - 2.
[827] Commonwealth of Australia. *Financial System Inquiry Final Report*. 1996. (hereinafter Wallis Inquiry).
[828] Cooper "The integration of financial regulatory authorities – the Australian experience" Australian Securities and Investments Commission (September 2006). Available at http://download.asic.gov.au/media/1339352/integration-financial-regulatory-authorities.pdf. Accessed 2 September 2020), (hereinafter Cooper 2006).

transition to a Twin Peaks model[829] of financial regulation and the country became the global pioneer when it adopted this new model in 1998.[830] Of particular importance is that the Wallis Inquiry recommended that bank supervision be removed from the remit of the RBA and given to a separate, independent regulator to be established for such purpose, namely the Australian Prudential Regulation Authority, as discussed in more detail below.[831]

The Australian Twin Peaks model that has been in operation since 1998, is in fact a three peak-model that comprises the following entities: The RBA as central bank that is tasked with an overall financial stability mandate; the Australian Prudential Regulation Authority (APRA) as prudential regulator and supervisor of Australian deposit-taking institutions (ADIs) and the Australian Securities and Investments Commission (ASIC) as market conduct regulator and supervisor.[832] Under the Australian Twin Peaks model, APRA, established in terms of the *Australian Prudential Authority Act*,[833] has, as mentioned above, taken over the mandate of bank supervision previously exercised by the RBA and is tasked with overseeing the safety and soundness of banks in Australia. Notably APRA also has a statutory duty to promote financial system stability in Australia through

[829] Australia became the first country in 1998 to implement a 'Twin Peaks' model of regulatory reform, conceptualized by Michael Taylor. Generally the Twin Peaks model separates financial regulation into two broad functions: market conduct regulation including consumer protection and prudential regulation. See Godwin "Introduction to special issue – the twin peaks model of financial regulation and reform in South Africa" (2017) 11 *Law and Financial Markets Review* 151.

[830] Cooper (2006) 2; Wallis Inquiry (March 1997) http://fsi.treasury.gov.au/content/FinalReport.asp (accessed 30 March 2017) hereinafter Wallis Inquiry 1997; See further Department of Parliamentary Library. 1997. *Wallis Report on the Australian Financial System: Summary and Critique – Research Paper No. 16 1996-97*. Available at https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/RP9697/97rp16#MAJOR. Accessed 30 December 2017).

[831] Cooper 2006 5. See also Jensen & Kingston (2010) 549.

[832] Australia adopted a functionally based twin peaks model under which regulatory responsibility is divided primarily between two regulators namely: the Australian Securities and Investments Commission (ASIC) which is responsible for the regulation of companies, market conduct and consumer protection and the Australian Prudential Regulation Authority (APRA) which is responsible for prudential regulation. The twin peaks model requires that the objectives of each regulator and the boundaries, or regulatory perimeters, between them to be explicitly defined. APRA is mandated with the promotion of financial system stability, whereas ASIC is responsible for promoting the confidence and informed participation of investors and consumers in the financial system. See Godwin & Ramsay "Twin Peaks – the legal and regulatory anatomy of Australia's system of financial regulation" 2015 *SSRN Electronic Journal* 1.

[833] Act 50 of 1998, hereinafter the APRA Act.

prudential regulation and supervision.[834] The RBA and APRA thus exercise a joint financial stability mandate, albeit focusing on different aspects of such mandate.

The *Banking Act 1959* has also undergone amendments over the years in order to provide a more robust framework for the regulation and supervision of banks.[835] Australian banks currently fall under the category of "Authorised Deposit-taking Institutions" (ADIs) to which the Banking Act, as amended, applies.[836] In its current format, the main objects of the Act, as amended, are: "(a) to protect the interests of depositors in ADIs in ways that are consistent with the continued development of a viable, competitive and innovative banking industry; and (b) to promote financial system stability in Australia".[837]

The framework for dealing with failing banks was upgraded in 2018 with the introduction of the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act*.[838] This Act provides powers that allow APRA to set requirements on resolution planning and to ensure that ADIs are better prepared for crisis situations. It also expanded on the crisis resolution powers to enable APRA to act decisively to facilitate the orderly resolution of ADIs.[839] The Act amended a number of Australian financial sector statutes to provide APRA with an enhanced suite of crisis resolution powers. Schedules 1 to 3 of the Act amend the Banking Act 1959, the Insurance Act 1973

[834] Section 8(2) APRA Act. See also section 11B of the Banking Act 1959 (as amended) which is titled "APRA to monitor prudential matters and which provides that the functions of APRA include the collection and analysis of information in respect of prudential matters relating to ADIs…; the encouragement and promotion of the carrying out by ADIs of sound practices in relation to prudential matters; and the evaluation of the effectiveness and carrying out of those practices."
[835] In order to distinguish the current version of the Banking Act from the original 1959 version all references to the Banking Act in its current form will be referred to in this thesis as the Banking Act 1959 (as amended).
[836] "Authorized deposit-taking institution" is defined in section 5(1) of the Banking Act, 1959 (as amended) as a "body corporate in relation to which an authority under subsection 9(3) is in force." It is also stated in section 5(1) that "ADI is short for authorized deposit-taking institution."
[837] Section 2A (1) of the Banking Act, 1959 (as amended). As per section 2A (2) these objectives are sought to be achieved mainly by inter alia restricting who can carry on banking business in Australia; providing for prudential supervision of ADIs by APRA by determining prudential standards and taking other action to ensure the prudent management of ADIs; providing that APRA can "manage or respond to circumstances in which the ability of an ADI to meet its obligations may be threatened".
[838] See also International Monetary Fund *Australia: Financial Sector Assessment Program Technical Note: Bank Resolution and Crisis Management* (January 2019) available at https://www.imf.org/en/Publications/CR/Issues/2019/02/13/Australia-Financial-Sector-Assessment-Program-Technical-Note-Bank-Resolution-and-Crisis-46605. (Accessed on 14 October 2020).
[839] Jacobson available at brightlaw.com.au/apra-crisis-resolution-powers/pdf (accessed on 22 July 2021).

and the Life Insurance Act 1995, to ensure that each statute contains similar provisions pertaining inter alia to: authorisation and registration requirements; formal conversion and write-off provisions; APRA's power to issue binding directions (including directions for recapitalisation); statutory management of ADIs; appointment of external administrators; moratoria to prevent enforcement actions by creditors; and provisions for the winding-up of ADIs.[840]

Part II of the Banking Act, 1959, as amended, sets out more extensive provisions relating to the authority to carry on banking business and provides that APRA may at any time impose conditions or additional conditions on an ADI's authority to conduct banking business.[841] APRA may also revoke such authority to conduct banking business in various instances, for example if a bank provided false or misleading information when applying for a licence or failed to comply with certain provisions as the Banking Act or becomes insolvent.[842] In terms of section 11 AF of the Banking Act, 1959, as amended, APRA can make prudential standards for ADIs. A prudential standard may provide for the exercise of powers and discretions by APRA to approve, impose, adjust or exclude specific prudential requirements in relation to one or more specified ADIs.

APRA's powers to issue directions to ADIs is provided for in Division 1BA of the *Banking Act* and permits APRA to issue directions to ADIs in various instances, for example when an ADI contravenes the *Banking Act* or if it contravenes a prudential requirement regulation or a prudential standard or becomes, or is about to become, unable to meet its liabilities.[843] The direction may then specify certain action that the ADI is required to take, for example that it should comply with the prudential standard that it failed to observe or that it should remove a director from the board of the bank.[844] APRA may also give a bank directions to recapitalise.[845] The *Banking Act*, as amended, further provides extensively

840 Pyburne and Hawkins "Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017" *Bills Digest* No 80, 2017 https://www.aph.gov.au/Parliamentary_Business/Bills_LEGislation/Bills_Search_Results/Result?bId=r5989. (Accessed 22 July 2021).
841 Section 9AA of the Banking Act 1959, (as amended).
842 Section 9A of the Banking Act, 1959 (as amended).
843 Section 11CA of the Banking Act 1959 (as amended)
844 Section 11 CA (1C) (2) of the Banking Act 1959 (as amended).
845 Section 13D to 13R of the Banking Act 1959 (as amended).

for corporate governance of banks as a measure to ensure their safety and soundness[846] and incorporates a comprehensive penalty regime.[847] Provision is also made for the appointment of a statutory manager for a failing bank and an administrator to take control of such bank's business.[848]

4.2 The evolution of the Australian depositor protection regime

Having had a robust framework for banking regulation and supervision as well as a resilient banking sector over the years, meaning that no significant bank failures occurred, Australia did not have the need for a comprehensive explicit deposit insurance system framework and only transitioned to an EDIS in 2008 in solidarity with international regulatory reforms post-GFC.[849] However, the concept of depositor protection was not new in Australia. It first came into existence in 1937 when the *Royal Commission into Monetary and Banking Systems* [850] tabled its report to the Australian Parliament in August 1937. The 1937 Royal Commission Report recommended, under the heading 'Prevention of Bank Failures', that the Commonwealth Bank be empowered to take over a bank that was unable to meet its obligations.[851] The Royal Commission pointed out that the solvency of any banking system relies heavily on the ability of banks to repay deposited funds on demand as they become due.[852] The Commission was consequently of the view that the failure of one bank to meet its obligations to depositors, even with ample assets at its disposal to meet all its liabilities if allowed time, would bring about a condition which would seriously threaten the stability of the whole financial system.[853] In particular, the

[846] Sections 19 to 23 of the Banking Act 1959 (as amended).
[847] Schedule 2 to the Banking Act 1959 (as amended).
[848] Section 14 A to 16 A of the Banking Act 1959 (as amended)
[849] Gray "Australia's Implicit deposit insurance – should it be reconsidered?" 2004 *Australian Accounting Review* 41.
[850] Australia. Royal Commission Appointed to Inquire into the Monetary and Banking Systems at Present in Operation in Australia. 1937, *Report : of the Royal Commission appointed to inquire into the monetary and banking systems at present in operation in Australia, and to report whether any, and if so what, alterations are desirable in the interests of the people of Australia, as a whole, and the manner in which any such alteration should be effected* Government Printer Canberra.
[851] The 1937 Royal Commission (1937) 237.
[852] The 1937 Royal Commission (1937) 235.
[853] *Ibid*.

Commission suggested the guaranteeing of deposits to shore up confidence in the Australian financial sector.[854]

Following the 1937 Royal Commission Report, the *Commonwealth Bank Bill 1938*[855] was introduced into parliament.[856] The Bill transferred a large number of the recommendations of the 1937 Royal Commission into legislation, including the provision for the Commonwealth Bank to take over an insolvent and illiquid bank.[857] However, it was only in 1945 when the *Banking Bill 1945* was introduced that the issue of depositor protection was formally discussed with the Commonwealth Bank.[858] Subsequently when the Banking *Act 1945* was enacted, it introduced some limited measure of depositor protection in Australia, as discussed hereinafter.

4.2.1 Banking Act 1945

The Banking Act 1945 specifically outlined depositor protection as a function of the Commonwealth Bank in accordance with its responsibility for prudential regulation of banks and the resolution of distressed banks.[859] As mentioned above, the *Banking Act*

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[854] However, if the Commonwealth Bank determined that the bank was unsound, the central bank was to take control of the unsound institution either by appointing a person to stand in the position of a receiver for the depositors, or by appointing some of its own offices to control the affairs of the bank. It was further recommended that the Commonwealth Bank announce to the depositors, as soon as it is in a position to do so, its estimate of the amount which the depositors may expect to receive and make arrangements for the release of part of their deposits to those in need. See The 1937 Royal Commission (1937) 236.

[855] The Parliament of the Commonwealth: House of Representatives (1937-1938) *Commonwealth Bank Bill 1938* Memorandum showing the Amendments proposed to be made to the Commonwealth Bank Act 1911-1932. Available at https://parlinfo.aph.gov.au/parlInfo/download/legislation/emshistorical/HEM193740V100050/upload_binary. (Accessed on 8 December 2020).

[856] Berg 'The Curtin-Chifley Origins of the Australian Bank Deposit Guarantee' 2016 *AGENDA* 26.

[857] Berg (2016) *AGENDA* 30.

[858] Section 11 covered under the heading 'Protection of depositors' in Division 2 of the Banking Bill 1945 read 'It shall be the duty of the Commonwealth Bank to exercise its powers and functions under this Division for the protection of the depositors of the several banks'. See Banking Bill 1945 (Cth). However, the Commonwealth Bank voiced its concern over taking over a distressed bank and guaranteeing depositors' funds. In particular, the Commonwealth Bank stipulated that taking over a distressed bank and guaranteeing deposits could mean that any shortfall between assets and depositor guarantees would have to be covered by the Commonwealth Bank. It noted the government had not proposed to allocate any more capital to the Commonwealth Bank to protect against such an occurrence, and it was possible that wearing these losses could impede the operations of the central bank. See Berg (2016) *AGENDA* 30

[859] Section 11 of the *Banking Act* 1945.

1945 introduced a mechanism for the Commonwealth Bank to take over banks that could not meet their liabilities.[860] In this regard, the *Banking Act 1945* placed a duty on the Commonwealth Bank to exercise its powers and duties for the protection of depositors of Australian banks.[861] In pursuance of its duty to protect depositors, the Commonwealth Bank could at any time require any bank to supply it, within a specified time, with such information relating to financial stability[862] in Australia as it required.[863] Should a bank have failed to supply the Commonwealth Bank with the required information, the Bank had the power to appoint an officer to investigate the affairs of such non-compliant bank.[864]

On the other hand, whenever a bank realized or suspected that it was likely to become unable to meet its obligations, or was about to suspend its payments, it had the duty to inform the Commonwealth Bank of this realization or suspicion.[865] The Commonwealth Bank could then appoint an officer of the Bank to investigate the affairs of such distressed bank and to assume control of, and carry on the business of that bank.[866] After assuming control of the business of the distressed bank, the Commonwealth Bank was expected to remain in control of such bank until the deposits with the bank had been repaid or suitable provision was made for repayment.[867] Alternatively, the Commonwealth Bank would remain in control of the distressed bank until it considered that it was no longer necessary for it to remain in control thereof.[868]

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860 Berg (2016) *AGENDA* 22.
861 Section 11 of the *Banking Act* 1945.
862 The financial stability mandate of the Commonwealth Bank of Australia rested on the provisions in section 10 of the Reserve Bank Act 1959 requiring the Bank to 'ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia' and that its powers are 'exercised in such a manner as, in the opinion of the Bank Board, will best contribute to: (a) the stability of the currency of Australia; (b) the maintenance of full employment in Australia; and (c) the economic prosperity and welfare of the people of Australia'.
863 The required information, if supplied, was expected to be verified by a statutory declaration made by a senior officer of the bank concerned. See section 12(1) of the *Banking Act* 1945.
864 Section 12(3) of the *Banking Act* 1945. See also Wilson "Australia's Central Bank" 1947 *Journal of Political Economy* 32.
865 Section 13(1) of the *Banking Act* 1945.
866 Section 13(2) of the *Banking Act* 1945.
867 Section 13(5) (a) of the *Banking Act* 1945. See also Wilson (1947) 33.
868 Section 13(5) (b) of the *Banking Act* 1945.

Notably the Banking *Act 1945* also required banks to hold, in Australia, tangible assets of a value not less than the amount of their deposit liabilities.[869] Whenever a bank became unable to meet its obligations or suspended payments, the assets of that bank were to be made available to meet the bank's liabilities in Australia in priority to all other liabilities that the bank had outside Australia (the so-called "depositor protection priority"-provision).[870]

Although the provisions of the *Banking Act 1945*, as discussed above, were taken by the Curtin government to constitute an explicit guarantee of depositors' funds,[871] Hogan and Sharpe believe that the ambiguous nature of the protection provided under the depositor protection provisions of the 1945 Act was problematic.[872] In particular, they argue that the *Banking Act 1945* was not clear whether the word 'repaid' in the Act meant repayment of the deposits in full. Another challenge posed by the *Banking Act's* approach to depositor protection, as pointed out by Hogan and Sharpe, was that it extended equally to all bank depositors without specifying the extent of the protection afforded. [873]

4.2.2 Banking Act 1959

As observed above, the *Banking Act 1959* was largely a re-enactment of the provisions of the *Banking Act 1945*. Similar to the *Banking Act 1945*, the *Banking Act 1959* also contained a few provisions pertaining to depositor protection. Like the *1945 Act*, it provided that it was the RBA's duty to exercise its supervisory powers and functions under Division 2 of the Act for the protection of bank depositors.[874] Similarly, it gave the RBA the power to require banks to supply it with information pertaining to their financial stability, failing which the RBA could appoint an officer of the RBA to investigate such

[869] Section 15(1) of the *Banking Act* 1945. See also Wilson (1947) 34.
[870] Section 15(2) of the *Banking Act* 1945. However, this provision was criticized by the former Governor of the Reserve Bank of Australia when he suggested that "the Banking Act is silent in regard to the priority to be given to depositors. So the legislation is less than a guarantee to depositors of full repayment and is no assurance of the solvency of an individual bank, nor how the parties would emerge in the event of a winding-up." See Johnston "Prudential Supervision of Banks" 1985 *Reserve Bank of Australia March Bulletin* 572.
[871] Berg (2016) *AGENDA* 22.
[872] Hogan & Sharpe "Prudential Supervision of Australian Banks" 1990 *The Economic Record* 131.
[873] Hogan & Sharpe (1990) *The Economic Record* 132.
[874] Section 12 of the Banking Act 1959.

bank.[875] Where a bank was likely to become unable to meet its obligations or was about to suspend payment, the RBA could launch an investigation into such bank's affairs and could take over the control of that bank and carry on its business. The RBA would then remain in control of the bank and continue to carry on its until such time as the deposits with the bank had been repaid or the RBA was satisfied that suitable provision was made for their repayment; and the RBA was of the opinion that it was no longer necessary for the bank to remain under the RBA's control.[876] Like the *1945 Act*, the *Banking Act 1959* required banks to hold assets in Australia of a value that was not less than the total amount of their deposit liabilities in Australia. It also contained a depositor protection–provision like the *Banking Act 1945*, stipulating that in the event of a bank becoming unable to meet its obligations or suspending payment, the assets of such bank in Australia would be "available to meet that bank's deposit liabilities in Australia in priority to all other liabilities of that bank.[877]

Given that the limited depositor protection provisions in the *Banking Act 1959* were carried over unchanged to the *1959 Act*, the comments above by Hogan and Sharpe regarding the problematic nature of these provisions are equally applicable to the depositor protection provisions of the *Banking Act 1959* in its original format.[878]

4.3 The transition to EDIS in Australia

The depositor protection mechanism through which the Curtin–Chifley government believed many years ago that deposits were guaranteed remained untested until 2004 when a Royal Commission[879] was established to examine the circumstances surrounding

[875] Section 13(1) to (c) of the Banking Act 1959.
[876] Article 14 of the Banking Act 1959.
[877] Section 16 of the Banking Act 1959.
[878] See par 4.1.2.1 above.
[879] Following the collapse of HIH insurance, there were subsequent suspicions about a serious level of corporate mismanagement within HIH Insurance which led to the appointment of a Royal Commission in August 2001. The Royal Commissioner, Hon. Justice Neville John Owen, was appointed to inquire into the reasons for and the circumstances surrounding the failure of HIH prior to the appointment of the provisional liquidators. The Royal Commission's report was publicly released on 16 April 2003. See Department of the Parliamentary Library: Information, Analysis and Advise for the Parliament *Report of the Royal Commssion into HIH* (2003) Research Note No 32.

the failure of the HIH Group of Companies (HIH).[880] In 2005, following a comprehensive review of Australia's failure and crisis management arrangements which drew on the Study of Financial Guarantees[881] (otherwise known as the *Davis Report*), the Council of Financial Regulators,[882] as coordinating body between the RBA, APRA and ASIC, recommended that the government introduce a private limited deposit insurance scheme to give depositors prompt access to their funds in the event of bank failure.[883] The Council's reasons for this suggestion was that, given the lengthy nature of the winding-up process for banks, it could take months or even years before funds became available for distribution to depositors.[884] According to the Council, such delay could create unnecessary financial hardships for many households and businesses, which in turn,

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[880] HIH Insurance which was Australia's largest insurer at the time, was placed into provisional liquidation in 2001, following a rapid expansion across a range of product lines, driven by domestic and overseas acquisitions. The effects of the collapse were not limited to policyholders, creditors and employees, but also extended to markets for certain products. Its failure was said to have been a critical event in the evolution of Australia's financial system and was associated with underpricing, under-reserving, corporate governance failures and mismanagement. In the wake of its collapse, the Australian Government moved to restore confidence in Australia's general insurance industry. As a result, government support was required to ensure the provision of certain services and to prevent further destabilizing effects. Most importantly, the failure of HIH spurred changes in a number of related areas including the introduction of the Financial Claims Scheme in 2008. Its failure and the establishment of the HIH Scheme had the effect of challenging the credibility of government statements that there were no implicit guarantees for policyholders and concerns that EDIS could create moral hazard became of less import if there was widespread public belief that implicit guarantee existed. The Government, therefore, responded to the Royal Commission's recommendations by commissioning a technical study to consider the merits of introducing EDIS in the Australian financial system. See generally Damiani *et al* "The HIH Claims Support Scheme" 2015 *Economic Round-Up* Australian Treasury. Available at www.treasury.gov.au. Accessed on the 12th August 2019.

[881] Following the recommendation made by the Royal Commission that Australia establish a deposit insurance scheme to support policyholders of general insurance companies in the event of the failure of any such company (Recommendation 61 of the Royal Commission Report), the Treasurer announced that the Australian government would commission an independent and comprehensive Technical Study led by Professor Kevin Davis, to examine nature of, and experiences with deposit insurance schemes. The study, therefore, presented a balanced framework in which the general arguments in favour of, and against, limited explicit deposit insurance in Australia's financial system could be considered. See Commonwealth of Australia *Study of Financial System Guarantees* (2004) 6.

[882] The Council of Financial Regulators is the coordinating body in Australia's main financial regulatory agencies whose objective is to contribute to the efficiency and effectiveness of financial regulation as well as to promote financial stability in Australia. It consists of the Reserve Bank of Australia, the Australia Prudential Regulation Authority (APRA), the Australian Securities and Investment Commission (ASIC) and the Australian Treasury. See https://www.rba.gov.au/fin-stanility/reg-framework/crf.html. Assessed on 3rd November 2019.

[883] Australian Treasury (the Treasury) Council of Financial Regulators – Failure and Crisis Management in the Australian Financial System (2005) 1.

[884] The Treasury (2005) 1.

could generate pressure on Government to do ‘something’.[885] Moreover, the Council was of the view that this delay was an inappropriate outcome for both the more vulnerable members of society and the Government.[886]

The Council of Financial Regulators consequently recommended that the Australian Government consider a ‘minimalist’ Financial Claims Compensation scheme with, inter alia, the following characteristics:[887] the scheme should be administered by APRA; it should apply to retail deposits in ADIs only; depositors should be able to lodge a claim for further monies up to a predetermined amount; and the arrangements for compensation should apply to the bank’s liabilities in Australia. Subsequent to the publication of the *Davis Report*, commissioned by the Treasurer to investigate the case for, and potential design issues of, deposit insurance guarantees, a long period of consultations and discussions followed before a legislative framework was eventually conceptualized for the establishment of an Australian EDIS.[888]

4.3.1 Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act 129 of 2008

Albeit that Australia had a resilient financial system which meant that it did not experience the severe financial collapses that characterized the 2008 GFC, the Australian Government nevertheless took heed of international financial regulation reform initiatives in response to the GFC and introduced a series of legislative reforms to enhance prudential regulation and financial consumer protection in Australia.[889] In relation to protection for depositors the arrangements that were introduced comprised two types of

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885 *Ibid.*
886 *Ibid.*
887 *Ibid.*
888 Davis & Jenkinson “The Financial Claims Scheme: An Assessment of the scheme’s broader economic impact” 2013 *The Australian Centre for financial Studies* 9.
889 The Parliament of the Commonwealth of Australia: House of Representatives *Financial Sector Legislation Amendment (Crisis resolution powers and other measures) Bill* 2017 – *Explanatory Memorandum (Crisis Resolution Bill Explanatory Memorandum)* (2016-2017) 8.

deposit guarantees: the Deposit Guarantee Scheme for Large Deposits and Wholesale Funding (LDWF)[890] and the Financial Claims Scheme.[891]

The LDWF was announced in October 2008 amid extremely difficult conditions in the global financial system.[892] For a period late in 2008, as a result of the drying up of interbank lending during the GFC, Australian banks encountered great difficulty in borrowing offshore,[893] thus threatening the flow of credit to the entire Australian economy.[894] To ensure the stability of the Australian financial system and to assist in buffering the domestic economy from the worst of the global economic contraction at the time, the Australian Government acted swiftly by introducing the LDWF.[895]

The LDWF was established under the *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act* 129 of 2008.[896] The aim of the Act was to allow for the appropriation of funds to enable claims made by registered ADIs[897] to be paid under a Deed of Guarantee[898] in accordance with a set of Scheme Rules.[899] Section 6(1) of the

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[890] Unlike the Financial Claims Scheme, this arrangement, the LDWF was to be employed as part of a new retail deposit focused, Financial Claims Scheme but would "also guarantee wholesale term funding of Australian Incorporated banks and other authorized deposit-taking institutions" for a fee.
[891] Under this arrangement, all deposits under $1 million in authorized deposit-taking institutions were automatically protected.
[892] Schwartz 'The Australian Government Guarantee Scheme' 2010 *Reserve Bank Bulletin* 19.
[893] Mohammed *et al* (2012) 106.
[894] Australian Treasury *Report on the operation of the Guarantee Scheme for Large Deposits and Wholesale Funding* (2011) The statement by Deputy Prime Minister and Treasurer Hon Wayne Swan, October 2011.
[895] *Ibid*.
[896] The *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act* 129 of 2008 stipulates in its preamble that it seeks to provide for an appropriation for the Guarantee Scheme for Large Deposits and wholesale funding, and for related purposes.
[897] Eligible ADIs were to apply to have their new and/or existing eligible wholesale funding securities guaranteed, for a fee, under the LDWF and access to the Scheme was voluntary and subject to an approval process with a fee payable monthly on all guaranteed liabilities. See Reserve Bank of Australia *Financial Stability Review* (March 2009) 44. Available at https://www.rba.gov.au/publications/fsr/2009/mar/pdf/box-a.pdf. Accessed on 9th December 2020).
[898] The Deed of Guarantee, as defined in section 3 of the *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act* 2008, refers to the Deed of Guarantee in respect of the Australian Government Guarantee Scheme for Large Deposits and Wholesale funding, executed on behalf of the Commonwealth on 20 November 2008, as that Deed is in force from time to time.
[899] In exchange for the guarantee, which bestowed the government's AAA rating on this debt, ADIs paid a monthly fee based on their credit rating and the value of the debt/deposits guaranteed. See The Parliament of the Commonwealth of Australia: House of Representatives *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Bill 2008 – Explanatory Memorandum* (2008) 3.

Act also provided a borrowing power in the case where there were insufficient funds in the Consolidated Revenue Fund[900] at the time claims were to be paid.[901] However, this borrowing was not to exceed a period of 24 months.[902]

The LDWF only applied to deposits over 1 million dollars for each customer in any one ADI and for which a fee to secure the guarantee in terms of the DGWF was charged.[903] Only senior unsecured debt instruments of a non-complex nature issued by ADIs were eligible for the guarantee under the LDWF and eligible ADIs were allowed to choose to apply for the Government guarantee for particular securities, or programs, and to have other securities unguaranteed.[904]

During its operation, the LDWF provided wholesale funding protection to approximately 150 Australian ADIs, which included regional banks, building societies and credit unions.[905] Deposit guarantee arrangements under the LDWF were to remain in place until 12 October 2011.[906] However, the scheme closed to new borrowings on 31 March 2010 on the advice of the Council of Financial Regulators that funding conditions had

[900] Established in terms of section 81 of the Australian Constitution, the Consolidated Revenue Fund was created to hold all revenues or moneys raised or received by the Executive Government of the Commonwealth and shall be appropriated for the purposes of the Commonwealth in the manner and subject to the charges and liabilities imposed by the Constitution. Section 5(a) and (b) of the *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act* 2008, provides that the purposes of appropriating the Consolidated Revenue Fund are twofold: first, to pay claims under the Deed of Guarantee in accordance with the Scheme Rules; and second, to repay a borrowing as well as the interest on a borrowing, made on behalf of the Commonwealth for the purposes of paying claims under the Deed of Guarantee in accordance with the Scheme Rules. See Reserve Bank of Australia *The Australian Government Guarantee Scheme: 2008–15* (March 2016) *Bulletin* 39. Available at https://www.rba.gov.au/publications/bulletin/2016/mar/pdf/bu-0316-5.pdf. (Accessed on 8 December 2020). See also The Parliament of the Commonwealth of Australia: House of Representatives *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Bill 2008 – Explanatory Memorandum* (2008) 6.

[901] Section 6(1) of the *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act* 2008 provides that the Minister may, on behalf of the Commonwealth, borrow money for the purposes of paying claims under the Deed of Guarantee in accordance with the Scheme Rules.

[902] Section 6(2) of the *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act* 2008.

[903] Hogan 'The Bank Deposit and wholesale guarantees of 12 October 2008: An Appraisal' (2009) *Agenda* 6.

[904] RBA *Financial Stability Review* (2009) 44.

[905] Ferran *et al The Regulatory Aftermath of the Global Financial Crisis* (2012) 246.

[906] RBA *Financial Stability Review* (2009) 44.

'normalized'.[907] The Council noted that the scheme was no longer largely used to address problems of market access and that similar schemes in many other countries had closed or were soon to close.[908] By the time the scheme closed to new issuance, Australian banks had considerably moved their funding practices to structures measured more stable, improving deposit and long-term funding while plummeting use of short-term wholesale funding.[909]

The RBA was of the view that the LDWF was successful as it attained its objective of assisting to stabilize the financial system and promote the flow of credit to the economy, while also safeguarding ADIs against a disadvantaged standing to their international peers that could access similar government guarantee.[910]

4.3.2 Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act (FSLA Financial Claims Scheme Act) 105 of 2008

Turner explains that the Financial Claims Scheme is a form of EDIS that guarantees the recovery of depositors' funds up to a certain amount in the event that an ADI fails.[911] Established under the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act (FSLA Financial Claims Scheme Act)* of 2008, the Financial Claims Scheme is a crucial element of Australia's framework protecting

[907] According to the RBA, no closure date was announced when the scheme was introduced, rather it was declared open 'until conditions normalized'. Most other governments set a closure date when announcing their schemes, with many subsequently extending these dates. However, given the improvement in funding conditions, the Council of Regulators advised the Australian Government to withdraw the scheme. Acting on this advice, the Australian Government announced that the LDWF would close to new liabilities from 31 March 2010. The notice was issued in terms of Rule 3.1.2 of the Australian Government Scheme for Large Deposits and Wholesale Funding Rules. See Schwartz (2010) 20. See also RBA Bulletin (March 2016) 40.
[908] RBA Bulletin (March 2016) 40.
[909] *Ibid*.
[910] The RBA noted that the scheme's intervention in markets was somewhat contained to the period where it was needed because it was implemented soon after international conditions and the actions of international authorities demanded it, and it was closed to new issuance when other international schemes had begun to close and market conditions were conclude to have normalized. See RBA Bulletin (March 2016) 44.
[911] Turner (2011) 51.

depositors and supporting financial stability.[912] The overarching aim for the establishment of the Financial Claims Scheme was to ensure that protected depositors in a failed ADI have immediate access to certain amounts of money to maintain the account-holders'[913] liquidity before they would receive payment in a winding up of the ADI.[914] In essence, the Financial Claims Scheme's objectives, as contained in the *FSLA Financial Claims Scheme Act* 2008, are twofold: first, to protect Australian retail depositors by providing them with certainty of recovery of their protected deposits;[915] second, to support depositor liquidity by providing depositors with prompt access to their protected deposits.[916]

The Financial Claims Scheme covers all deposits held at ADIs incorporated in Australia, including banks, building societies and credit unions.[917] The definition of a 'protected account' is important in determining the coverage of the Financial Claims Scheme.[918] As such, section 12(4) defines a 'protected account' as 'an account or covered financial product that is kept by an account-holder (whether alone or jointly with one or more other account-holders) with an ADI and either:

(a) is an account that is prescribed by the regulations for the purposes of this paragraph; or[919]

(b) is an account, or covered financial product, that is kept under an agreement between the account-holder and the ADI requiring the ADI to pay the account-holder, on demand by the account-holder or at a time agreed by them, the net

[912] Commonwealth of Australia. The Treasury *Post-Implementation Review and Regulation impact Statement: Financial Claims Scheme* (2011) 3.
[913] An account-holder means an entity (as defined in section 960-100 of the Income Tax Assessment Act 1997) that has (either alone or jointly with another entity) an account or covered financial product with an ADI.
[914] Section 16 AB (b) of the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act (FSLA Financial Claims Scheme Act)* 105 of 2008.
[915] Section 16AB (b) of the *FSLA Financial Claims Scheme Act* 2008. See also The Treasury *Post-Implementation Review: FINANCIAL CLAIMS SCHEME* (2011) 3.
[916] Section 16AB (c) of the *FSLA Financial Claims Scheme Act* 2008.
[917] Financial Claims Scheme website. Available at www.Financial Claims Scheme.gov.au. Accessed on 20 July 2019.
[918] Australian Treasurer *Explanatory Statement – Declaration of covered products Banking Act* 1959
[919] Section 12(4) (a) of the *FSLA Financial Claims Scheme Act* 2008.

> credit balance of the account or covered financial product at the time of the demand or the agreed time (as appropriate).'[920]

The coverage of deposits by the Financial Claims Scheme is also an important determinant of whether a deposit is treated as 'stable' for purposes of the Liquidity Coverage Ratio.[921] For purposes of subsection 16AG(1) of the *FSLA Financial Claims Scheme Act* 2008,[922] the prescribed limit in relation to a protected account, or protected accounts, that an account-holder has with a particular declared ADI is currently AUS $250 000.[923] Initially, when it was established, the Australian EDIS provided no cap of the amount guaranteed to depositors in ADIs under the Financial Claims Scheme.[924] The absence of a cap on guaranteed deposits was criticized for giving large institutions an incentive to abuse the scheme by injecting large sums of money into Australian banks.[925] The amount for covered deposits was subsequently revised and replaced in 2012, after the Financial Claims Scheme reassessment by the Treasury, to AUS $250 000 to align it with international best practice.[926]

Under the *FSLA Financial Claims Scheme Act 2008*, the responsible Minister may invoke the Financial Claims Scheme when APRA has applied to the Federal Court for an ADI to

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920 Section 12(4) (b) of the *FSLA Financial Claims Scheme Act* 2008.

921 The Liquidity Coverage Ratio (LCR) is a quantitative liquidity measure that is part of the Basel III reforms. It was implemented by APRA in Australia on January 2015 and it requires Australian ADIs to hold sufficient liquid assets to meet 30-day net cash outflows projected under APRA-prescribed stress scenarios. See Commonwealth Bank *Basel III Pillar 3: Capital Adequacy and Risk Disclosures as at 31 March 2019* (2019) 12. See also Davis & Maddock "Depositor protection and bank liquidity regulation: Distortions affecting superannuation" (2019) *The Australian Economic Review* 152.

922 Section 16AG of the *FSLA Financial Claims Scheme Act* 2008 provides that an account-holder is not entitled under section 16AF to be paid, in connection with the protected account or protected accounts the account-holder has with a particular declared ADI at a particular time, one or more amounts totalling more than the limit prescribed by, or worked out under the regulations.

923 Governor General of the Commonwealth of Australia *Banking Regulation* (2016) 4.

924 Lui (2016) 76. Is Liu in the bibliography?

925 Lui (2016) 76.

926 The Financial Claims Scheme limit is set by Regulations made under the Banking Act. Regulation 5(4) of the *Banking Amendment Regulations 2011 (No 1)* amended the Financial Claims Scheme limit on payments by providing that "on or before 1 January 2013, the limit in relation to a protected account, or protected accounts, that an account-holder has with a particular declared ADI at a particular time is $250 000.

be wound up under section 14F of the Act.[927] APRA may apply for a winding-up order if it considers that the ADI is insolvent and could not be restored to solvency within a reasonable period.[928] If APRA makes an application for the winding up of an ADI, it must inform the Minister of the application as soon as possible.[929] Once informed, the Minister may then make a declaration in respect of such ADI for the Financial Claims Scheme to be invoked in terms of section 16AD(1) of the *FSLA Financial Claims Scheme Act 2008*. The declaration must inter alia stipulate the amount that is to be credited to the Financial Claims Scheme Special Account in connection with the depositors of the ADI as well as the amount that is to be credited to the APRA Special Account in connection with the administration of the Financial Claims Scheme in relation to the ADI concerned.[930] According to APRA, the Financial Claims Scheme is only likely to be utilised where other remedies for resolving an ADI's financial difficulties, such as transferring all of its deposits to another ADI or facilitating the recapitalization of the ADI, are not feasible or cost-effective in the circumstances.[931]

The Financial Claims Scheme operates an *ex post* funded deposit insurance scheme, supported by a standing budgetary appropriation.[932] The payouts of deposits insured by the Financial Claims Scheme are funded by the Australian Government through a standing appropriation of AUS $20 000 000 000 per failed ADI.[933] In an attempt to reduce the risk of payment errors in the event that the Financial Claims Scheme has been activated, the Australian ADIs are expected to identify, in advance, every protected account-holder and to develop and implement an aggregated deposit balance for each

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[927] Section 16AB of the *FSLA Financial Claims Scheme Act* 2008 provides that APRA may apply for winding up if: an ADI statutory manager is in control of the ADI's business; and APRA considers that the ADI is insolvent and could not be restored to solvency within a reasonable period.
[928] Section 16AAA of the *Banking Act 1959*.
[929] Section 14F (3) of the *FSLA Financial Claims Scheme Act* 2008.
[930] Section 16AD (2) and (3) of the *FSLA Financial Claims Scheme Act* 2008.
[931] Australian Prudential Regulation Authority (APRA) *Financial Claims Scheme for authorized deposit-taking institutions: Proposed requirements for payment, reporting and communications* (2012) Discussion Paper 10. Available at https://www.apra.gov.au/sites/default/files/121107-dp-Financial Claims Scheme-adi-november-2012_0.pdf. (Accessed 12 December 2020).
[932] IMF (2019) *FSAP Bank and Crisis Management* 27.
[933] Section 16AD (2) of the *FSLA Financial Claims Scheme Act* 2008 provides that the declaration made by the Minister in terms of section 16AD (1) must specify the amount that is to be credited to the Financial Claims Scheme Special Account in connection with the payment of account-holders in relation to the declared ADI and the amount must not be more than $20 000 000 000.

account-holder known as a 'single customer view'.[934] In addition, ADIs are required to be able to generate Financial Claims Scheme data within a reasonable specified time after a request has been made by APRA to ensure that prompt payouts can be made to depositors.[935]

As indicated above, the Financial Claims Scheme was designed to entitle account-holders who have certain protected accounts with a declared ADI to be paid certain amounts to maintain their liquidity before they would receive payment in a winding-up of the ADI.[936] Where the account-holder has two or more protected accounts with the declared ADI at the time it becomes insolvent, APRA may determine in writing, for each of the protected accounts, the amount of the entitlement connected with the protected accounts so that the total entitlement is equivalent to the limit prescribed.[937] In making this determination, APRA has to take into consideration the desirability of the account-holder receiving its entitlements as early as possible.[938]

The Financial Claims Scheme was also created to substitute APRA for those account-holders as a creditor of the declared ADI to the extent of the payouts that are made.[939] Therefore, in the event that an ADI fails, the position is that APRA pays out insured depositors and stands at the head of the priority queue of persons with claims on the failed ADI's assets.[940] This basically means that payouts are recovered from the liquidation of a failed ADI and, where it there are insufficient funds to cover these payouts, an ad hoc levy[941] is placed on the banking sector. This entails the Australian government

[934] Section16AK (4) (1) of the *FSLA Financial Claims Scheme Act* 2008. See also Turner (2011) 54.
[935] Section 16AK (1) (a) *FSLA Financial Claims Scheme Act* 2008.
[936] Section 16AB (b) of the *FSLA Financial Claims Scheme Act* 105 of 2008.
[937] Section 16AG (3) (a) of the *FSLA Financial Claims Scheme Act* 2008.
[938] Section 16AG (4) of the *FSLA Financial Claims Scheme Act* 2008.
[939] Section 16AB (c) of the *FSLA Financial Claims Scheme Act* 2008. As seen in Chapter 2, Core Principle 16 states that the deposit insurer's role in the recovery process should be explicitly specified in legislation and the deposit insurer should be clearly recognized as a creditor of the failed bank by subrogation.
[940] Section 13A (3) (a) & (b) of the *FSLA Financial Claims Scheme Act* 2008 provides that if an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet the ADI's liabilities in the following order: first the ADI's liabilities to APRA because of the rights APRA has against the ADI because of section 16AI; second, the ADI's debts to APRA under section 16AO.
[941] A levy is defined in terms of section 7 of the *FSLA Financial Claims Scheme Act* 2008 as levy imposed by the *Authorized Deposit-taking Institutions Supervisory Levy Imposition Act* 1998.

stepping in to provide the necessary funds which will subsequently be reclaimed from the proceeds yielded by the liquidation of the failed ADI.[942] Where the funds provided by the Government are insufficient, the Government can, as indicated, place a levy on industry to make further recoveries.[943]

As the administrator of the Financial Claims Scheme, APRA recovers payments and accompanying expenses from the assets of the failed ADI.[944] In the event that funds that are recouped following the liquidation process are not sufficient to cover the outstanding claims by depositors then, as pointed out above, each Australian ADI may be charged a Financial Claims Scheme levy to recoup the shortfall.[945] The Australian Treasury is mandated by legislation to determine, among other things: the maximum restricted levy amount[946] for each financial year; the minimum restricted levy amount for each financial year; the restricted levy percentage for each financial year; and the unrestricted levy percentage.[947] Where a levy is imposed on an ADI, such levy becomes payable on the

[942] Section 16AO (1) of the *FSLA Financial Claims Scheme Act* 2008 provides that the costs incurred by APRA in relation to the exercise of its powers and the performance of its functions relating to a declared ADI are a debt due by the declared ADI to APRA.
[943] Section 8(1) of the *Authorized Deposit-taking Institutions Supervisory Levy Imposition Act* 1998 provides that a body corporate that is an ADI at any time during a financial year that ends after the commencement of the *Authorized Deposit-taking Institutions Supervisory Levy Imposition Act* 1998 is liable to pay a levy in respect of that financial year.
[944] Section 13A (3) (a) & (b) of the *FSLA Financial Claims Scheme Act* 2008 gives APRA first priority over other creditors to recover pay-outs made to depositors as well as accompanying expenses.
[945] In terms of section 6 of the *Authorized Deposit-taking Institutions Supervisory Levy Imposition Act* 1998, the imposed levy is payable in accordance with subsection 8(1) of the *Financial Institutions Supervisory Levies Collection Act* 1998. According to section 26B (1) of the *FSLA Financial Claims Scheme Act* 2008, an ADI is liable to pay a levy imposed on the ADI's liabilities to its depositors. See also Australian Prudential Regulation Authority (APRA) (2019) *Cost Recovery Implementation Statements: Prudential regulation of financial institutions* APRA 8. Available at www.apra.gv.co accessed on 25th September 2019.
[946] In terms of section 7(1A) of the *Authorized Deposit-taking Institutions Supervisory Levy Imposition Act* 1998, the restricted levy amount for the financial year is the amount that, for the financial year, is the restricted levy percentage of the ADI's levy base, or if that amount exceeds the maximum restricted levy amount for the financial year, the maximum restricted levy amount, or if that amount is less than the minimum restricted levy amount for the financial year, the minimum restricted levy amount.
[947] The unrestricted levy component for the financial year is, in terms of section 7(1B) of the *Authorized Deposit-taking Institutions Supervisory Levy Imposition Act* 1998, the amount that, for the financial year, is the unrestricted levy percentage of the ADI's levy base.

date specified in the regulations imposing the levy.[948] An ADI that fails to pay the levy at the start of a levy month is liable to pay the relevant penalty[949] to the Commonwealth.[950]

In 2012, APRA issued a *Discussion Paper*[951] with proposals for the implementation of the most cost-effective means by which Financial Claims Scheme payments, reporting and communications could be facilitated. APRA indicated that it was aware that many account-holders require immediate access to liquid funds following the closure of an ADI.[952] Accordingly, APRA proposed various alternative options to facilitate prompt access to protected accounts.[953] APRA inter alia considered the Financial Claims Scheme transferring protected accounts from a declared ADI to another solvent ADI (the acquiring ADI), together with associated payment functionality, data and systems.[954] The view was that this option would allow account-holders access to their accounts in the acquiring ADI within a day or two of the declaration of the applicability of the Financial Claims Scheme and the acquiring ADI would then operate the relevant systems of the declared ADI until such time as those systems could be integrated into the acquiring ADI's own systems.[955]

[948] This date must be earlier than the 28th day after the day on which the regulation imposing the levy took effect. See Section 26C (1) and (2) of the *FSLA Financial Claims Scheme Act* 2008.
[949] Section 26D (1) of the *FSLA Financial Claims Scheme Act* 2008 provides that "if any levy payable by an ADI remains unpaid at the start of a levy month after the levy became due for payment, the ADI is liable to pay the Commonwealth, for that levy month, a penalty worked out using the formula: Amount of the levy remaining divided by unpaid at the start of the levy month." Late payment penalty for a levy month becomes due and payable at the end of the levy month. See section 26D (2) of the *FSLA Financial Claims Scheme Act* 2008.
[950] Section 26D (1) of the *FSLA Financial Claims Scheme Act* 2008.
[951] Australian Prudential Regulation Authority (APRA) *Financial Claims Scheme for authorized deposit-taking institutions: Proposed requirements for payment, reporting and communications* (2012) Discussion Paper 10. Available at https://www.apra.gov.au/sites/default/files/121107-dp-Financial Claims Scheme-adi-november-2012_0.pdf. (Accessed 12 December 2020).
[952] APRA Discussion Paper (2012) 28.
[953] *Ibid.*
[954] *Ibid*.
[955] This option is known as a "bridge bank" and is the principal method used by the US Federal Deposit Insurance Corporation when a bank fails. See Chapter 2 on discussions relating to bridge banks and Chapter 3 for FDIC bridge banks. See also the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions as discussed in Chapter 2.

4.3.3 Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018

In the aftermath of the 2008 GFC, it was recognized that APRA should be equipped with improved powerful, flexible and timely powers to manage the potential failure of a regulated entity.[956] Financial regulatory reforms to the Australian financial system which commenced after the 2008 GFC culminated in new crisis management legislation which sought to enhance APRA's management powers by providing clear powers to enable it to set requirements on resolution planning for banks and ensure that banks are better prepared for a crisis.[957] The enactment of the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* consequently introduced an enhanced suite of crisis resolution powers applicable to prudentially regulated ADIs and gave APRA more powers in relation to the resolution of distressed ADIs.[958]

The *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* has also broadened APRA's mandate to allowing the Financial Claims Scheme funds to be used to support a compulsory transfer of business.[959] The scope of funding for a transfer of business extends to the amount to which each account-holder would be entitled to under the Financial Claims Scheme.[960] Prior to the enactment of the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*, the determination of whether the Financial Claims Scheme would apply to a specific failed bank was declared by the Treasurer following APRA's application to the Federal Court.[961] The amended Act now permits the Treasurer to declare the application of the Financial Claims Scheme immediately after a statutory manager has been appointed to take control of the failed ADI,[962] thereby minimizing the reservation

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956 APRA Capability Review (2019) 15.
957 APRA Capability Review (2019) 15.
958 *Crisis Resolution Bill Explanatory Memorandum* (2016-2017) 7.
959 Section 16AB (d) of the *FSLA (Crisis Resolution Powers and Other Measures) Act* 2018.
960 Section 16AIA (1) (c) (i) & (ii) of the *FSLA (Crisis Resolution Powers and Other Measures) Act* 2018.
961 Section 16AAA (1) provides that APRA may apply to the Federal Court of Australia for an order that an ADI be wound up if APRA considers that the ADI is insolvent and could not be restored to solvency within a reasonable period.
962 Section 16AB (a) (ii) of the *FSLA (Crisis Resolution Powers and Other Measures) Act* 2018

[what do you mean by 'reservation'?] by depositors in relation to the activation of the Financial Claims Scheme.[963]

4.3.4 The IMF Financial Sector Assessment Program (2019) and suggestions for strengthening deposit insurance in Australia

Notably the IMF, in its Country Report on the *2019 Financial Sector Assessment Program*[964] conducted in respect of the Australian financial system, pointed out that although Australia's framework for bank resolution has been strengthened by the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018*, the country should also introduce an *ex ante* funded deposit insurance scheme in its Financial Claims Scheme and a statutory bail-in regime, based on international best practice.[965]

4.3.5 The Banking Amendment (Deposits) Bill 2020

In 2020, the *Banking Amendment Deposits Bill* was published for comment. This Bill proposed to insert certain definitions into the *Banking Act 1959*, particularly that of 'bail-in' (to give effect to the recommendation by the IMF in its 2019 Financial Sector Assessment Program) and 'deposit account.[966] The *Bill* further sought to insert a clause

[963] IMF (2019) *FSAP Bank and Crisis Management*.
[964] International Monetary Fund *Australia Financial Sector Assessment Program Technical Note – Bank Resolution and Crisis Management* (IMF Country Report No 19/48) published on 21 February 2019, available at https://www.imf.org/en/Publications/CR/Issues/2019/02/13/Australia-Financial-Sector-Assessment-Program-Technical-Note-Bank-Resolution-and-Crisis-46605. (accessed on 11 October 2020).
[965] IMF Country Report 19/54. In the context of the bank resolution framework it was also indicated that the "no creditor worse off"-principle should be added as an additional legal safeguard which requires that during bank resolution, as a general principle , the creditor hierarchy in insolvency should be respected and no creditor should be treated worse than if the bank concerned had been liquidated. See the Financial Stability Board's Key Attributes of Effective Resolution Regimes (2014) *Key Attributes of Effective Resolution Regimes for Financial Institutions.*
[966] In terms of clause 11CAA of the Bill a "deposit account" was defined as "an account that is kept:
(a) by an account-holder (whether alone or jointly with one or more account-holders) with an ADI; and
(b) under an agreement between the account-holder and the ADI, requiring the ADI to pay the account-holder, on demand by the account holder or at a time agreed by them, the net credit balance of the account at the time of the demand or the agreed time (as appropriate)."

into the *Banking Act 1959* which confirms that nothing in the *Banking Act 1959* or any other Commonwealth legislation gives APRA the power to "implement, authorize or direct the implementation of bail-in in a deposit account." In this regard, clause 5 of the Bill sought to ads section 11CAD to the Banking Act to provide as follows:

'(1) Nothing in this Act or any other Commonwealth law gives APRA power (whether by way of a prudential standard or otherwise) to:

(a) implement a bail-in of deposit accounts; or

(b) authorize or direct the implementation of a bail-in of deposit accounts; or

(c) authorize or direct the amendment of any contract, agreement or other instrument to provide for a bail-in of deposit accounts.'

In the *Explanatory Memorandum to the Banking Amendment Bill*, it was indicated that the *Bill* was intended to avoid doubt as to the meaning and intent of various provisions in the *Banking Act 1959* in relation to bail-in during the resolution of a failed bank. In particular, it confirmed that the conversion and write-off provisions in the context of the bail-in provisions in the *Banking Act 1959* would not apply in respect of deposit accounts[967] thus confirming the 'preference' created for protected deposit accounts.[968]

4.4 Compliance of the Australian legal framework for deposit insurance with the IADI Core Principles

4.4.1 Principle 1: Public Policy objectives

[967] See clause 2 and the inclusion it effects to section 11CAA of the Banking Act 1959; clause 4 and the insertion it effects into section 11CAB(1) of the Banking Act 1959 and clause 5 which adds section 11CAD.

[968] Explanatory Memorandum to the Banking Amendment (Deposits) Bill 2020. Chan, Godwin and Ramsay "Depositor preferences and deposit insurance schemes – challenges for regulatory convergence and regulatory coordination in Asia" 2018 *Law and Financial Markets Review* 71-85. As explained by the aforesaid authors, "depositor preference" is the granting of priority to the claims of depositors on the assets of an insolvent bank over the claims of other unsecured creditors. It therefore allocates losses to the other unsecured creditors of an insolvent bank who are not depositors of such bank. Chan, Godwin and Ramsay points out (at 72) that this elevation of the position of depositors in the creditor hierarchy is a departure from the fundamental *pari passu* principle in insolvency law which traditionally requires that all unsecured creditors of a relevant class, including depositors, should share losses equally.

Considering the above overview, it is evident that the Australian EDIS has, since its inception, complied with the public policy objectives set out in IADI Core Principle 1. Having been established in the midst of the GFC, its objectives were from the beginning, to reimburse depositors' funds as well as to promote financial system stability in Australia.[969] These objectives, as incorporated in the *Financial Claims Scheme Act*, flow from Australia's overarching mission to protect depositors' interests. As seen from the provisions of both the *Banking Act 1945* and *the Banking Act 1959*, albeit that they did not have a formal explicit deposit insurance scheme at the time, Australia has always sought to protect depositors as concurrent creditors in the context of bank failures by giving them first priority in terms of claiming in the event of a bank failure.[970]

4.4.2 Core Principle 2: Mandate and Powers

As indicated, the Australian EDIS operates a 'pay-box' mandate.[971] Generally, a 'pay-box' mandate is largely restricted to reimbursing depositors only after the bank has been closed.[972] As such, a 'pay-box' mandate usually lacks prudential regulatory or supervisory powers as well as intervention powers.[973] As seen from the above discussion, the Financial Claims Scheme has the sole purpose of reimbursing depositors in a failed Australian ADI.[974] This mandate has recently been expanded to allow the Financial Claims Scheme funds to be used to support a compulsory transfer of business. This means that the new Crisis Management legislation now enables some or all of the business of a regulated ADI (including assets, liabilities, legal rights and obligations, data and systems) to be transferred to another regulated ADI in the same category.[975] The scope of funding for a transfer of business now extends to the amount to which each account-holder would be entitled to under the Financial Claims Scheme.[976] It is, therefore,

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969 Paragraph 4.1.2.4. Check these references.
970 Paragraphs 4.1.2.1 and 4.1.2.2.
971 Paragraph 4.1.2.4.
972 Principle 2 of the IADI Core Principles (2014) 19. See also Chapter 2, paragraph 2.5.2.
973 Chapter 2, paragraph 2.6.2.
974 Paragraph 4.3.2.
975 Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017 Explanatory Memorandum.
976 Paragraph 4.3.2.

submitted that the Australian EDIS has all the legal powers to give effect to its objectives, and that it's extended powers appear to have broadened its powers from a 'pay-box' to a 'pay-box plus' mandate.

4.4.3 Core Principle 3: Governance

As indicated, APRA is responsible for administering the Financial Claims Scheme.[977] Although the Financial Claims Scheme lacks the operational independence requirement for an effective deposit insurance system, it is submitted that APRA, as the administrator of the Financial Claims Scheme, does have the operational independence to perform its duties and functions without external interference. While the Financial Claims Scheme falls short on the requirement of operational independence,[978] the IMF has observed, however, that APRA provides economies of scale and reduces the possibility of coordination challenges between resolution and depositor payout.[979]

4.4.4 Core Principle 4: Relationship with other safety net participants

As observed, the Australian Government expects APRA, in pursuance of its administrator functions and powers, to cooperate with other financial sector supervisory agencies, and with other agencies specified in regulations.[980] Memoranda of Understanding also exist between APRA and the RBA[981] and coordination of activities and information-sharing is also facilitated by the Council of Financial Regulators. In light of this, it is clear that the Australian Financial Claims Scheme has in place, the relevant coordination mechanism to allow it to function effectively with other financial regulators. IADI Core Principle 4

[977] Paragraph 4.3.2.
[978] Core Principle 3 of the IADI Core Principles (2014) 21.
[979] IMF (2019) *FSAP Bank Resolution and Crisis Management* 27.
[980] Section 10A (1) of the *APRA Act* 1998.
[981] See the MOU between the RBA and APRA signed in October 1998 available at https://apra.gov.au/sites/default/files/MOU-RBA-Reserve Bank of Australia.pdf (accessed on 19 December 2021).

regarding the relationship of APRA, as the administrator of the Financial Claims Scheme, with other financial safety net participants, is thus complied with.

4.4.5 Core Principle 5: Cross-border issues

Drawing from the above overview of the Australian banking system, it is clear that there is recognition of the presence of foreign banks in Australia as well as the presence of Australian banks in other countries and the risks emanating from these presences. It further appears that Australia is committed to engaging in coordination arrangements with the relevant jurisdictions. Arrangements between Australia and New Zealand serve as an example of this commitment. In light of the very close integration of their financial systems, these countries recognized an interest in an explicit and mutual commitment to take into account cross-border spillovers.[982] In this regard, Australia and New Zealand entered into a memorandum of understanding (MoU) with the aim of assisting the participants to achieve a coordinated response to financial distress in any bank or banking group that has significant operations in Australia and New Zealand in a manner that avoids, where practicable, instability in the financial systems of Australia and New Zealand as well as promotes an effective resolution of the bank's financial distress.[983] It is, therefore, safe to conclude that Australia is well in place with the requirements for formal information sharing and coordination arrangements with other jurisdictions.

4.4.6 Core Principle 6: APRA'S role in contingency planning and crisis management

The Financial *Claims Scheme Act* is not clear on what role APRA, as administrator of the Financial Claims Scheme, should play in contingency planning and crisis management. However, the Australian ADIs are required, in terms of the prudential standard known as

[982] International Monetary Fund: European Department Staff *Selected Issues – Issues 13-281 of IMF Staff Country Reports* (2013) 66.
[983] *Memorandum of Cooperation on Trans-Tasman Bank Distress Management.*

APS 210,[984] to have in place a formal contingency funding plan (CFP) that explicitly outlines the strategies for addressing liquidity shortfalls in emergency situations.[985] The required CFP should contain the policies, procedures and action plans that would be used to respond to severe disruptions to an ADI's ability to fund some or all of its activities in a timely manner.[986] The retail deposit contingency plan seeks to address the ADIs' operational and logistical preparedness for depositors seeking to withdraw funds *en masse.*[987] APRA expects that the ADIs' plan should focus on repayment of retail depositors as a priority within contractual terms.[988]

According to APRA, the retail deposit contingency plan should ideally be separated from the CFP.[989] The key objective of the retail deposits contingency plan is to ensure that depositors wanting to withdraw their funds would be reasonably able to do so.[990] Moreover, it is required that a sound retail deposit contingency plan should estimate the amount of reasonably foreseeable physical and electronic cash required by depositors as well as the locations and channels from which the demands would likely arise.[991] Finally, ADIs are expected to report to APRA and the Reserve Bank of Australia (RBA) as soon as they realize that they are facing a retail run or consider that they might be facing it in the near future.[992]

From the above overview, it seems that Australia is on par with international best practice regarding the requirement for contingency planning and APRA seems to be doing well enforcing the APS 210 prudential standard for retail deposit ADIs.

4.4.7 *Core Principle 7: Membership*

[984] APS 210 is a prudential standard which requires ADIs to adopt prudent practices in managing liquidity risks and to maintain an adequate level of liquidity to meet their obligations as they fall due across a wide range of operating circumstances. See APRA *Prudential Standard APS 210 Liquidity* (2018) 9.
[985] APRA (2016) *Prudential Practice Guide: APS 210 – Liquidity* 12.
[986] APRA (2016) *Prudential Practice Guide* 12.
[987] APRA (2016) *Prudential Practice Guide* 14.
[988] *Ibid.*
[989] *Ibid*.
[990] *Ibid.*
[991] *Ibid*.
[992] APRA (2016) *Prudential Practice Guide* 15.

In line with international best practice as set out in IADI Core Principle 7, membership of the Financial Claims Scheme membership is compulsory for all Australian licensed ADIs and an explicit and transparent procedure is in place setting out the conditions, process and time frame for attaining such membership.[993]

4.4.8 *Core Principle 8: Coverage*

As indicated, the Australian Financial Claims Scheme covers deposits of up to AUS $250 000 for each account-holder of an Australian incorporated ADI.[994] This amount includes Australian banks and locally incorporated foreign subsidiary banks. Compared to international best practices, the Financial Claims Scheme coverage is relatively high as it fully covers around 97 percent of depositors.[995] However, the Financial Claims Scheme did not, from the beginning, always comply with the limited coverage requirement as the cap for guaranteed deposits was initially not specified in legislation.[996] Following the Financial Claims Scheme reassessment in 2012, the Financial Claims Scheme's level of coverage is now clearly stated and publicly defined in law.[997]

4.4.9 Core Principle 9: Sources and uses of Funds

The Financial Claims Scheme is an *ex post* funded deposit insurance scheme which is supported by a standing budgetary appropriation.[998] As alluded to above, the Australian ADIs pay no deposit insurance premiums and all expenses are expected to be recouped through recoveries on asset liquidation.[999] Accordingly, where the amount recouped is insufficient, the ADIs are charged a levy to cover the costs of depositors' claims.[1000] In this regard, it is submitted that the Financial Claims Scheme complies with the

[993] Paragraph 4.3.2.
[994] Paragraph 4.3.2.
[995] IMF (2019) *FSAP Bank and Crisis Management* 28.
[996] Paragraph 4.3.2.
[997] Principle 8 of the IADI Core Principles (2014) 27. See also chapter 2, paragraph 2.6.8.
[998] IMF (2019) *FSAP Bank Resolution and Crisis Management* 26.
[999] Paragraph 4.3.2.
[1000] Paragraph 4.3.2.

requirement that banks should bear some of the costs of bank failure through the paying of levies.

In 2014, the *Financial Services Inquiry* recommended that Australia must retain the *ex post* funding structure of the Financial Claims Scheme for ADIs.[1001] Thereafter, the Australian government, in accepting the Inquiry's recommendation, indicated that the increasing costs to the banking sector as well as the proposed plans to strengthen the resilience of the financial sector would limit the risk of failure and reduce the costs of failures that do occur.[1002] However, the Council of Financial Regulators conceded that the absence of risk-based premiums for ADIs and the retention of a post-funded arrangement arguably creates a higher level of moral hazard than would otherwise apply.[1003]

4.4.10 Core Principle 10: Public Awareness

The *Financial Claims Scheme Act* does not contain any provision relating to the promotion of public awareness. However, APS 910[1004] stipulates that the Financial Claims Scheme is more likely to provide financial stability if the public is aware of it.[1005] As such, APS 910 requires ADIs to examine the Financial Claims Scheme information currently on their website and in Product Design Specifications (PDS) documents to ensure it is accurate, up-to-date and easily accessible.[1006] APRA has however commented that a number of

[1001] Financial System Inquiry (2014) 82.
[1002] IMF (2019) *FSAP Bank and Crisis Management* 28.
[1003] Council of Regulators (2009) *Final Report on the Financial Claims Scheme Review: Early Access Facility for depositors* Minutes of the twenty-seventh meeting B-2.
[1004] APS 910 is the prudential standard established in terms of *Banking (prudential standard) determination No.2 of 2013: Prudential Standard APS 910 Financial Claims Scheme* which sets out the minimum requirements that a locally incorporated ADI must meet to ensure that it is adequately prepared for, should it become a declared ADI for the Financial Claims Scheme.
[1005] APRA (2019) *Prudential Standard APS 910 Financial Claims Scheme (APS 910) Requirements and Operational Preparedness* Letter to all locally incorporated authorized deposit-taking institutions 5. Available at www.apra.gov.co accessed on 25 September 2019.
[1006] APRA (2012) *Prudential Standard APS 910 Financial Claims Scheme* (APS 910). This Prudential standard is made under section 11AF of the *Banking Act* 1959.

ADIs' websites lack easily accessible information on the Financial Claims Scheme and the protection it offers.[1007]

4.4.11 Core Principle 11: Legal Protection

The administration of the Financial Claims Scheme vests with APRA. Accordingly, all immunities that apply to APRA staff also apply to the administrators of the Financial Claims Scheme. In this regard, an APRA staff member, agent or member is not subject to any liability to any person in respect of anything done, or omitted to be done, in the exercise or performance, or the purported exercise or performance of powers, functions or duties conferred or imposed on APRA, an APRA member or APRA staff member under the APRA Act 1998 or another law of the Commonwealth.[1008] The immunity from liability only applies to actions or omissions done in good faith.[1009]

4.4.12 Core Principle 12: Dealing with parties at fault in ADI failure

The Australian deposit insurance legislation contained no provision for dealing with parties at fault in ADI failure. However, in February 2018, the *Treasury Laws Amendment (Banking Executive Accountability and Regulated Measures) Bill 2018* was passed.[1010] The *Bill* introduced specific accountability obligations for ADIs and individual accountable persons who are required to register with APRA.[1011] The accountability regime seeks to drive improvement in ADI governance by establishing clear obligations and providing additional enforcement powers to APRA to take action when those obligations have been breached.[1012] Therefore, it is understood that this is APRA's way of ensuring that directors

[1007] APRA (2019) *Prudential Standard APS 910 Financial Claims Scheme (APS 910) Requirements and Operational Preparedness* 5.
[1008] Section 58(1) (a) of the *APRA Act* 1998.
[1009] Section 58(2) of the *APRA Act* 1998.
[1010] APRA (2017/2018) *Annual Report* 34.
[1011] *Ibid.*
[1012] *Ibid*.

and ADI executives are held accountable for their actions or failure to act in the event that an ADI fails.

4.4.13 Core Principle 13: Early detection and timely intervention

As indicated, APRA has intervention powers regarding an ADI that is likely to become unable to meet its financial obligations or an ADI which is about to suspend payments as well as depositor protection mandate.[1013] The operational efficiency of APRA's 'depositor protection'-provisions provides for early intervention in a financially troubled institution and makes clear that the regulator can close an insolvent entity.[1014] Accordingly, APRA is empowered by legislation to take direct action if it identifies behavior or financial distress that may threaten an ADI's ability to meet its financial obligations to depositors, or otherwise threaten financial system stability.[1015] In addition, section 10(1) of the APRA Act 1998 provides that APRA must give advice to the relevant Minister as soon as practicable if it has a reasonable belief that an ADI is in financial distress.[1016] The Australian EDIS thus appropriately provides for early detection and timely intervention as recommended by the IADI Core Principles.

4.4.14 Core Principle 14: Failure resolution

The IMF has commended Australia for having a relatively well-advanced set of resolution tools.[1017] In Australia, APRA is the designated resolution authority.[1018] The purpose of APRA's resolution function is to plan and implement prompt and effective responses to the failure of a regulated institution or a crisis in the financial system.[1019] These responses

[1013] Paragraphs 4.3.2.
[1014] Paragraph 4.3.2.
[1015] Paragraph 4.3.2.
[1016] Section 10(1) of the *Australian Prudential Regulation Authority Act* 1998.
[1017] IMF (2019) *FSAP Bank and Crisis Management* 18.
[1018] Paragraph 4.1.2.4.
[1019] APRA (2017/2018) *Annual Report* 39.

could comprise of early intervention with problem entities through the resolution of a failed institution, including administration of the Financial Claims Scheme.[1020]

Accordingly, APRA seeks to prepare financial institutions to be appropriately prepared to recover from severe adversity, supported by credible plans for effective resolution at the point of failure.[1021] This preparation entails working with institutions to make sure that they are ready for the effective implementation of resolution plans and working with domestic and international counterparts to ensure readiness for international cooperation if needed.[1022]

In order to properly prepare for distress in a regulated entity, APRA needs to plan for the effective resolution of an ADI.[1023] As observed by the Australian Treasury, this entails some degree of 'pre-positioning' or putting measures in place to allow APRA to intervene smoothly if required.[1024] Currently, APRA has the power to appoint a Banking Act statutory manager to an ADI[1025] to provide a flexible mechanism for dealing with a financial institution with acute distress and where APRA does not have confidence that the board and management of the ADI is capable of resolving the distressed ADI satisfactorily.[1026] APRA also has the discretion to direct an ADI to take a certain action where such action is deemed necessary to promote the financial system stability of Australia.[1027] In addition, APRA has the power to apply for the winding-up of an ADI if it deems desirable to do so.[1028]

Of great importance, as indicated above, the post-2008 GFC financial regulatory reform to the Australian financial system culminated in new crisis management legislation namely *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* which seeks to enhance APRA's management powers by providing

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[1020] *Ibid.*
[1021] APRA Capability Review (2019) 7.
[1022] *Ibid.*
[1023] Australian Treasury *Strengthening APRA's Crisis Management Powers – Consultation Powers* (2012) Commonwealth of Australia.
[1024] Australian Treasury *Strengthening APRA's Crisis Management Powers* (2012) 30.
[1025] Paragraph 4.1.2.4.
[1026] Australian Treasury *Strengthening APRA's Crisis Management Powers* (2012) 56.
[1027] Paragraph 4.3.2.
[1028] Paragraph 4.3.2.

clear powers to enable it to set requirements on resolution planning and ensure that banks are better prepared for a crisis.[1029] The *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* also gives APRA an expanded set of crisis resolution powers that enable it to act decisively to facilitate the orderly resolution of a distressed bank.[1030] In light of this, it is submitted that the introduction of the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act* 2018 *proves* that Australia is making significant progress with regards to having a resolution regime capable of providing extensively for the orderly resolution of distressed Australian ADIs.

4.4.15 Core Principle 15: Reimbursing depositors

The APS 910 puts its focus on banking sector readiness to operationalize the Financial Claims Scheme.[1031] It outlines the minimum requirements to be met by the locally incorporated ADIs to enable prompt and accurate reimbursements of depositors in the event that the Financial Claims is triggered for ADIs.[1032] The primary requirements of APS 910 include, inter alia, identifying each unique account-holder and developing and implementing a Single Customer View (SCV),[1033] along with payment, reporting and communication requirements.[1034]

The overarching purpose of APS 910 is to facilitate speedy and safe payments, to minimize the operational risks and administrative costs and to maintain the credibility of the Financial Claims Scheme.[1035] Accordingly, the Financial Claims Scheme gives priority

[1029] Paragraph 4.3.2.
[1030] Paragraph 4.3.2.
[1031] APS 910 (2012).
[1032] The objective of the APS 910 is to set out the requirements that a locally incorporated ADI must meet to ensure that it is adequately prepared, should it become a declared ADI for Financial Claims Scheme purposes. See APS 910.
[1033] A Single Customer View requires that an ADI must identify each unique account-holder, to the extent practicable, for the purposes of being able to pay account-holders who holds a protected account holder should the ADI be declared under section 16AD of the Banking Act 1959. See *Banking (prudential standard) determination No.2 of 2013: Prudential Standard APS 910 Financial Claims Scheme* (2013) 4.
[1034] APS 910.
[1035] APRA (2013) *Financial Claims Scheme for authorized deposit-taking institutions: Proposed requirements for payment, reporting and communications* Response to submissions 8.

to prompt payment to depositors of failed ADIs. As such, when an ADI fails, the liquidator must admit as debt or claim, the amount of the debt or claim, in relation to one or more protected accounts held by an account-holder with a declared ADI.[1036] Although, there is no statutory provision for the target time for the Financial Claims Scheme payments, APRA's intention is to provide depositors with access to the funds in their protected accounts as soon as possible following the declaration of the Financial Claims Scheme.[1037] More specifically, APRA seeks to pay depositors in a failed ADI within 7 days of the day on which the Financial Claims Scheme declaration is made.[1038] In light of the above, it is submitted that the Financial Claims Scheme is in compliance with the recommended prompt payments for depositors as it seeks to pay depositors of a failed ADI as soon as the ADI has been declared.

4.4.16 Core Principle 16: Recoveries

As observed, APRA is expected to facilitate depositor payouts within 7 days after the Minister of Finance has made a declaration for the Financial Claims Scheme to be invoked in the event that an ADI fails.[1039] Thereafter, APRA will recover the money used for payouts from the liquidation of a failed ADI by standing at the head of the priority queue of claimants on the failed ADI's assets.[1040] Where this amount is not sufficient to cover all costs, the Australian Government has to impose a levy on "surviving" ADIs to cover the outstanding costs.[1041] It is, therefore, clear that the Australian EDIS is in compliance with IADI Core Principle 14 relating to recoveries.

4.5 Concluding remarks

[1036] Section 14 of the *Australian Banking Regulations* 2016.
[1037] APRA (2012) *Financial Claims Scheme for authorized deposit-taking institutions: Proposed requirements for payment, reporting and communications* 10.
[1038] *Ibid.*
[1039] Paragraph 4.3.2.
[1040] Paragraph 4.3.2.
[1041] Paragraph 4.3.2.

In this chapter, the discussion focused on the history of depositor protection as well as the evolution of EDIS in Australia. Australian depositors in ADIs have traditionally, in the absence of EDIS, been protected by prudential regulation undertaken by APRA and its predecessors as well as the 'depositor priority provisions' of the *Banking Act* 1945 and *Banking Act* 1959, as amended. Although there has been a debate over the introduction of EDIS in Australia in previous years, it was only in 2008, in the wake of the spectacular failure of the British Bank 'Northern Rock' that the Australian government decided to formalize depositor protection.[1042]

The Australian EDIS, which was introduced amid the 2008 GFC, is a significant element of Australia's framework protecting depositors and supporting financial system stability. However, as seen from the chapter, the Financial Claims Scheme has always been somewhat unique by international standards with a maximum insurable amount as large as any other without requiring an *ex ante* fee for protection.[1043] In addition, the Financial Claims Scheme is also relatively unique in the priority it offers APRA for recovery of amounts paid to insured depositors of a failed ADI.[1044]

Unlike most EDIS, the Financial Claims Scheme requires no premium payments from ADIs. Only when the amount recouped from the liquidation assets is insufficient can ADIs be asked to pay the levy amounts to cover the costs of paying depositors. Another distinguishing feature of the Financial Claims Scheme is the absence of risk-based assessments for ADIs.

Although it can be said that the Financial Claims Scheme is largely compliant with most of the IADI Core Principles, it does not comply with the requirement to have an *ex ante*

[1042] The failure of Northern Rock in September 2007 marked the first time that the United Kingdom experienced a bank run in over 100 years. Although it was not particularly a large bank, it ranked among significant retail banks and mortgage lenders. Its run followed news of the bank experiencing funding problems in rolling its short-term debt and ended when the authorities pledged 100% guarantees for deposits at Northern Rock and other possibly troubled UK banks. It was alluded that the combination of poorly designed deposit insurance, poor regulatory supervision and a poor insolvency resolution regime for banks led to a very visible and disruptive run on the Northern Rock in the UK. See Eisenbeis and Kaufman "Lessons from the demise of the UK's Northern Rock and the US's countrywide and Indymac" in Bruni and Llewellyn (Eds) *The failure of Northern Rock: A Multi-dimensional case study* (2009) The European Money and Finance Forum Vienna.
[1043] Davis & Jenkinson (2013) 3.
[1044] *Ibid.*

funding mechanism, as also suggested by the IMF. Considering the strength of the Australian banking industry it could probably be argued that bank failure in Australia is sufficiently unlikely to justify their approach of having an *ex post* funded EDIS. However, it is submitted that an *ex ante* funded EDIS is more likely to boost depositor confidence and avoid having to make plans to manage payouts or effect deposit transfers only once the crisis of a bank failure has already manifested itself.

CHAPTER FIVE

DEPOSIT INSURANCE IN SOUTH AFRICA

5.1 Introduction

5.1.1 *General Overview of the South African Banking system*

The South African banking sector is oligopolistic and highly concentrated with the four largest banks cumulatively accounting for approximately 90% market share in the banking sector, making these banks systemically important in the South African financial system.[1045] Formal bank regulation was introduced on a national level in 1921 with the enactment of the Currency and Banking Act, 31 of 1920 which also established the South African Reserve Bank ('SARB') as central bank.[1046] Subsequently the Banking Act 38 of 1942 was enacted to provide a framework for the prudential regulation of banks and the function of bank supervision was entrusted to the SARB.[1047] The Banking Act of 1942 was amended,[1048] later consolidated with the Building Societies Act 82 of 1986, and eventually repealed by the current framework for prudential regulation of banks, the Deposit Taking Institutions Act 94 of 1990 which was thereafter renamed the Banks Act 94 of 1990.[1049]

The SARB, widely regarded as a robust bank regulator, [1050] became a member of the Bank of International Settlements ("BIS") in 1971 and South Africa became a G-20

[1045] Ifeacho & Ngalawa "Performance of the South African Banking sector since 1994" 2014 *Journal of Applied Business Research* 1184.
[1046] The Currency and Banking Act 31 of 1920 was replaced by the South African Reserve Bank Act 29 of 1944, which Act was subsequently replaced by the South African Reserve Bank Act 90 of 1989. South African Reserve Bank, *Commemorative publication,* 2011 available at https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/4987/SARB%20Commemorative%20publication.pdf (accessed 12 June 2020 3-4. See also De Jager "The South African Reserve Bank: blowing winds of change" 2013 *SA Merc LJ* 342.
[1047] Banking Act 38 of 1942. See also Moorcroft and Vessio *Moorcroft Banking Law and Practice* (2009 *et seq*) chapter 14 (hereinafter *Moorcroft* (2009 *et seq*)) par 1-3.
[1048] Banking Amendment Act 25 of 1947, Banking Amendment Act 41 of 1951 and Banks Act 23 of 1965.
[1049] Moorcroft (2009 *et seq*) par 2-1.
[1050] Moyo 'An Analysis of competition, efficiency and soundness in the South African banking sector' (2018) *South African Journal of Economic and Management Sciences* 3.

member in 2009,[1051] The SARB's main powers and functions are set out in section 10 of the South African Reserve Bank Act[1052] read with the Banks Act[1053] and the Regulations relating to Banks issued in terms of section 90 of the Banks Act.[1054] Prior to South Africa's transition to a Twin Peaks model as discussed in more detail hereinafter, the SARB executed its mandate of bank supervision by means of its Bank Supervision Department that set up the Office for Banks headed by the Registrar of Banks.[1055] The Banks Act, as amended over the years, tasked the SARB with licensing of banks that entailed a comprehensive two-stage authorization process, which also included grounds for license suspension and revocation.[1056] The Banks Act further inter alia regulated banks in relation to capital[1057] and liquidity;[1058] corporate governance;[1059] risk management[1060] and various other prudential measures and imposed supervisory reporting requirements and sanctions for non-compliance with the provisions of the Act. As prudential regulator of banks, the SARB had wide investigative powers and could conduct on-site and off-site

[1051] Boulle "The Republic of South Africa and the G-20: Its political, national interests and priorities as member of the process" available at https://www.kas.de/c/document_library/get_file?uuid=9278c444-6163-2651-22ce-d8dec97cd104&groupId=252038 (accessed 19 January 2021).
[1052] The South African Reserve Bank Act 90 of 1989. In terms of section 10 (v) the SARB *inter alia* was tasked to perform the (supervisory) functions assigned by the Banks Act.
[1053] *The Banks Act, Act 94 of 1990.*
[1054] Regulations relating to Banks issued in terms of section 90 of the Banks Act, 1990, published in Government Gazette no. 34838 of 15 December 2011 accessible at: https://www.gov.za/sites/default/files/gcis_document/201409/34838rg9644gon1033.pdf (accessed 3 April 2021.)
[1055] Section 3 of the Banks Act 94 of 1990. See also De Jager "The South African Reserve Bank: blowing winds of change (part 2)" 2013 *SA Merc LJ* 506; International Monetary Fund Country Report No. 14/340 *South Africa Financial System Stability Assessment* (3 December 2014) https://www.imf.org/external/pubs/ft/scr/2014/cr14340.pdf (accessed 3 April 2021), hereinafter IMF 14/340, at 55; Van Niekerk "The role of the central bank in the promotion and maintenance of financial stability-a comparative appraisal" (2018), *LLD thesis, University of Pretoria.* See also De Jager "The South African Reserve Bank: an evaluation of the origin, evolution and status of a central bank (part 1)" 2006 *SA Merc LJ* 159; De Jager "The South African Reserve Bank: an evaluation of the origin, evolution and status of a central bank (part 2)" 2006 *SA Merc LJ* 274; Bekink and Botha "The role of a modern central bank in managing consumer bankruptcies and corporate failures: a South African public-law angle of incidence" 2009 *SA Merc LJ* 74.
[1056] Sections 11 to 35 of the Banks Act 94 of 1990 regarding authorization to establish banks including their registration and cancellation of registration and annual licensing obligations.
[1057] Section 70 and 70A of the Banks Act 94 of 1990.
[1058] Section 72 of the Banks Act 94 of 1990.
[1059] Section 60 of the Banks Act 94 of 1990.
[1060] Section 64A of the Banks Act 94 of 1990.

supervision to enforce compliance with the provisions of the Banks Act.[1061] It further had comprehensive enforcement powers that it could apply inter alia where banks failed to meet the conditions for their continued licensing or prudential requirements.[1062]

South Africa, as BIS-member and G20-member, has also over the years aligned itself with various international standards on banking regulation, such as the *Basel Core Principles of Effective Banking Supervision*,[1063] and implemented the Basel II (minimum regulatory capital, capital management and market discipline) reforms on 1 January 2008 until December 2011, and subsequently phased in Basel 2.5 (improved risk coverage and increased capital requirements with a particular focus on trading instruments exposed to credit risk) from January 2011 to December 2012 followed by Basel III reforms since January 2013 (raising the quality of capital, enhancing the risk coverage of the regulatory framework, introducing capital buffers, introducing a leverage ratio to prevent build-up of excessive risk; monitoring of minimum liquidity standards and introducing additional capital buffers for Systemically Important Financial Institutions).[1064]

The SARB's robust approach to banking regulation was instrumental in keeping the banking industry largely safe and sound without continuous widespread bank failures.[1065] Although some banks did fail on occasion it was generally smaller banks that encountered failure and not the large systemically important banks. South Africa did not experience extended periods bank failure but a series of bank failures nevertheless occurred in the 1990s followed by a small bank crisis in 2003 and 2004, as discussed below. Notably,

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[1061] Section 11 and 12 of the Reserve Bank Act 89 of 1990.
[1062] Section 23 to 29 of the Banks Act 94 of 1990 (cancellation of a bank's registration and withdrawal of its license); section 26 (restriction of certain activities of banks); section 74 (failure or inability to comply with prudential requirements); section 90 (offences and penalties).
[1063] Core Principles for Effective Banking Supervision (Basel Core Principles) September 1997 available at https://www.bis.org/publ/bcbsc102.pdf (accessed 12 August 2021).
[1064] The South African Reserve Bank, *South Africa's implementation of Basel II and Basel III* available at https://www.resbank.co.za/PrudentialAuthority/Deposit-takers/Banks/Supervision/Pages/South-Africa%27s-implementation-of-Basel-II-and-Basel-III.aspx accessed 12 March 2019. See also the South African Reserve Bank, *Financial Stability Review*, 2020 available at https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9956/FSRMay2020.pdf accessed on 12 June 2020 32-39 for a review of progress with Basel III implementation in South Africa. For detail regarding the various Basel concordats see the Basel website at https://www.bis.org/publ/bcbsc312.pdf (accessed 4 May 2019).
[1065] As observed in the *SARB resolution approach discussion paper* at 10: bank failures in South Africa are "a rare event."

although it was a BIS–member as well as a G20-member, South Africa never operated an explicit deposit insurance framework.[1066] This meant that in the event of bank failure there was a possibility, but not a guarantee, that the bank would be bailed-out with public funds to maintain financial stability and protect depositors.

Having had a robust bank regulatory framework over the course of many years the need for an explicit deposit insurance framework was simply not perceived as a matter of pressing urgency. In fact, the large banks that dominated the banking sector were well-capitalized and safe and sound hence depositors' money was generally not regarded to be at risk. Thus, requiring protection under a deposit protection framework that would impose levies and premiums on banks, thereby slicing into the capital they could use to earn greater profits, was not on top of the regulatory agenda. In the absence of an explicit deposit protection framework in the South African banking industry there was thus only 'implicit' deposit insurance operating on the principle of constructive ambiguity and therefore no guarantee that if a bank failed there would be a bail-out facilitated by dipping a hand into taxpayers' money. However, some bailouts were extended to banks that were considered systemic in the South African financial system, such as when African bank failed in 2014,[1067]

The absence over the course of many years of an explicit and privately funded deposit insurance system in South Africa has however been regarded as representing a gap in the design of the financial safety net aimed at promoting financial stability.[1068] The 2008 GFC, as discussed in Chapter One, albeit that it did not affect South Africa as severely

[1066] See para 7 below.

[1067] Van Heerden "Deposit Protection in South Africa: Recent Developments" 2020 *Journal of International Banking Law and Regulation* 45. Regarding implicit deposit insurance and the concept of constructive ambiguity see further Anginer, Demirguc-Kunt "Bank runs and moral hazard: a review of deposit insurance" World bank Policy Research Working Paper 8589 available at http://documents1.worldbank.org/curated/en/548031537377082747/pdf/WPS8589.pdf accessed 29 October 2019 (hereinafter Anginer & Demirguc-Kunt); Demirguc-Kunt, Kane, Laeven "Deposit Insurance Database" IMF Working Paper WP/14/118 available at https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Deposit-Insurance-Database-41710 accessed 29 October 2019. Regarding the failure of African Bank see Van Heerden "The Rescue of African Bank: a Step Forward in Banking Regulation in South Africa" 2017 *Journal of International Banking Law and Regulation* (*J.I.B.L.R*) 350.

[1068] South Africa (2017) South African Reserve Bank (SARB). *Designing a deposit insurance scheme for South Africa – a discussion paper*."

on a financial level as some other countries, however also impacted the trajectory and paradigm of financial sector regulation in South Africa given that the country committed itself at the G20-summit in Seoul in 2010 to align with the international financial reform agenda.[1069] Following a financial regulatory system review that began in 2007 and gained momentum post GFC South Africa thus embarked on comprehensive reforms of its approach to financial regulation.

At the heart of these reforms was a move from a silo sectoral model of financial regulation towards a Twin Peaks model of financial regulation by objective,[1070] as encapsulated in the *Financial Sector Regulation Act* 2017 (FSRA) which eventually came into operation in August 2017 and sets out the architecture of the South African Twin Peaks Model. The overriding objective for the adoption of the Twin Peaks model in South Africa was to ensure a safe and sound and more efficient financial sector in the interests of all South Africans by minimizing the possibility of threats to financial stability[1071] and protecting customers by ensuring that financial institutions treat them fairly.[1072]

[1069] The G20 Seoul Summit Leaders' Declaration available at http://www.g20.utoronto.ca/2010/g20seoul.html accessed (4 April 2020). See also the G20 Seoul Summit Action Plan and Table containing policy commitments by G20 members at 38 available at https://www.mofa.go.jp/policy/economy/g20_summit/2010-2/commitments.pdf (accessed 7 February 2021).

[1070] Godwin "Introduction to special issue – the twin peaks model of financial regulation and reform in South Africa" 2018 *Law and Financial Markets Review* 151-153.

[1071] In terms of section 4(1) (a), (b) and (c) of the FSRA, financial stability means" the ability by financial institutions to generally provide financial products and financial services, and of market infrastructures to generally perform their functions and duties in terms of financial sector laws without interruption; the capability of financial institution to provide financial products and financial services and of market infrastructures to continue to perform their functions and duties in terms of financial sector laws, without interruption despite changes in economic circumstances; and there is general confidence in the ability of financial institutions to continue to provide financial products and financial services; and the ability of market infrastructures to continue to perform their functions and duties without interruption, regardless of the changes in economic circumstances".

[1072] Section 7 (1) of the FSRA sets out the objectives of the Act and provides as follows "The object of this Act is to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the specific financial sector laws, a regulatory and supervisory framework that promotes – financial stability; the safety and soundness of financial institutions; the fair treatment and protection of financial customers; the efficiency and integrity of the financial system; the prevention of financial crime; financial inclusion; transformation of the financial sector; and confidence in the financial system." See also South Africa (2018) National Treasury. Press Release: *New Twin Peaks Regulators Established*.1.

The South African Twin Peaks model comprises of three peaks, namely the newly established Prudential Authority (PA)[1073] and the newly established Financial Sector Conduct Authority (FSCA),[1074] as twin regulators responsible for prudential and market conduct regulation respectively, with the South African Reserve Bank (SARB), as central bank,[1075] an apex peak tasked with financial stability.[1076] As part of its comprehensive stability mandate. which has now for the first time been captured explicitly in legislation,[1077], the FSRA requires the SARB to take all reasonable steps to prevent systemic events[1078] from occurring and to swiftly reduce the adverse effects of such a systemic event if it has occurred or is impending as well as to manage the systemic event and its effects.[1079] Note should further be taken that, in the Twin Peaks model introduced

[1073] The Prudential Authority was established in terms of section 32(1) of the FSRA to promote and enhance the safety and soundness of financial institutions that provide financial products and securities; to promote and enhance the safety and soundness of market infrastructures; to protect financial customers against the risk that those financial institutions may fail to meet their obligations; and to assist in maintaining financial stability. See section 33 of the FSR Act for the objectives of the PA.

[1074] Established in terms of section 56(1) of the FSRA, the Financial Sector Conduct Authority is a national public entity for the purposes of the Public Finance Management Act whose objective is to enhance and support the efficiency and integrity of financial markets; and protect financial customers by, inter alia: promoting fair treatment of financial customers by financial institutions; and providing financial customers and potential financial customers with financial education programs, and otherwise promoting financial literacy and the ability of financial customers and potential financial customers to make sound financial decisions as well as assist in maintaining financial stability.

[1075] As indicated, the *Currency and Banking Act* 31 of 1920 established the SARB as South African central bank. Currently, the SARB is regulated under the South African Reserve Act 90 of 1989 while its position as central bank is entrenched in section 223 of the Constitution of the Republic of South Africa 1996.

[1076] See sections 32-34 of the FSR Act 2017 regarding the establishment, objective and functions of the PA and sections 56-58 regarding the establishment, objectives and functions of the FSCA. The framework for the SARB's financial stability mandate is captured in sections 11-31 of the FSR Act 2017. See further Van Heerden & Van Niekerk 'The Financial Stability Mandate of the South African Central Bank in the Post-Crisis landscape' 2018 *Journal of International Banking Law and Regulation* 414.

[1077] Section 11 of the FSRA read with sections 12 to 19.

[1078] A systemic event is defined in terms of section 1 of the *Financial Sector Regulation Act* FSRA as "an event or circumstance, including one that occurs or arises outside the Republic, that may reasonably be expected to have a substantial adverse effect on the financial system or on economic activity in the Republic, including an event or circumstance that leads to a loss of confidence that operators of, or participants in, payment systems, settlement systems or financial markets, or financial institutions, are able to continue to provide financial products or financial services, or services provided by a market infrastructure."

[1079] Section 15(1) (a), (b) (i) and (ii) of the FSRA.

by the FSRA, the SARB no longer has the mandate of prudential supervision of banks as this mandate has now been given to the Prudential Authority.[1080]

In alignment with the international financial reform agenda post-GFC to which South Africa as G-20 member committed at the G-20 Seoul Conference in 2010,[1081] the SARB together with the National Treasury, inter alia, embarked on a regulatory journey to establish a new legislative framework that would facilitate the resolution of failing institutions in an orderly and transparent manner aimed at reducing the use of government funding to bail out such institutions.[1082] This new resolution framework would be a crucial pillar of the SARB's expanded and explicit financial stability mandate.[1083] In tandem with the establishment of this new resolution framework, South Africa also sought to introduce a legislative framework for an explicit deposit insurance scheme (EDIS) as discussed below.

5.1.2 Implicit deposit protection in South Africa

As Okeahalam observes, despite robust bank supervision, South Africa is however not immune against bank failures that result in loss of their deposits by depositors.[1084] Generally, as pointed out, these bank failures involve smaller non-systemic banks or banks with a limited client base, which made it possible for government to compensate the retail depositors through implicit deposit protection administered by the SARB.[1085] Although there is currently no statutory framework capturing the obligation to reimburse depositors of failed banks, the SARB has, since the 1980s, compensated small depositors

[1080] See section 33 and 34 of the FSRA. See further Van Heerden & Van Niekerk "The role of the SARB as central bank in the South African Twin Peaks model" in Godwin & Schmulow (eds) *The Cambridge Handbook of Twin Peak Financial Regulation* (2020) 153.

[1081] See National Treasury A safer financial sector to serve South Africa better (February 2011) available at http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf (accessed 22 September 2020).

[1082] South Africa (2017) South African Reserve Bank *Financial Stability Review* (2nd) edition 28.

[1083] SARB *Financial Stability Review* (2017) 28. This new resolution regime has been incorporated into the FSRA through the Financial Sector Laws Amendment Act 23 of 2021 as Chapter 12 A, comprising sections 166A to 166Z.

[1084] Okeahalam "The Political economy of bank failure and supervision in the Republic of South Africa" 1998 *African Journal of Political Science* 35.

[1085] SARB *Financial Stability Review* (2017) 28.

whilst leaving large depositors as well as shareholders to bear some of the losses of these failed banks.[1086]

In addition to the bank failures in the 1990s and the small bank crisis of 2002/2003, the following bank failures occurred, mainly due to inadequate capital and poor governance, since the enactment of the Banks Act 94 of 1990:[1087] Alpha Bank (1990), Cape Investment Bank (1991), Pretoria Bank, Sechold Bank (1993), Prima Bank (1994), African Bank (1995), Community Bank, and the Islamic Bank of South Africa (November 1997); FBC Fidelity Bank Ltd (1999), Cashbank (2000), and Regal Treasury Bank (2002). ABSA Bank further acquired Bankorp in 1995. Later the South African "small bank crisis of 2002/2003" occurred, the "first wave" commencing with a run on Saambou Bank in February 2002 and the bank being placed in curatorship in February 2009, followed by the failure of another seven banks (BOE Bank, Merrill Lynch, TA Bank, FirstCorp, PSG Investment Bank and International Bank). The "second wave" of bank failures commenced in September 2002 and involved the failure of Brait Merchant Bank (September 2002), Corpcapital (November 2002), Old Mutual Bank (December 2002), SECIB Bank (February 2003) and Unibank (March 2003). A "third wave of bank failures" followed that involved Nedcor Investment and Cape of Good Hope (February 2003), ING and Rand Merchant Bank (July 2003) and African Merchant Bank (September 2003).[1088]

Approximately a decade later two memorable bank failures occurred, namely the failures of African Bank Investments Ltd and VBS Mutual Bank. Before its failure, African Bank Investments Ltd was the largest unsecured lender in South Africa, advancing loans without the backing of a mortgage or security.[1089] In August 2014, African bank issued an advisory warning of significant losses due to bad debts.[1090] Following this announcement,

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[1086] SARB *Annual Report* (1998) 12. See also Lugulu *Addressing the moral hazard through explicit deposit insurance: A comparative appraisal of the Kenya Deposit Insurance Act 2012* (Unpublished University of Pretoria LLD thesis 2019) 185.
[1087] See Okeahalam "The political economy of bank failure and supervision in the Republic of South Africa" 1998 *African Journal of Political Science* 29 at 35-38.
[1088] See Havemann *Lessons from South African bank failures 2002 to 2014* (Unpublished PhD Economics Thesis, University of Stellenbosch, 2019) 11-12.
[1089] Batra "African bank goes under central bank's curatorship amidst mounting credit losses" 2014 *NUS Risk Management Institute Weekly Credit Brief* 1.
[1090] Oxford Business Group *The Report South Africa 2014* (2014) 50

its share price dropped 60%, ultimately leading to the announcement of curatorship a few days later.[1091] On the eve of its demise, African bank was described as systemic to the South African banking sector, based on its extensive client base, its niche role in financial inclusion as well as the negative impact on the socio-political environment.[1092] Following the African bank scare, the SARB moved swiftly to maintain confidence in the financial sector[1093] by placing the bank under curatorship.[1094]

Soon after the African Bank collapse, the VBS Mutual Bank[1095] failed in 2016. In a *Press conference*[1096] held by SARB on the 11th May 2018, SARB Governor Lesetja Kganyago stated that VBS bank had experienced liquidity challenges that emanated from the maturity of a large concentration of deposits from municipalities and was exacerbated by the termination of other sizeable deposits and the inability to source sufficient funding timeously.[1097] These liquidity challenges resulted in difficulty to settle its obligations in the National Payments System on several occasions.[1098] The bank was therefore placed

[1091] At the time it was placed under curatorship, the balance sheet of African bank presented a stark picture. The crisis of African bank was not one of liquidity in the sense of being unable to honour cash withdrawals. Instead, its troubles resulted from non-performing loans to over-stretched clientele. See Dow, Jesperson & Tily (Eds) *Money, Method and Contemporary Post-Keynesian Economics* (2018) 50.
[1092] Dow, Jesperson & Tily (2018) 50.
[1093] Tjiane *Curatorship of banks as a measure to rescue failing banks* (Unpublished Master of Laws dissertation, University of Pretoria, 2015) 5.
[1094] Tjiane (2015) 5.
[1095] VBS Mutual bank was established in 1982 as the Venda Building Society. VBS came under the spotlight in 2016 when it provided a loan of R7.8 million to the then President Jacob Zuma to help him repay money spent while upgrading his personal residence at Nkandla. In March 2018, VBS was placed under curatorship as a result of severe liquidity crisis. An independent investigation and report, commissioned by the SARB and authored by senior Advocate Terry Motau, revealed that nearly R1.9 billion in ‘gratuitous payments’ were made by VBS to 53 individuals and other entities. See Open Secrets *Corporations and Economic Crime Report – The Bankers* (2018) 39.
[1096] South African Reserve Bank (SARB) *Remarks by the Governor of the South African Reserve Bank Lesetja Kganyago in a press conference* held on 11th March 2018: VBS Mutual Bank.
[1097] SARB, *Press conference: VBS Mutual Bank* (2018) 2.
[1098] *Ibid.*

under curatorship[1099] with effect from the 11th March 2018.[1100] Given the nature of its financial woes which included wide-scale theft of funds by bank officials, it was subsequently placed in liquidation 13 November 2018.

In his speech, the Governor gave the assurance that the (then) Office of the Registrar of banks, having been tasked with the promotion of the safety of depositors' funds placed with banks, had to ensure that depositors retain confidence and trust in the South African banking system.[1101] For this reason, the SARB guaranteed the reimbursements of deposits in VBS in the amount of R50 000 per depositor albeit that no explicit deposit framework was in place at the time to regulate depositor protection.[1102]

In principle, in accordance with the Lender of Last Resort (LOLR) of the SARB as central bank, a South African bank experiencing temporary liquidity problems may be assisted with some emergency liquidity assistance (ELA), provided it is solvent.[1103] Thus, immediately upon realizing that a bank is potentially experiencing financial difficulties, the SARB has to launch a special investigation to establish whether such bank indeed suffers from a liquidity or solvency problem.[1104] If the investigation reveals that the bank's liquidity problem is temporary, the SARB has to then decide, in the interest of the stability of the banking system, whether or not to provide temporary emergency liquidity assistance against security provided by the bank.[1105]

[1099] Section 69 of the Banks Act 90 of 1989 read with section 69A provides for curatorship and an inquiry into the affairs of a bank under curatorship. Simply defined, curatorship is a managed insolvency tool that allows regulators of a financial institution that is likely to fail to meet its financial obligations subject to the necessary approvals, to appoint a competent and qualifying person to take over the management of the institution. See SARB *Strengthening South Africa's resolution framework* (2015) 30. The curatorship process will be repealed once the FSLA Bill comes into operation. See section of the 12(1) of the FSLA Bill 2018 which provides that "the Banks Act 1990, is hereby amended by the repeal of sections 68, 69 and 69A.

[1100] *SARB Press conference: VBS Mutual Bank* (2018) 2.

[1101] *Ibid.*

[1102] *Ibid.*

[1103] Section 10(f) of the South African Reserve Bank Act (SARB Act) 90 of 1989 allows the SARB to grant loans and advances under certain circumstances.

[1104] Section 11(1) of the SARB Act provides that the SARB "may appoint inspectors to carry out inspections of the affairs of the bank, or of any part thereof, of a bank or a mutual bank." See also SARB *Commemorative Publication* (2017) 65.

[1105] Section 10(1)(s) of the SARB Act 1989.

The decision to provide ELA facilities by the SARB is discretionary and it is usually based on the severity of the implications of a bank failure for the stability of the monetary and financial systems of South Africa.[1106] Since the SARB is a non-profit public institution with a public interest role, any ELA assistance is typically done at the expense of taxpayers' funds.[1107] This means that in circumstances in which depositors' funds were lost or likely to be lost during a bank failure, the SARB, with the concurrence of the Government, stepped in to ensure that depositors were repaid a substantial part of their deposits.[1108]

In the SARB Financial Stability Review of 2017 it was stated that, viewed from the banking sector perspective, the advantage of the implicit deposit insurance arrangements which South Africa had in place, was that it does not put direct cost on the banking sector.[1109] It was pointed out that, in any event, the country had to date not experienced the failure of any of the large banks hence these banks never felt the need to lobby for, and partake in, an explicit deposit insurance scheme.[1110] In fact, any suggestions[1111] to introduce an EDIS in South Africa were always countered with various counterarguments, including issues of affordability, the concentrated banking system dominated by few large banks as well as the risk of moral hazard.[1112]

[1106] SARB *Commemorative Publication* (2017) 67.
[1107] De Jager (2010) *De Jure* 230.
[1108] Mbuya *The Pillars of Banking* 219.
[1109] SARB *Financial Stability Review* (2017) 28.
[1110] In relating deposit insurance to bank failures in South Africa, Okeahalam reckons it is necessary to compare the cost and benefits of a limited explicit guarantee and the increased bank monitoring that would result from the establishment of a deposit insurance corporation, with that of the current implicit deposit insurance. See Okeahalam & Maxwell 'Deposit insurance design and bank regulation in South Africa' 2001 *Journal of Financial Regulation and Compliance* 139.
[1111] In 1998, in his article, Okeahalam made a case for the introduction of a deposit guarantee scheme similar to the one which prevailed in the US under the *Federal Deposit Insurance Corporation Improvement Act* (FDICIA) 1991 where rules were clearly substituted for discretion. See Okeahalam "The Political Economy of bank failures and supervision in SA" 1998 *African Journal of Political Science* 41. Ngaujake also presented a case for the establishment of EDIS in South Africa in his Master of Commerce thesis in 2003. According to Ngaujake, the absence of a well-defined depositor protection arrangement in South Africa provides further impetus for the speedy introduction of EDIS as such move would be a desirable departure from the implicit guarantee offered by the SARB, which is discretionary and uncertain. See Ngaujake *Protecting depositors and promoting financial stability in South Africa: Is there a case for the introduction of deposit insurance*? (Master of Commerce thesis, Rhodes University 2003) 93.
[1112] SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 33.

However, as indicated in Chapter One, the 2008 GFC prompted a fresh look into the role of depositor protection and its ability to protect depositors and contribute to financial stability by staving off bank runs and moral hazard that occasion bank failure as well as its interaction with resolution frameworks where it can fund certain resolution actions or facilitate prompt payouts to depositors in the event that a bank is liquidated.[1113] Against this background, the SARB and National Treasury issued a policy document in 2015 titled '*Strengthening South Africa's Resolution Framework for Financial Institutions*'[1114] (the 2015 *Policy Document*) which set out the motivation and policy proposal for strengthening the framework for the resolution of designated financial institutions in South Africa. As part of this framework, the establishment of an EDIS and its design features were preliminarily explored.[1115]

In 2017, the SARB and the National Treasury gave further momentum to the initiative to establish an EDIS with another document titled '*Designing a deposit insurance scheme for South Africa*' *(a Discussion Paper)*. [1116] This *Discussion Paper* contained more concrete proposals for the establishment of an explicit deposit insurance scheme for South Africa. Following the aforesaid policy documents, the South African Government tabled the *Financial Sector Laws Amendment Bill*[1117] in Parliament during August 2018 which sought to give effect to the proposals contained in the aforesaid policy documents. An updated version of the aforesaid Bill was introduced in 2020 and the *Financial Sector Laws Amendment Act* was eventually enacted in 2021.[1118]This Act, which is yet to be put into operation, introduces an EDIS framework as well as a resolution framework into the Financial Sector Regulation Act, being the framework law for the South African Twin Peaks Model. The main features of the South African EDIS, as conceptualized in the

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[1113] Chapter 1, paragraph 1.2.1.
[1114] SARB: National Treasury Strengthening *South Africa's resolution framework for financial institutions* (2015).
[1115] Refer to the relevant pages and annexure
[1116] SARB: Financial Stability Department *Designing a deposit insurance scheme for South Africa – a discussion paper* (2017).
[1117] *Financial Sector Laws Amendment Bill* 2018 as introduced in the National Assembly (proposed section 75): Explanatory summary of Bill published in Government Gazette No 41955 of 05 October 2018.
[1118] Financial Sector Laws Amendment Act 23 of 2021.

aforesaid policy documents and incorporated into the *Financial Sector Regulation Act* via the *Financial Sector Laws Amendment Act* are analysed below.

5.2 The transition to an EDIS in South Africa

5.2.1 Strengthening South Africa's resolution framework for financial institutions (2015)

The transition to an EDIS in South Africa commenced in 2008 when the National Treasury circulated a draft *Deposit Insurance Bill* for comments.[1119] However, a range of challenges complicated the completion of that initiative.[1120] Subsequently the initiative was revived with a policy document titled '*Strengthening South Africa's Resolution Framework for financial institutions*' (the *Policy Document*) setting out the motivation and proposals for a strengthened framework for the resolution of designated financial institutions in South Africa, including proposals for the introduction of an EDIS.[1121]

In the aforesaid *Policy Document*, the National Treasury expressed the view that introducing an EDIS would provide the SARB that would be the designated resolution authority, with more options for funding a particular resolution strategy without resorting to the use of public funds.[1122] It was stated that the introduction of an EDIS would enable the resolution of failed banks to be conducted efficiently, economically and impartially compared to the current implicit guarantee system.[1123] The *Policy Document* proposed that South Africa should implement an EDIS in line with the requirements of the *Key*

[1119] Although the National Treasury makes a mention of this Bill, all efforts to find it yielded no results. See South African National Treasury (NT) *A safer financial sector to serve South Africa better* (2011) 66.
[1120] Some of the challenges included the need to take into account the specifics of the South African financial system, in particular, the fact that South Africa is dominated by four big banks. See NT *A safer financial sector* (2011) 66.
[1121] According to Francois, the establishment of explicit deposit insurance scheme will ensure that depositors who are most exposed to an asymmetry of information and thus least able to hedge themselves against financial loss in the event of a bank failure. See South African Reserve Bank (SARB) *Opening remarks by Francois Groepe, Deputy Governor of the South African Reserve Bank, at the public workshop on proposals to establish a deposit insurance scheme for South Africa* (2017) 2.
[1122] *Ibid.*
[1123] Ngaujake (2003) 96.

Attributes, but that it should be implemented in such a way that it does not put excessive costs on the banking system.[1124]

In particular, the *Policy Document* recommended that before an EDIS could be implemented in South Africa, certain considerations regarding coverage had to be addressed.[1125] It was inter alia pointed out that a key question that policymakers need to ask is whether the proposed EDIS should cover all depositors or only a certain class of depositors such as retail and small business depositors.[1126] The *Policy Document* recommended introducing a deposit insurance scheme to protect vulnerable depositors who are most exposed to information asymmetry and who are most likely to suffer in the event of a bank failure.[1127] An additional consideration, according to the *Policy Document*, was whether only permanent residents of South Africa or also foreign depositors should be covered under the proposed EDIS.[1128] Moreover, considering that South Africa has a rare history of bank failures compared to various other countries on the African continent,[1129] the *Policy Document* proposed taking into consideration the cost of introducing an EDIS to the banking system.[1130]

1124 SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 35.

1125 Ngalawa, Tchana & Viegi believe that countries wishing to implement EDIS need to decide on the type of deposits that will be covered and the type of financial institutions that will be included or excluded from the coverage. See Ngalawa, Tchana & Viegi 'Banking instability and deposit insurance: The role of moral hazard' 2016 *Journal of Applied Economics* 334.

1126 In this regard, it is recommended that policymakers define clearly in law, prudential regulations or by-laws, what an insurable deposit is. Thereafter, the determined amount should adequately cover the large majority of depositors to meet the public policy objectives of the deposit insurance system. See IADI *Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage* (2013) 7.

1127 The reasoning behind this rests on the assumption that in the event of a bank failure, small depositors are more exposed to the risk of loss than large depositors because of their inability as well as lack of means to assess the financial health of banks compared to institutional depositors. The justification for protecting small depositors is also based on the fact that they (small depositors) are thought to be more adversely affected by losses incurred during a bank failure. See Ngaujake (Master of Commerce thesis, Rhodes University 2003) 50.

1128 SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 35.

1129 See for example, Nyaude (LLD Thesis, University of Pretoria, 2021) where she provides various examples of bank failures in Zimbabwe.

1130 SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 36.

With respect to funding, the *Policy Document* recommended that South Africa adopt a hybrid[1131] approach to the funding of the deposit insurance system.[1132] This would require a levy to be charged on all banks to pre-fund the EDIS to the targeted level.[1133] However, Treasury observed that there should be a formal legislative provision for government to provide funding in the event of a shortfall during the build-up period of the Fund as well as thereafter.[1134] It was further pointed out that the provision should also specify how the funding provided by the government should be recovered.[1135] According to the *Policy Document*, proposals on the South African deposit insurance system should take into consideration the base on which premiums should be levied as well as the level of the premiums.[1136] Moreover, given the high level of concentration in the South African banking sector, it was proposed that banks should be charged premiums on a flat-rate structure which can later be changed to a risk-based fee after its establishment.[1137]

The *Policy Document* proposed that the trigger for deposit insurance payouts to depositors should be when the SARB invokes the deposit insurance system.[1138] As the SARB would be the resolution authority in the proposed bank resolution dispensation, the *Policy Document* indicated that the decision to invoke the deposit insurance scheme was best left to the SARB and should depend on the resolution strategy it adopts. However, it

[1131] A hybrid funding mechanism is a form of funding that involves elements of both ex-ante and ex-post funding such as charging levies before a bank failure, increasing premiums, charging additional levies and receiving the proceeds of liquidations. See SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 37.
[1132] Long before the South African government could announce the move towards an EDIS, Ngaujake proposed that should South Africa introduce EDIS, the South African policymakers should consider adopting an ex ante deposit insurance system instead of relying on ex post assessments and contributions. He also recommended integrating some aspects of ex post system into the ex-ante system, thus making it a hybrid mechanism. See Ngaujake (2003) 105. See also SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 37.
[1133] SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 39.
[1134] *Ibid*.
[1135] According to the *Policy Document*, the funding provided by the government should be recovered through a combination of liquidation proceeds and levies on surviving banks afterwards. SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 39.
[1136] SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 39.
[1137] See Chapter 2, para 2.5.9.
[1138] SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 39.

emphasized that the payout of depositors' funds should be facilitated as soon as possible after a bank has entered resolution.[1139]

5.2.2 Designing a deposit insurance scheme – a Discussion Paper (2017)

The aforesaid *Policy Document* was followed up with a *Discussion Paper*[1140] issued by SARB (in its capacity as proposed new resolution authority) in May 2017, containing proposals on the key design features of the envisaged South African EDIS. This discussion paper should be read in conjunction with the 2015 *Policy Document*.[1141] According to the *Discussion Paper*, and in line with what was stated in the *Policy Document*, the key objective for introducing an EDIS is to afford protection to less financially sophisticated depositors in the event of a bank failure and to promote the stability of the South African financial system.[1142] To allow for the prompt payout of depositors' funds when a bank fails as well as to allow the EDIS to financially support other forms of resolution without putting too much costs to it, a 'pay-box plus' mandate was recommended for South Africa.[1143] Accordingly, the *Discussion Paper* indicated that the envisaged EDIS will have the legal powers to give effect to its objectives and mandate, including the powers associated with a 'pay-box plus' mandate.[1144]

[1139] The *Policy Document* recommended that the pay-out of deposits should be within seven days after the closure of the bank. In this regard, deposit insurance members should be required to implement a single customer view (SCV) recordkeeping to facilitate a rapid pay-out. Accordingly, members should be afforded a reasonable time in which to phase in the necessary information system and other reforms to enable a seven-day pay-out. See International Monetary Fund (IMF) *South Africa Financial Sector Assessment Program: Financial safety net, bank resolution, and crisis management framework – Technical note* (2015) IMF Country Report No 15/53 34. See also SARB *Strengthening South Africa's resolution framework for financial institutions* (2015) 41.

[1140] SARB: Financial Stability Department *Designing a deposit insurance scheme for South Africa – a discussion paper* (2017).

[1141] SARB *Designing a deposit insurance scheme* (2017) 1.

[1142] *Ibid*.

[1143] SARB *Designing a deposit insurance scheme* (2017) 20.

[1144] According to the IADI Core Principle 2, the powers associated with a 'pay-box plus mandate' include, but are not limited to: assessing and collecting premiums, levies or other charges; transferring deposits to another bank; reimbursing insured depositors; obtaining directly from banks timely, accurate and comprehensive information necessary to fulfil its mandate; receiving and sharing timely, accurate and comprehensive information within the financial safety-net, and with applicable safety-net participants in other jurisdictions; compelling banks to comply with their legally enforceable obligations to the deposit

The *Discussion Paper* proposed that the EDIS be positioned within the SARB as its subsidiary, making it a separate legal entity with its own legislative framework and governance requirements but located within the SARB as the SARB would be the designated resolution authority.[1145] It is submitted that this arrangement will help reduce the start-up costs for the EDIS as the logistics of finding a separate location might be too costly. However, to ensure its operational independence, it was proposed that the EDIS should have a governing board consisting of the representatives from the SARB, National Treasury, the Prudential Authority (PA), the Financial Sector Conduct Authority (FSCA) and the Head of the EDIS.[1146] Once appointed, the *Discussion Paper* indicated that the board should create a framework to govern, inter alia: the frequency of meetings: internal controls; duties and responsibilities; communication processes; transparency; disclosure arrangements and the transparent processes for the appointment and removal of Board members.[1147]

Before determining the scope and level of coverage for the envisaged EDIS, the SARB carried out an in-depth appraisal to determine the exact size and distribution of all deposits held by South African banks with the exclusion of large corporations' deposits.[1148] As a result of the aforesaid survey, the *Discussion Paper* indicated that the

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insurer; setting operational budgets, policies, systems and practices; and entering into contracts. See also SARB *Designing a deposit insurance scheme* (2017) 22.

[1145] SARB *Designing a deposit insurance scheme* (2017) 22.

[1146] The FSLAA 23 of 2021 in not clear on who, out of all the appointed Board members, will be Head of the Corporation. However, it is submitted that a representative from the SARB would best serve as Head of the Corporation since they would be having extensive knowledge and expertise in the financial sector.

[1147] It is recommended that the process for appointing and removing members of the governing body and the deposit insurer's head of management should be clearly set out in law, by-laws, or administrative procedures. See International Association of Deposit Insurers (IADI) *A handbook for the Assessment of Compliance with the Core Principles for Effective Deposit Insurance Systems* (2016) 29. See also SARB *Designing a deposit insurance scheme* (2017) 25.

[1148] The reason for excluding these large deposits from deposit insurance stems from the belief that these deposits are made by institutions which are financially sophisticated and are therefore able to make informed investment decisions. The deposits that have been classified as large corporations' deposits in South Africa include, inter alia: deposits by banks; deposits by non-bank private financial sector including money market unit trusts, non-money market unit trusts, insurers, pension funds, fund managers and private financial corporate sector institutions; deposits by government, including local, provincial and national government public sector entities, the Public Investment Corporation, other public non-financial corporations and monetary authorities; and bearer deposit instruments such as negotiable certificates of deposit (NCDs) and promissory notes. See generally SARB *Designing a deposit insurance scheme in South Africa* (2017) 28.

envisaged EDIS should extend coverage up to a maximum of R100 000 to all deposits,[1149] regardless of the type or term of such deposits.[1150] In the SARB's view, this amount was adequate for the protection of retail as well as small and medium enterprises (SMEs) depositors.[1151] The aforesaid level and scope of coverage was considered appropriate by the SARB to prevent bank runs resulting from retail depositors' *en masse* withdrawals from a financially distressed bank.[1152] The *Discussion Paper* further indicated that to ensure that the level and scope of coverage meets the stated public objectives, it will be legally required to undergo a review every 5 years.[1153]

The *Discussion Paper* further proposed that the EDIS should follow an automatic and compulsory membership approach for all registered (licensed) banks in order to avoid adverse selection.[1154] As pointed out by Lugulu, the purpose of this approach is to avoid giving the stronger and well-capitalized banks the leeway to opt out of the deposit insurance membership, thereby leaving membership to smaller and less capitalized banks only.[1155]However, whenever a new application for a banking license is lodged, the *Discussion Paper* stated that the EDIS should be consulted to allow it to set conditions for the approval of membership.[1156] Although it was indicated that the envisaged EDIS will not have the power to reject the approval of a new bank license, the *Discussion Paper* nevertheless proposed that compliance with the requirements of the EDIS should be a

[1149] Based on the survey of the deposits at all banks, it is estimated that R100 000 would be sufficient to fully cover the deposits of about 98% of the retail depositors in South Africa. See SARB *Deputy Governor Speech* (2017) 4.
[1150] SARB *Designing a deposit insurance scheme in South Africa* (2017) 31. See also Kawadza "The South African financial safety net: In support of the proposed deposit protection framework" 2018 *South African Law Journal* 520.
[1151] Kawadza (2018) *South African Law Journal* 520.
[1152] More importantly, it is expected that this level of coverage would help the small banks to expand their funding base and subsequently contribute to the diversification of the banking sector. See SARB *Deputy-Governor Speech* (2017) 4. See also Kawadza (2018) 520.
[1153] SARB *Designing a deposit insurance scheme in South Africa* (2017) 28.
[1154] An adverse selection is defined as the tendency of higher-risks banks to opt for deposit insurance and of lower-risk banks to opt out of deposit insurance when membership in the deposit insurance scheme is voluntary. See SARB *Designing a deposit insurance scheme in South Africa* (2017) 27.
[1155] Lugulu (2019) 2017.
[1156] SARB *Designing a deposit insurance scheme in South Africa* (2017) 27.

prerequisite for granting a new license.[1157] Once a bank becomes a member of the EDIS, its membership should be terminated upon deregistering as a licensed bank.[1158]

To ensure that the deposit insurance scheme does not run out of funds in the event of a bank failure, the SARB indicated that the envisaged EDIS should adopt a partially pre-funded[1159] mechanism for funding, supplemented by emergency funding as well as post-funding[1160] arrangements.[1161] In this regard, it was proposed that the EDIS would receive an interest free loan from the SARB as 'seed funding' which is to be repaid in due course by levying premiums from the member banks.[1162] The payment of premiums by banks serve to shield public funds from being applied to bear the costs of depositor reimbursement and moves such burden to the EDIS member banks.[1163] Alternatively, to reduce the cost of the initial funding of the EDIS, the *Discussion Paper* indicated that the SARB should consider allowing a once-off reduction in the statutory cash reserve requirement[1164] from 2.5% to 2.0% of liabilities, as adjusted.[1165]

In order to give practical effect to the initiative to establish an EDIS, the *Discussion Paper* proposed the establishment of a Deposit Insurance Fund[1166] within the SARB and that

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[1157] *Ibid*.
[1158] *Ibid*.
[1159] A pre-funded scheme requires the deposit insurance system to accumulate and maintain a deposit insurance fund to cover deposit insurance claims and related expenses before the bank fails. See SARB *Designing a deposit insurance scheme in South Africa* (2017) 32.
[1160] In a purely post-funded approach, no money is held in a deposit Insurance fund. This means that in the event of a bank failure, the deposit insurance system receives funding from the banking sector, the government or the central bank to facilitate depositor reimbursements. These funds are then recovered from the surviving banks through premiums. See SARB *Designing a deposit insurance scheme in South Africa* (2017) 32.
[1161] SARB *Designing a deposit insurance scheme in South Africa* (2017) 34. See also Kawadza (2018) 542.
[1162] SARB *Designing a deposit insurance scheme in South Africa* (2017) 36.
[1163] Principle 9 of the *IADI Core Principles* stipulates that the responsibility for paying the deposit insurance should be borne by banks. See also Lugulu (2019) 208.
[1164] See section 10A of the SARB Act 90 of 1989 for the banks' requirement to maintain the minimum reserve balances in accounts with the Bank. The South African banks are required to maintain cash reserves of 2.5% in the South African Multiple Option Settlement (SAMOS) system. Lukhele reckons that the proposal to reduce each bank's Cash Reserve Ratio held by the SARB by 50 basis points to 2% of deposits means that banks would have to transfer the Rand equivalent of that reduction from being an asset on their balance sheet to being a liability. See Lukhele (2017) 39.
[1165] SARB *Designing a deposit insurance scheme in South Africa* (2017) 37.
[1166] In his paper, Okeahalam suggested that, given the level of concentration and the high proportion of small deposit balances, a Deposit Insurance Fund in South Africa should have two key features: First, it should have the ability of assuming the role of lender of last resort for the South African government, which

SARB carry the start-up costs[1167] associated with such fund.[1168] As indicated, these costs will have to be repaid by member banks in order to adhere to the requirements of the EDIS.[1169] Notably, Zongwe however observes that a deposit insurance fund that forms part of a government institution may create challenges when money is needed.[1170] He believes that even an independent or stand-alone deposit insurance fund can only have money at its disposal if the premiums charged are high enough and assumptions made about possible losses are realistic.[1171]

It was further proposed in the *Discussion Paper* that after its establishment, the ongoing operating costs of the EDIS would be recovered through an annual membership fee to the deposit insurance scheme which will be levied independently from the contributions to the Deposit Insurance Fund.[1172] In terms of the *Discussion Paper,* the SARB would provide, in line with the conditions set out in the *South African Reserve Bank Act 90 of 1989*, a committed line of funding to the EDIS for emergency funding purposes which should be recovered through liquidation proceeds as well as contributions by surviving banks.[1173]

The *Discussion Paper* also recommended that the proposed *Special Resolution Bill* (SR Bill), as mentioned in the 2015 *Policy Document*, should make provision for the EDIS to

means it should be able to meet the costs of the failure of one of the ‘big four’ banks. Second, considering the extreme level of income inequalities in South Africa, the per account coverage limit of a South African EDIS should be relatively low. See Okeahalam & Maxwell (2001) *Journal of Financial Regulation and Compliance* 139.

[1167] Start-up costs refer to the initial money that should be available for the fund to become fully operational, including costs associated with implementing the necessary systems, recruiting staff, ensuring that banks can provide the necessary data and information as well as running public awareness campaigns. See SARB *Designing a deposit insurance scheme in South Africa* (2017) 40.

[1168] The IMF recommended the housing of the SADIC within the SARB so that the operational footprint and costs of the deposit insurance scheme could be minimized to give the SADIC a relatively narrow mandate to collect and invest levies, pay out depositors in the event of a bank failure as well as to make funds available to the Resolution Authority for other types of resolution. See IMF (2015) *IMF Country Report No 15/53* 37.

[1169] SARB *Designing a deposit insurance scheme in South Africa* (2017) 40.

[1170] Zongwe “Deposit insurance in Namibia and South Africa: Pricing its necessity and design” 2019 *Annual Banking Law Update* (ABLU) 33.

[1171] Zongwe (2018) 33.

[1172] SARB *Designing a deposit insurance scheme* (2017) 24. See s10(s) of the Reserve Bank Act 90 of 1989.

[1173] SARB *Designing a deposit insurance scheme in South Africa* (2017) 41.

enter into memoranda of understanding (MoU) and other arrangements with other financial safety net participants such as the PA and the FSCA for purposes of sharing information and coordinating activities.[1174] In these Moues, roles and responsibilities between the different financial safety net participants should be clarified.[1175]

The *Discussion Paper* further pointed out that over the past number of years, South African banks have expanded into foreign countries, especially African countries.[1176] Consequently, it stated that it is important that the envisaged EDIS enter into bilateral agreements with deposit insurance entities in such foreign jurisdictions, covering the deposits of the local branches of foreign banks in South Africa to determine, inter alia: which deposit insurance system will be responsible for reimbursements and public awareness, as well as to determine how much levies and contributions should be made by the relevant banks.[1177]

In particular, the *Discussion Paper* recommended that the envisaged South African EDIS be implemented in such a way that it will be able to develop a systemic analysis of the banking sector as well as develop early warning systems.[1178] This would entail having regular meetings between the EDIS, the PA and other financial safety net participants to discuss trends as well as the risks that have been identified in order for them to be addressed.[1179] The EDIS should also have a legal framework which will clearly specify the triggers for prompt corrective action[1180] and timely early intervention.[1181] In order to be able to identify risks timely, the EDIS should develop contingency plans and crisis

[1174] SARB *Designing a deposit insurance scheme in South Africa* (2017) 42.
[1175] *Ibid*.
[1176] *Ibid*.
[1177] *Ibid*.
[1178] *Ibid*.
[1179] SARB *Designing a deposit insurance scheme in South Africa* (2017) 43.
[1180] SARB *Designing a deposit insurance scheme in South Africa* (2017) 43.
[1181] Timely detection of weak or problem banks is crucial for the effective and stable functioning of the financial and deposit insurance systems because they ensure due preparation for expected insured events such as bank failures. Moreover, early identification of weaknesses and threats to the deposit insurance system allows supervisors and other financial safety-net players to take efficient measures for minimizing the probability and costs of bank failures. See IADI *Guidance on early detection and timely intervention for deposit insurance systems* (2013) 4.

management policies and procedures for its core functions.[1182] It should further formulate and test system-wide crisis preparedness strategies and policies and develop pre- and post-crisis management communication plans with other financial safety net participants.[1183]

As indicated, the *Discussion Paper* proposed a 'pay-box plus' mandate for the EDIS. This means the envisaged EDIS would not only have the power to reimburse depositors, but would also have a say in resolution and would have the power to:[1184]

(a) Facilitate depositors' payout and take their place in a 'liquidation waterfall';[1185]

(b) Provide full or partial funding for the cost of a purchase and assumption resolution;[1186]

(c) Reimburse insured depositors who have been written off through bail-in;[1187]

(d) Fund the transfers to a bridge bank or the sale to a private sector entity;[1188]

(e) Fund an open bank resolution.[1189]

[1182] According to the IADI, a prerequisite for a contingency planning framework is that deposit insurers have in place the necessary tools and procedures to perform its day-to-day functions according to the stated mandate. See IADI *Deposit Insurers' Role in Contingency Planning and System-wide Crisis Preparedness and Management – Guidance Paper* (2019) 21. See also SARB *Designing a deposit insurance scheme in South Africa* (2017) 44.
[1183] SARB *Designing a deposit insurance scheme in South Africa* (2017) 44.
[1184] *Ibid.*
[1185] A liquidation waterfall basically refers to the hierarchy of claims in liquidation. The Corporation's actions will be subject to the rule that no creditor should be worse off as a result of resolution actions than would have been the case in liquidation. In essence, the Corporation will be expected to respect the creditor hierarchy in the Insolvency Act 24 of 1936. See SARB: Financial Stability Department *Ending too big to fail: South Africa's intended approach to bank resolution* (2019) 19.
[1186] The FSLAB required the Corporation to provide funding for the cost of purchase and assumption resolution of a failed institution.
[1187] The FSLAB introduced a new tranche of loss-absorbing instruments, referred to as 'Flac' instruments, which will be subordinated to unsecured liabilities and be clearly intended for bail-in resolution. See SARB *Ending too big to fail* (2019) 15.
[1188] As the designated resolution authority, the SARB will have the ability to restructure a designated institution in resolution. In this regard, section 166R of FSLAB empowers to transfer any or all of the assets and/or liabilities as well as conduct a sale, merger or similar arrangement. See also SARB *Ending too big to fail* (2019) 18.
[1189] In an open-bank resolution, the bank is allowed to continue to function in its existing form under its own license. The aim of an open-bank resolution strategy is to resolve a failing bank in such a way that the provision of critical functions and critical shared services continues without interruption. As such, the bank

Since the main objective for the South African EDIS would be to put systems in place to be able to effect payouts to depositors, it was proposed that such payouts would be made within 20 working days after the closure of a bank for deposit accounts where ownership is easily identifiable.[1190]

5.2.3 The Financial Sector Laws Amendment Act 23 of 2021

As indicated, over the course of many years there were no explicit deposit insurance arrangements in place in South Africa for the protection of depositors in the event of a bank failure.[1191] However, in August 2018, the *Financial Sector Laws Amendment Bill 2018* (*FSLAB*) was tabled before Parliament to give effect to the proposals contained in the policy documents discussed above. A revised version of this *Bill* was issued in 2020 and was eventually enacted as the *Financial Sector Laws Amendment Act 23 of 2021(FSLAA)*, which is yet to be put in operation.

The *Financial Sector Laws Amendment Act* 23 of 2021 inserted provisions for an explicit Deposit Insurance framework as part of a new Chapter 12A into the *Financial Sector Regulation Act 9 of 2017* that, once put into operation, will establish the Corporation[1192] for the South African Deposit Insurance (and further referred to herein as the Deposit Insurance Corporation or Corporation)[1193] that will provide a pre-planned, orderly and efficient mechanism to protect depositors.[1194] The share capital of the Corporation will be R1 000 000 but such share capital may be increased by the Board of the Corporation at any time. Only the SARB and the Government may hold shares in the Corporation.[1195]

stays open for business and is preserved in its existing form. An open-bank resolution is, therefore, often used for banks that are too big and systemically important to fail as their failure would have adverse negative effects on the stability of the financial system. See generally SARB *Ending too big to fail* (2019) 21.

1190 SARB, *Designing a deposit insurance scheme for South Africa* (2017) 44.

1191 SARB *Financial Stability Report* (2018/19) 50.

1192 As per section 1 of the FSRA, amended by the FSLAA 2021 'Corporation' means the Corporation for Deposit insurance.

1193 Section 166AD of the FSLAA 23 of 2021. Section 166AW provides that the Corporation may not be wound up except by, or on authority of, an Act.

1194 Section 166AD of the FSRA as introduced by the FSLAA 23 of 2021

1195 Section 166AR (1) and (2) of the FSRA as introduced by the Financial Sector Laws Amendment Act 2021. Section 166AR (3) limits the liability of the Reserve Bank as holder of a share in the Corporation to

The Corporation must further determine the personnel, accommodation, facilities, use of assets, resources and other services necessary for its effective functioning.[1196] The SARB will provide such personnel, accommodation, facilities, use of assets, resources and other services to the Corporation and must second the personnel it provides to the Corporation.[1197]

5.2.3.1 Objectives and functions of the Deposit Insurance Corporation

The objective of the Corporation is, by providing deposit insurance and carrying out its functions as set out in section 166AF(2) of the *Financial Sector Regulation Act*, to support the SARB in fulfilling its financial stability mandate.[1198] To achieve this the Corporation is assigned the following functions:[1199]

(a) to establish, maintain and administer, the Fund established in terms of section 166BC of the *Financial Sector Regulation Act 2017* in the interests of holders of 'covered deposits', as explained below,[1200] and

(b) to promote awareness among financial customers of the protections afforded by the deposit insurance framework set out in Chapter 12A of the *Financial Sector Regulation Act 2017*.

the amount unpaid in respect of such share. The financial year end of the Corporation is 31 March - see Section 166AS.

1196 Section 166AX (1) of the FSRA as introduced by the FSLAA 2021. In terms of section 166AX(2) the Corporation may "enter into secondment arrangements in respect of persons; engage persons on contract otherwise than as employees; enter into contracts; acquire or dispose of property; insure itself against any loss damage, risk or liability that it may suffer or incur; and do anything else necessary for the performance of its functions." For purposes of entering into a secondment arrangement in respect of a person, or engaging a person on contract the Corporation and such person must agree in writing on performance measures for assessment of such person's performance and the level of performance that must be achieved against those measures.

1197 Section 166 AY (1) and (2) of the FSRA as introduced by the FSLAA 2021.

1198 See section11 of the FSRA read with section 3(2) of the Reserve Bank Act, 90 of 1989 and section 224 of the Constitution1996.

1199 Section 166AF (2) (a) and (b) of the FSRA as introduced by the FSLAA 2021.

1200 See par 5.2.3.6 below.

5.2.3.2 Membership

It is provided that a bank will become a member of the Corporation upon its registration or on the day that such bank obtains its license to operate as a deposit-taking institution and is allowed to hold covered deposits.[1201] Alternatively, a bank which was licensed or registered in terms of a relevant financial sector law before the establishment of the Corporation will become a member of the Corporation once the latter is established.[1202] The *Act* makes it mandatory for a bank, when applying for a bank license or registration, to provide the responsible authority with information that will enable it to meet the requirements[1203] of the Corporation.[1204]

5.2.3.3 Governance

In terms of section 166AH of the *Act*, the Corporation will appoint a Board of Directors to manage its affairs, including the Fund, that will be required to establish and implement appropriate and effective governance systems and processes, taking into account internationally accepted standards. As such, the affairs of the Corporation will be managed and controlled by the aforesaid Board of Directors, which will be required to exercise the powers and perform the duties conferred and imposed upon the Corporation by the *Financial Sector Regulation Act*.[1205] The Board will be comprised of the following persons:[1206] a representative from the National Treasury appointed by the Director-General of the National Treasury; a Deputy-Governor of the SARB appointed by the Governor; the Chief Executive Officer of the Prudential Authority; the Commissioner of

[1201] Section 166AG (1) of the FSRA as introduced by the FSLAA 2021. (1)
[1202] Section 166AG (2) of the FSRA as introduced by the FSLAA 2021.
[1203] The provision is not clear on the requirements of the Corporation. However, it is suspected that the requirements referred to here are the requirements for becoming a member of the Corporation, inter alia obtaining a bank licence and registering a bank in terms of the relevant legislation.
[1204] Section 166AG (3) of the FSRA as introduced by the FSLAA 2021.
[1205] Section 166AI (1) of the FSRA as introduced by the FSLAA 2021.
[1206] Section 166AI (2) of the FSRA as introduced by the FSLAA 2021. For the appointment of the two other directors of the Corporation's Board by the Governor there must be concurrence with the Minister of Finance. In terms of section 166AI(3) directors will hold office for a 5 year term that can be extended once for a further 5 years. See further section 166AI (4) to (9) regarding inter alia resignation and removal from office of directors.

the Financial Sector Conduct Authority; the Chief Executive Officer of the Corporation; the Group Chief Financial Officer of the SARB; and two other persons appointed by the Governor of the SARB.

In general, the appointed Board will be responsible for overseeing the management and administration of the Corporation to ensure that it operates efficiently and effectively.[1207] Furthermore, the Board will act on behalf of the Corporation in, inter alia:[1208] authorizing the CEO to sign memoranda of understanding and amendments on behalf of the Corporation; appointing members of relevant committees and providing directions on how such committees should conduct their work; making determinations on how to apply the Fund during bank resolution; determining the deposit insurance levy for the purposes of *Financial Sector and Deposit Insurance Levies (Administration) and Deposit Insurance Premiums Bill* 2022 (FSDILDIPB) ;[1209] as well as performing any other matter assigned to it in terms of a financial sector law.

Board meetings will be held at a time determined by the Board or the chairperson of the Board.[1210] A quorum for a meeting of the Board is a majority of the directors of the Board with the condition that it must include the representative of the National Treasury appointed by the Director-General of the National Treasury or his alternate and a Deputy Governor or his alternate. A decision of the majority of the directors of the Board present at a meeting constitutes a decision of the Board. If the votes are equal the person presiding at such meeting has a casting vote as well as a deliberative vote.[1211]

An employee of the Reserve Bank (who must not be a disqualified person or a person not ordinarily resident in South Africa) with appropriate expertise in the financial sector will be

1207 Section 166AJ (a) of the FSRA as introduced by the FSLAA 2021.
1208 Section 166AJ (b) (i), (ii), (iii), (iv) & (v) of the FSRA as introduced by the FSLAA 2021.
1209 The Financial Sector and Deposit Insurance Levies (Administration) and Deposit Insurance Premiums Bill has been accepted by the National Council of Provinces and is currently awaiting Presidential assent. See https://www.parliament.gov.za/bill/230064#:~:text=To%20provide%20for%20the%20collectionand%20Deposit %20Insurance%20Levies%20Act%2C.pdf (Accessed 8 October 2022) (hereinafter FSDILDIPB).
1210 Section 166AK (1) of the FSRA as introduced by the FSLAA 2021. See also section 166AK(2) to (6) and (9) to (12) regarding processes to be followed at these meetings.
1211 Section 166AK (7) and (8) of the FSRA as introduced by the FSLAA 2021.

appointed as Chief Executive Officer of the Corporation.[1212] Except as provided in section 166AJ(b), the Chief Executive Officer will be responsible inter alia, for the day-to-day management and administration of the Corporation and must perform the functions of the Corporation, including exercising the powers and carrying out the duties associated with those functions. When acting as such he must implement the policies and strategies that have been adopted by the Board.[1213]

In terms of section 166AO the Board may establish committees it deems necessary. A safeguard provided in relation to dealing with the Fund and ensuring it is not mal-administered, is that the Board must at least establish an investment committee to review the Fund's portfolio and this investment committee must make recommendations regarding the investment of the Fund to the Board.[1214]

The duties of the Board of Directors and committee members are set out in section 166AP (a) and (b) and entail that they must act honestly in all matters relating to the corporation. In addition, they must perform their functions in good faith; for a proper purpose; and 'with the degree of care and diligence that a reasonable person in the director's or member's position would exercise.; A Director of the Board is further required to disclose any interest in any matter that is being or may be considered by the Board, that the director has, or that a person who is related to such director, has. Such disclosure must be made as soon

[1212] Section 166AL of the FSRA as introduced by the FSLAA 2021. When making such appointment, the Board and the appointed person should agree, in writing, on the performance measures that will be used to assess the Chief Executive Officer's 's performance and the level of performance to be achieved against those performance measures. See section 166AL (2) (a) and (b) of the FSLAA 2021.

[1213] Section 166AL(1) to (5) of the FSRA as introduced by the FSLAA 2021. In terms of section 166AL(6) the Board may appoint a senior staff member of the Corporation to be the acting Chief Executive Officer if the latter is absent from office or otherwise unable to perform his functions. The Chief Executive Officer will hold office for a term of no longer than five years as the Board may determine, serving in a full-time executive capacity. See section 166AM(1). In terms of section 166AN(2) the Board must, subject to following due process, revoke the appointment of a Chief Executive Officer who becomes a "disqualified person". The grounds for removal of the Chief Executive Officer are listed in section 166AN (2) as: where the Chief Executive Officer r is unable to perform his duties for health or other reasons; where the Chief Executive Officer has failed in a material way to achieve the level of performance against the performance measures agreed to; where the Chief Executive Officer has failed in a material way to discharge the responsibilities of office, including any responsibilities entrusted in terms of legislation; and where the Chief Executive Officer has acted in a way that is inconsistent with continuing to hold the office.

[1214] Section 166AO(1) and (2) of the FSRA as introduced by the FSLAA 2021. See further section 166AO(3) to (6) regarding the composition, functions, procedures and membership of committees established by the Board.

as practicable after the director concerned became aware thereof and must be done at a meeting or in writing to each of the other directors. Absent the aforesaid disclosure such director may not participate in the consideration of, or a decision on, a matter to which such interest relates except if he has properly disclosed the interest and the other directors decided that the interest does not affect the proper execution of the functions of the director concerned in relation to the matter.[1215] The duty to disclose possible conflicting interests also extends to the each Member of the Corporations staff and each person to whom a power or function of the Corporation has been delegated.[1216]

Further duties of directors, committee members and corporation Staff members are set out in section 166AZ and entail that a person who is, or has been, a Board director, committee member or Corporation staff member, may not use that position or any information obtained as a result of holding such position to: improperly benefit himself or another person; cause improper detriment to the ability of the Corporation or SARB to perform its functions; or cause improper detriment to another person. Notably for purposes of section 166AZ ‘benefit and ‘detriment’ are not limited to financial benefit or detriment.[1217]

5.2.3.4 Cooperation and collaboration with financial sector regulators and SARB

In line with the objective of the *Financial Sector Regulation Act* to encourage cooperation and collaboration[1218] between the SARB and financial regulators and between the financial regulators themselves for purposes of financial stability and the broader efficient and effective working of the South African Twin Peaks Model, the Corporation will be obliged, in terms of section 166BA, to co-operate and collaborate with other financial

[1215] Section 166AQ (1) to (3) of the FSRA as introduced by the FSLAA 2021.
[1216] Section 166AQ(5) provides that :”(a) Each member of the Corporation’s staff and each person to whom a power or function of the Corporation has been delegated must make timely, proper and adequate disclosure of his or her interests, including interests of a related party, that could reasonably be seen as interests that may affect the proper execution of his or her functions of office or the delegated power.
(b) The Chief Executive Officer of the Corporation must ensure that paragraph (a) is complied with.”
[1217] Section 166AZ(1) and (2) of the FSRA as introduced by the FSLAA 2021.
[1218] Sections 26 and 76 of the FSRA respectively. See also Van Niekerk & Van Heerden “The importance of a legislative framework for the co-operation and collaboration in the Twin Peaks Model of financial regulation” 2020 *SALJ* 110-146.

sector regulators as well as the SARB to assist it to exercise its powers and perform its functions in terms of the FSRA.[1219] This includes providing assistance and information and promptly reporting any matter of which it becomes aware of that affects or may affect the performance of any of these powers or functions.[1220] Furthermore, the financial sector regulators will be expected to comply with any reasonable request from the Corporation, including requests to make standards and issue regulator's directives, in order to promote public awareness among financial customers regarding the protections afforded to them by the new deposit insurance framework incorporated into the *Financial Sector Regulation Act*.[1221]

In this regard, the Corporation will enter into a memorandum of understanding (MoU) with the SARB, a financial sector regulator or a body in a foreign country that has powers or functions corresponding to its powers and functions. [1222] The envisaged MoU and other relevant agreements should clearly elucidate the roles and responsibilities between the different financial safety net participants.[1223] Moreover, the Corporation will, in terms of section 166BB of the *Financial Sector Regulation Act,* enter into bilateral arrangements with deposit insurers in countries where South African banks are materially present as well as with the host countries of the head offices of foreign banks with presence in South Africa.[1224] Notably however, it is provided in section 166BB(2) that '[T]he validity of an action taken by the Corporation in terms of this Act or a financial sector law is not affected by a failure to comply with this section or a memorandum of understanding contemplated in subsection (1).'

Section 166BF further obliges the Prudential Authority, the Financial Sector Conduct Authority and banks that are members of the Corporation to comply with any request by

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[1219] Section 166BA (1) of the FSRA as introduced by the FSLAA 2021.
[1220] Ibid.
[1221] Section 166AZ (2) of the FSRA as introduced by the FSLAA 2021. In this regard, a budget should be provided and a program implemented by the SADIC manager and member banks to raise public awareness of the existence and limits of the SADIC. The aim of promoting public awareness should be to ensure clarity as to what banks, instruments and values will be covered by the SADIC and conveying this message should be done through media in a form most accessible to retail depositors. See IMF (2015) *IMF Country Report No 15/53* 38.
[1222] Section 166BB (1) of the FSRA as introduced by the FSLAA 2021.
[1223] SARB, *Designing a deposit insurance scheme in South Africa* (2017) 42.
[1224] *Ibid.*

the Corporation for information that is relevant to the performance of the Corporation's functions in terms of this Act.

5.2.3.5 The Funding of the Corporation

The funding of the operations and administration of the Corporation itself must be distinguished from the Deposit Insurance Fund, discussed below. Section 166AT provides that the amount of any surplus funds of the Corporation, after deducting the corporations' expenses and making proper provisions at the end of each financial year of the Corporation, must be credited to the Fund. This does however not prevent the crediting of amounts of surplus funds to the Corporation at other times.[1225]

In terms of section 166BC (1) the Corporation is permitted to charge member banks certain deposit insurance levies[1226] to fund the Corporation's operations and the administration of the Fund. These deposit insurance levies are payable to the Corporation at the time specified by the Corporation in accordance with the legislation that empowers the imposition of these levies, once enacted.[1227]

Section 35 of the *Financial Sector Laws Amendment Act 23 of 2021* has introduced some new definitions into section 1 of the FSRA which deal specifically with levies and premiums. A deposit insurance levy is defined as 'a levy of that name that may be imposed by legislation in accordance with section 166BC'. A deposit insurance premium means 'a premium imposed by legislation in accordance with section 166BG'.

5.2.3.6 The Deposit Insurance Fund

The Deposit Insurance Fund will be established in terms of section 166BD of the *Financial Sector Regulation Act* and the Fund will be held by the Corporation, which must establish

[1225] Section 166AT(1) and (2) of the FSRA as introduced by the FSLAA 2021.
[1226] Section 1 of the FSRA, as amended by the FSLAA, defines a deposit insurance levy as "a levy of that name that may be imposed by legislation in accordance with section 166BC."
[1227] Section 166 BC(2) of the FSRA as introduced by the FSLAA 2021.

an account at the SARB for purposes of the Fund.[1228] The sources of funding of the Fund will consist of;

(a) the 'amount standing to' the Corporation;

(b) credit in the aforesaid SARB account;

(c) investments made with the Fund's money; and

other assets of the Corporation attributable to the Fund.[1229]

Other amounts to be credited to the Fund include:[1230]

(a) the Corporation's surplus funds as indicated in section 166AT;

(b) amounts collected as deposit insurance premiums in accordance with section 166BG;

(c) interest and other amounts earned from investments of the Fund;

(d) amounts that the corporation recover in respect of amounts paid out by the Fund (for example to reimburse depositors or support a resolution action such as moving depositors to a bridge bank); and

(e) other amounts that the Corporation received for purposes of, or in connection with, the Fund.

It is provided that the Corporation may collect premiums[1231] from member banks (sufficient) to ensure that the Fund is able to make the payments it is required to make during bank resolution in terms of Chapter 12A.[1232] The Corporation is required to publish premiums that have been collected, in the Register and on its website.[1233]

[1228] Section 166BD(1) to (3) of the FSRA as introduced by the FSLAA 2021.
[1229] Section 166BD(4) of the FSRA as introduced by the FSLAA 2021.
[1230] Section 166BD(5) of the FSRA as introduced by the FSLAA 2021.
[1231] Section 1 of the FSRA, as amended by the FSLAA 2021, defines a "deposit insurance premium" as "a premium imposed by legislation in accordance with section 166BG".
[1232] Section 166BG(1) of the FSRA as introduced by the FSLAA 2021.
[1233] Section 166BG (2) of the FSRA as introduced by the FSLAA 2021. In terms of s166BG(3) deposit insurance premiums must be paid to the Corporation at the time specified by the Corporation or agreed with the Corporation.

Fund liquidity is addressed in section 166BH which provides that banks that are Corporation members and hold covered deposits must maintain a minimum amount in the Fund's account as specified by the Corporation in a standard.[1234] The Corporation is thus given the power to arrange certain aspects in standards that it may issue.

The use of the Fund is safe-guarded by the stipulation in section 166(6) that the Fund may only be used:

'(a) To make payments in terms of section 166AA, including in terms of agreements contemplated by that section;

(b) by way of investments in terms of section 166BE(1);

(c) to repay amounts paid into the Fund in error.'

Thus the main application of the Fund is limited to facilitating resolution actions to ensure that depositors who hold covered deposits have reasonable access to such deposits as contemplated in section 166AA, namely: reimbursing the bank in resolution for payments made by such bank to depositors who hold covered deposits; or directly reimbursing depositors of the bank in resolution who hold covered deposits; or making payments in terms of an agreement regarding covered deposits of the bank in resolution as envisaged in section 166S(1); or investing the money as permitted by the *Financial Sector Regulation Act*.[1235] 'Covered deposits' are defined as 'the portion of a qualifying deposit covered by the Deposit Insurance Fund provided for in section 166AB.[1236] A 'qualifying deposit' is now defined in the aforesaid Act and means 'a deposit with a bank, other than-

(a) a deposit evidenced by a bearer deposit instrument; or

(b) a deposit where the depositor holds the deposit in the capacity of-

(i) a financial institution, excluding a financial institution that is a co-operative financial institution as defined in section 1(1) of the Co-Operative Banks Act;

[1234] Section 166BH of the FSRA as introduced by the FSLAA 2021. In terms of section 166BH the Corporation must pay interest to member banks on the amount that such member banks must maintain in the Fund's account. Such interest must also be specified in a standard.
[1235] Section 166 AA(1) of the FSRA as introduced by the FSLAA 2021.
[1236] Section 1 of the FSRA as amended by the FSLAA 2021.

(ii) the national government, a provincial government, a local government or an organ of state;

(iii) an entity listed in Schedule 2 to the Public Finance Management Act;

(iv) The Corporation for Public Deposits established by section 2 of the Corporation for Public Deposits Act, 1984 (Act No. 46 of 1984); or

(v) The Public Investment Corporation established by section 2 of the Public Investment Corporation Act, 2004 (Act No.23 of 2004).'

Agreements envisaged in section 166AA (1) (c) include: a secured loan to the bank in resolution; or a loss sharing agreement between the bank in resolution or a person assuming liability for the bank in resolution's covered deposits; or a guarantee in favour of the bank in resolution, by the SARB or another person in respect of the covered deposits of the bank in resolution.[1237] Notably the cost to the Fund of entering into an agreement as envisaged in section 166AA (2) may not exceed the total amount of covered deposits held by the bank in resolution. This prohibition however does not apply to costs incurred by the Corporation when it exercises its functions in terms of section 166AF.[1238] Certain safeguards are laid down in the *Financial Sector Regulation Act* regarding investment of the Fund by the Corporation, requiring the Corporation to apply money standing to the Fund's credit consistent with the 'investment strategy' of the Fund, formulated by the Corporation. This investment strategy, which must be reviewed regularly, must be aimed at achieving the objective of the Corporation by ensuring that the Fund is able to make payments as required by Chapter 12A. When the Corporation formulates and reviews the investment strategy for the Fund, it is obliged to consider, inter alia, 'the risk involved in making, holding and realizing, and the likely return from the Fund's investments'.[1239]

[1237] Section 166 AA(2) of the FSRA as introduced by the FSLAA 2021. A caveat is added by section 166AA(3) which provides that the Corporation may only enter into an agreement mentioned in this subsection if the Corporation believes that the agreement will contribute to the bank's orderly resolution.
[1238] Section 166AA(3)(a), (b) and (c) of the FSRA as introduced by the FSLAA 2021.
[1239] Section 166BE of the FSRA as introduced by the FSLAA 2021.

5.2.3.7 Limit of cover for covered deposits

In terms of the new explicit deposit insurance framework inserted into the *Financial Sector Regulation Act* a depositor is defined as 'a person that holds a deposit as defined in section 1 of the Banks Act.[1240] The new regime also caps the protection of covered deposits of a bank in resolution at a certain maximum amount. The maximum amount of coverage is determined by whichever amount is the *lesser* of:[1241]

'(a) the sum of-

(i) the total of the amounts standing to the credit of the accounts with the bank held by the depositor alone; and

(ii) for each account with the bank held by the depositor together with one or more other persons, an amount calculated as the amount standing to the credit of the account divided by the number of account holders on the account; and

(b) the amount prescribed by the Minister in Regulations made for purposes of this section.'

The legislation does thus not specify a blanket amount that will apply to all depositors and once Chapter 12A of the Financial Sector Regulation Act is put into operation, the Minister will issue regulations prescribing covered amounts.

The aspect of payments made by the Corporation in error or fraud is addressed in section 166AC. It is provided that, if the Corporation makes one or more payments out of the Fund as contemplated by section 166AA above, in respect of a depositor who deposited money in a bank that subsequently was placed in resolution and the total amount paid was more than the amount permitted by section 166AB, and the excess amounts was paid as a result of error by the Corporation or the bank in resolution or fraud (except fraud

[1240] Section 1 of the FSRA as amended by section 35 of the FSLAA 2021.
[1241] Section 166AB(1) of the FSRA as introduced by the FSLAA 2021. It is further provided in section 166AB (2) that a reference in section 166(1) to "the amount standing to the credit of an account" is a reference to the amount standing to the credit of the account "as at the date that the bank was placed in resolution."

by an official or employee of the Corporation), then the Corporation can recover such excess amount from the bank in resolution.[1242]

5.2.3.8 Bookkeeping, auditing and annual reporting

The Corporation is obliged to ensure that proper account is kept of all financial transactions, assets and liabilities of the Corporation and the Fund. It must further cause financial statements to be compiled for each financial year and copies of such statements, after auditing as required by the law, must be submitted to the Minister of Finance and the SARB. [1243] Within 6 months after the end of each financial year the Corporation must submit a report on its operations, as well as the Fund's operations, to the Minister of Finance and the SARB. This report and the financial statements referred to in section 166AU(b) must be tabled in Parliament when the Minister of Finance also tables copies of the reports referred to in section 32(3) of the Reserve Bank Act.[1244]

5.2.3.9 Subrogation

Subrogation in relation to the Deposit Corporation is provided for in section 166AD of the *Financial Sector Regulation Act* which states that if the Corporation makes a payment out of the Fund as envisaged in section 166AA in respect of a depositor of a bank that has been placed in resolution, the Corporation may 'assume and exercise the rights and remedies of the depositor against the bank to the extent of the payment.'[1245]

5.2.3.10 Immunity (Legal protection)

[1242] Section 166AC(a) to (c) of the FSRA as introduced by the FSLAA 2021. Section 166(c)(i) covers an error before or after the bank was placed in resolution, including a failure to comply with an obligation to provide information.
[1243] Section 166 AU (a) and (b) of the FSRA as introduced by the FSLAA 2021.
[1244] Section 166AW of the FSRA as introduced by the FSLAA 2021. These reports referred to in section 32 of the Reserve Bank Act inter alia include the SARB'S financial statements and reports on its assets and liabilities.
[1245] Section 166AD of the FSRA as introduced by the FSLAA 2021.

Provision is further made for immunity in relation to any loss or damage suffered or incurred by any person arising from a decision taken or action performed in good faith in the exercise of power or performance of a function in terms of a financial sector law to include:[1246] the Corporation; a Board member; a staff member of the Corporation; a resolution practitioner appointed for a designated institution[1247] in resolution; and a person appointed or delegated by a financial sector regulator; or the SARB or the Corporation.[1248]

5.2.4 Financial Sector and Deposit Insurance Levies (Administration) and Deposit Insurance Premiums Bill B4 of 2022 (FSDILDIPB)

The *Financial Sector and Deposit Insurance Levies (Administration) and Deposit Insurance Premiums Bill B4 of 2022* (FSDILDIPB) was approved at the National Council of Provinces and was assented to on 6 December 2022 as the *Financial Sector and Deposit Insurance Levies Act*, 2022 (FSDILA) which is yet to be put into operation.[1249] . The aforesaid Act inter alia provides for the collection and administration of levies imposed in terms of the *Financial Sector and Deposit Insurance Levies Act 2022*; to amend the *Financial Sector Regulation Act* to provide for the *Financial Sector and Deposit Insurance Levies Act, 2022* to address the imposition, collection and administration of deposit insurance premiums.[1250]

[1246] Section 285 of the *FSRA* 2017 as amended by the FSLAA 2021.
[1247] A designated institution has been defined in section 29(A) (1) of THE FSLAA 23 of 2021 as each of the following: a bank; a SIFI; a payment system operator and participants of a systemically important payment system; a company that is a holding company of a bank or a SIFI, or a payment system operator of a systemically important payment system; and subject to any determination, if a bank or a SIFI is a member of a financial conglomerate, each of the other members of the financial conglomerate. The practical implication of this definition of designated institutions is that all banks, mutual banks and cooperative banks will fall under the provisions of the FSRA. See [1247] South African Reserve Bank: Financial Stability Department *Ending too big to fail: South Africa's intended approach to bank resolution* (2019) 9.
[1248] It is recommended that directors, officers and employees of supervisory agencies and resolution authorities should be able to exercise their professional judgement and take necessary action where circumstances require without fear of lawsuits against their actions. See International Monetary Fund (IMF) *South Africa Financial Sector Assessment Program: Financial safety net, bank resolution, and crisis management framework – Technical note* (2015) IMF Country Report No 15/53 34.
[1249] Published in Government Gazette No.47695 of 9 December 2022.
[1250] Preamble of the FSDILA 2022. See also the Memorandum on the Objects of the Financial Sector and Deposit Insurance Levies (administration) and Deposit Insurance Premiums Act 2022 available at https://www.parliament.gov.za/storage/app/media/Bills/2022/B4_2022_Financial_Sector_and_Deposit_In

The SARB will be responsible for the collection and administration, on behalf of the Corporation of the deposit insurance levy referred to in Schedule 6 to the *Financial Sector and Deposit Insurance Levies Act 2022* as well as deposit insurance premiums. These levies and premiums must be collected and administered by the SARB in accordance with section 246 of the *Financial Sector Regulation Act*.[1251] The Act further amends, in, section 4, the definition of a 'deposit insurance premium' in section 1 of the *Financial Sector Regulation Act* to refer to a 'premium imposed in terms of section 166BG and Schedule 5.'[1252]It also amends the definition of a 'levy' to refer to 'a levy imposed in terms of the Financial Sector and Deposit Insurance Levies Act, and includes interest payable on an unpaid levy.' A definition of a 'special levy' is also provided to mean 'a levy imposed as a special levy in terms of the Financial Sector and Deposit Insurance Levies Act, and includes interest payable on an unpaid special levy.' It also inserts a definition of 'member' which means 'a member of the Corporation, in accordance with section 166AG'.

Section 4 of the Act further amends s166BG of the *Financial Sector Regulation Act* to read as follows:

'(1) There shall be charged, imposed and collected by the Corporation, in accordance with this Act, a premium to be known as the deposit insurance premium, to ensure that the Fund is able to make payments required by this Chapter.

(2) The deposit insurance premium is payable by each member.

(3) The amount of the deposit insurance premium payable in respect of a premium period is determined in accordance with Schedule 5.

(4)(a) Where a member becomes a member during a premium period, or ceases to be a member during a premium period, the premium payable must be proportional to the

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surance_Levies_Administration_and_Deposit_Insurance_Premiums_Bill/B4B.pdf (accessed 21 December 2022).

1251 Section 2(2) (b) and 3(1) and 3(2) of the FSDILA 2022.

1252 A definition is further inserted by section 4 of the FSDILA 2022 of a "premium period" to mean "the period from the first day of a calendar month to the last day of that calendar month, in respect of which a deposit insurance premium is determined in terms of section 166BG and Schedule 5."

remainder of the premium period during which the entity that is a member or (sic) ceases to be a member.

4(b) Where a premium has already been paid in full for a premium period during which a member ceases to be a member, a refund of the premium must be provided to the former member for the proportion of the premium period subsequent to the cessation of the membership.'[1253]

Schedule 6 of the *Financial Sector and Deposit Insurance Levies* Act 2022 sets out a Table A that must be used to calculate the deposit insurance premiums that will be collected from banks, co-operative banks, mutual banks, branches of banks - indicating the premium frequency; minimum amount; variable amount(s); description of the variable; and formula for calculation of the premium as well as the maximum premium cap. It further contains a Table F that indicates how the deposit insurance levies that the aforementioned banks will have to pay, will be calculated.

5.3 Interaction between the Deposit Insurance Framework and the Resolution Framework

[1253] See further section 237, 238 and 239 of the FSRA as amended by section 4 of the FSDILA 2022 which provides for "Fees, levies and deposit insurance premiums: and deposit insurance levies to constitute debts due to the Corporation and for "Budget, fees, levies and deposit insurance proposals" respectively. Notably, section 240 as amended of the FSRA will provide for consultation requirements; section 241 as amended will provide for determinations of information required for assessment of levies or deposit insurance premiums"; section 242 as amended will provide for assessment of levies or deposit insurance premiums whilst section 243 as amended will provide for payments of deposit insurance premiums and levies in instalments and section 244 as amended will provide for interest on late payment or non-payment of deposit insurance premiums and levies. Provision is also made in section 45 as amended for exemption from deposit insurance premiums by the Corporation for a specified period, if the Corporation is satisfied that such exemption: "will alleviate undue financial or other hardship or prejudice to the member, or financial customers due to circumstances outside the control of that member; is not contrary to the public interest; is necessary for developmental or financial inclusion, as well as transformation objectives to facilitate progressive or incremental compliance with the Act, or another financial sector law or other sound reasons; and is necessary to facilitate the affordability of the deposit insurance premiums for the member." Each such exemption must be published by the Corporation. Section 246 as amended deals with the management of deposit insurance premiums and levies. See also section 247 as amended; section 248 as amended and section 288 as amended that deals with general administrative and operating costs of the Fund and the Corporation's annual budget and banking and financial accounting arrangements for the administration of deposit insurance levies and premiums, respectively.

As indicated, the SARB is the designated resolution authority in the new resolution framework and will have the resolution functions conferred on it by the Chapter 12A of the *Financial Sector Regulation Act*.[1254] The key objective of the SARB in performing its resolution powers is: firstly, to assist with the maintenance of financial stability; and secondly, to protect the interests of depositors of banks through the orderly resolution of designated institutions that are in resolution.[1255] In pursuance of these objectives, the SARB must carry out its functions regarding a designated institution and ascertain that the affairs of the designated institution in resolution are managed as to maintain financial stability where practicable to do so.[1256]

Most importantly, in furtherance of its resolution mandate, the SARB must, inter alia:[1257] consider and seek to mitigate any adverse impact on the interests of the shareholders and creditors of other members in the group of companies of which the designated institution forms part; and comply with, and ensure that the designated institution complies with, applicable labour laws.

Accordingly, if in the opinion of the SARB, a bank (solvent or insolvent) is, or will likely be, unable to meet its obligations and it is necessary to ensure the orderly resolution of the designated institution to maintain financial stability or, in the case of a bank or a member or a group of companies of which a bank is a member, to protect depositors of the bank, the SARB may recommend to the Minister that the designated institution be placed in resolution.[1258] To ensure the orderly resolution of the designated institution as well as to maintain financial stability, the Minister may, upon such recommendation, write a determination to the Governor, placing the bank in resolution.[1259]

Although it was indicated in the delimitation statement in Chapter One that a discussion of bank resolution is beyond the scope of this thesis, it is nevertheless imperative to make

[1254] Section 166A (1) of the FSRA as introduced by the FSLAA 23 of 2021. The resolution functions are performed by the Governor as per section 166A(2).
[1255] Section 166B of the FSRA as introduced by the FSLAA 23 of 2021.
[1256] Section 166C (1) of the FSRA as introduced by the FSLAA 23 of 2021.
[1257] Section 166C (1) (a) and (b) of the FSRA as introduced by the FSLAA 23 of 2021.
[1258] Section 166J (1) (a) & (b)(i) & (ii) of the FSRA as introduced by the FSLAA 23 of 2021.
[1259] However, the Minister may only do this if he or she considers that the designated institution is or will probably be unable to meet its obligations and it is necessary to protect depositors. See section 166J (2) (a) & (b) (i) & (ii) of the FSRA as introduced by the FSLAA 23 of 2021.

a brief reference to the envisaged resolution framework introduced by the *Financial Sector Laws Amendment Act* 23 of 2021 and incorporated into the *Financial Sector Regulation Act* as Chapter 12A for purposes of contextualization and assessment of compliance with the IADI Core Principles. In this regard, in the event that a bank is placed in resolution, the SARB is given the power and authority to manage and control the affairs of such bank and to exercise any of the powers of the governing body and the shareholders or a class of shareholders of the bank that has been placed in resolution.[1260] Accordingly, the SARB will have the power to:

(a) Convene meetings of creditors of the bank that has been placed in resolution, to consult with them in relation to the exercise and proposed exercise of those powers and the powers of the SARB in terms of the *Financial Sector Laws Amendment Act*;[1261]

(b) Enter into negotiations with the creditors of such bank in order to finalize the settlement of the creditors' claims against the bank;[1262] and

(c) Make proposals and enter into arrangements or compromises between the bank that has been placed in resolution and all its creditors, or all the creditors of a class of the designated institution's creditors in terms of section 155 of the Companies Act.[1263]

Once a failing bank has been placed in resolution, the SARB must, as soon as practicable thereafter, make an appointment in writing, of a person who will assume the role of the resolution practitioner for the said bank while it is in resolution, clearly specifying the powers and functions delegated to the practitioner in terms of section 166I.[1264] However, if in the opinion of the SARB and in consideration of the circumstances at hand, it is not necessary to appoint a resolution practitioner to achieve the orderly resolution of the failing bank, then the SARB may refrain from doing such appointment.[1265]

[1260] Section 166M (1) of the FSRA as introduced by the FSLAA 23 of 2021.
[1261] Section 166M (2) (a) of the FSRA as introduced by the FSLAA 23 of 2021.
[1262] Section 166M (2) (b) of the FSRA as introduced by the FSLAA 23 of 2021.
[1263] Section 166M (2) (c) of the FSRA as introduced by the FSLAA 23 of 2021.
[1264] Section 166O (1) of the FSRA as introduced by the FSLAA 23 of 2021.
[1265] Section 166O (2) of the FSRA as introduced by the FSLAA 23 of 2021.

The role of the appointed resolution practitioner will differ from that of a curator and other similar functionaries.[1266] As such, the appointed resolution practitioner for a bank in resolution will be expected to comply with any instruction from the SARB relating to the institution in resolution;[1267] to give a monthly report to the SARB of his or her activities to the designated institution;[1268] and also to comply with all the other terms of his or her appointment.[1269] In consideration of the risk analyses carried out in consultation with the financial sector regulators, the SARB will appropriately take requisite steps to plan for the potential need for the orderly resolution of failing banks.[1270] Whenever it deems fit, the SARB may, for the purpose of pursuing the orderly resolution of a bank that has been placed in resolution, transfer some or all of the shares that it holds in a bridge company to any person.[1271] Accordingly, where a bridge company is being used in relation to the resolution of a bank that has been placed in resolution, the SARB must in consultation with the responsible authorities, develop a plan for the bridge company to meet the set criteria in terms of applicable financial sector laws.[1272] The new resolution regime is largely compliant with the FSB key Attributes as discussed in Chapter One and incorporates aspects such as the 'no creditor worse off than in liquidation"(NCWOL)-principle, *pari passu* treatment of creditors of the same standing and an improved suite of resolution tools which includes bridge banks as aforementioned as well as a bail in-tool.[1273]

As the Resolution Authority, the SARB is also authorized to enter into memoranda of understanding (MoU) with either or both the Corporation and a body in a foreign country that has functions corresponding to the resolution functions of the SARB.[1274] The MoU must clearly indicate how the SARB and the Corporation or a body in a foreign country will cooperate and collaborate with, as well as assist, each other in connection with their

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[1266] SARB *Ending too big to fail* (2019) 23.
[1267] Section 166O (4) (a) of the FSRA as introduced by the FSLAA 23 of 2021.
[1268] Section 166O (4) (b) of the FSRA as introduced by the FSLAA 23 of 2021.
[1269] Section 166O (4) (c) of the FSRA as introduced by the FSLAA 23 of 2021.
[1270] Section 166E of the FSRA as introduced by the FSLAA 23 of 2021.
[1271] Section 166F (2) of the FSRA as introduced by the FSLAA 23 of 2021.
[1272] Section 166F (3) (a) & (b) of the FSRA as introduced by the FSLAA 23 of 2021.
[1273] See Chapter One, paragraph 4.1. See also section 166AA to 166Z of the FSRA as introduced by the FSLAA 23 of 2021.
[1274] Section 27 (3A) (a) & (b) of the FSRA as introduced by the FSLAA 23 of 2021.

functions in relation to a bank resolution in terms of the *Financial Sector Laws Amendment Act 23 of 2021* or the law of the foreign country.[1275]

5.4 Compliance with the IAD Core Principles for effective deposit insurance systems

5.4.1 Core Principle 1: Public Policy Objectives

The Corporation's public policy objectives are on par with the recommended standard for deposit insurers as set out in IADI Core Principle 1 As observed, once established the Corporation will, in terms of section 166AF, reimburse depositors of failed banks as well as maintain financial stability of the SA financial system.[1276] This objective is further confirmed by section 166AF that requires the Corporation to apply the Fund to ensure that depositors have reasonable access to their covered deposits by reimbursing the bank in resolution for payments made to depositors; or for reimbursing depositors of covered deposits or for making payment in terms of an agreement related to a transaction mentioned in section 166S(1).The reimbursement of depositors' funds is a clear indication of protection of depositors' interests, which in turn, will bolster depositors' confidence in the banking system, thereby contributing to the stability of the financial system. Better alignment with the public policy objectives would however be achieved if the objectives are rephrased to clearly reflect that protection of depositors and financial stability are both main objectives.

5.4.2 Core Principle 2: Mandates and Powers

The mandate of the Corporation, as set out in section 166AG read with section 166AA (that specifies the various manners in which the Corporation must apply the Fund during resolution) is well aligned with IADI Core Principle 2, as it clearly supports the public policy objectives, namely to protect depositors by establishing, maintaining and administering

[1275] Section 27 (3A) (a) & (b) of the FSRA as introduced by the FSLAA 23 of 2021.
[1276] Paragraph 5.2.3.1.

the Deposit Insurance Fund and promoting awareness of the deposit protection it affords, thereby also promoting financial stability.[1277] The Corporation's mandate and powers, as required by IADI Core Principle 2, are clearly defined and formally specified in Chapter 12A of the *Financial Sector Regulation Act*. As indicated, the Corporation will operate a 'pay-box plus' mandate which means it will not only effect deposit payouts in bank liquidation but will also have other resolution functions for which the deposit insurance fund can be used.[1278] As such, it will possess all the powers of a 'pay-box' plus, including the power to partake in resolution of a failed institution, for example by facilitating the transfer of covered deposits to a bridge bank.[1279] Although the SARB is the designated resolution authority for failed banks in South Africa, the 'pay-box' plus mandate will thus allow the Corporation to provide financial assistance to support the chosen resolution strategy. In particular, a feature that would support the proper execution of the Corporation's mandate and ensure timeous intervention by the SARB as resolution authority to whom the Corporation reports, is the Corporation's powers to make requests from other financial sector regulators which will put it in a position to gauge the safety and soundness of its member banks. This information will be shared within the safety net to facilitate swift, appropriate action.

5.4.3 Core Principle 3: Governance

As indicated, the Corporation will be positioned within the SARB, apparently as its subsidiary –although section 166AE merely states '[The] Corporation for Deposit Insurance is hereby established' without stating whether it is indeed a subsidiary of the SARB and a separate juristic person. However, the operational independence of the Corporation is not so clear given that the Reserve Bank as well as the Government hold the shares in the Corporation. There is consequently a danger that the Government may require the Corporation to provide resolution funding in instances where it is not

[1277] Paragraph 5.2.3.1.
[1278] Paragraph 5.2.3.1.
[1279] Paragraph 5.2.3.1.

appropriate or refrain from providing such funding to facilitate an orderly bank resolution where it would indeed be appropriate.

In alignment with Core Principle 3, the Corporation will appoint a Board of Directors, established in terms of section 166I, comprising various safety net participants, being 'fit and proper' persons, who are subject to various measures, for example relating to conflict of interest, to ensure good corporate governance, to manage and administer its affairs as well as the affairs of the Fund.[1280] The Group Chief Financial Officer of the SARB is also on the Corporation's Board thus ensuring oversight in respect of appropriate financial management of the Corporation and the Fund.[1281] The process for appointment and removal of members of the Board is transparent. In this regard, it is submitted that the provisions relating to the establishment and implementation of an appropriate and effective governance systems and processes, together with the provisions pertaining to the Corporation's board of directors adequately meet the requirements of the IADI Core Principle 3 on the governance of an EDIS. As required by IADI Core Principle 3, essential criteria 2, the governing body of the Corporation is held accountable to a higher body given that its reports have to be submitted to the Minister of Finance and the SARB and also tabled in Parliament. The Corporation, once established, will also be sufficiently resourced and have skilled personnel which aspects the SARB will be obliged to assist with.

Good governance in the new South African deposit insurance system is further ensured by section 166AH that obliges the Corporation to manage its own affairs as well as the fund in an efficient and effective way by means of establishing and implementing appropriate and effective governance systems and processes. Alignment with international good practice is ensured by requiring the Corporation to have regard to international best practices when it carries out its corporate governance obligations.

The all-encompassing functions of the Board are clearly specified in section 166AJ (a) and (b) and ties in with the good governance objectives to manage the Corporation as well as the Fund efficiently and effectively by overseeing their management and

1280 Paragraph 5.2.3.3.
1281 Section 166AI (2) of the FSRA as incorporated by the FSLAA 23 of 2021.

administration and acting for the Corporation in respect of entering into, and amending, memoranda of understanding, appointing committees and giving directions as to how their work should be conducted; determining how the Fund will be applied during bank resolution; determining the deposit insurance levy and any other matters required to be dealt with by the Board in terms of a financial sector law.

Good Corporate governance is also further facilitated by the provisions in section 166AP that requires Board members and committee members to act honestly in all matters relating to the Corporation (and thus by implication in relation to the Fund) and to perform their functions in good faith, for a proper purpose and with the appropriate degree of care and diligence expected of a person in their position as well as the obligation in section 166AQ to disclose conflicts of interest. Provision is also appropriately made for surplus funds of the Corporation to be transferred to the Fund after covering the expenses of the Corporation as well as for appropriate bookkeeping and auditing.[1282] The accountability of the Corporation is addressed through the annual reporting requirements laid down in section 166AV,which requires the Corporation to submit an annual report, which gets tabled in Parliament, to the Minister of Finance and the SARB on both the Corporation's and the Fund's operations.

5.4.4 Core Principle 4: Relationship with other safety-net participants

As indicated, the adoption of the Twin Peaks model in South Africa has brought about significant changes in the financial supervisory architecture.[1283] In particular, the model introduced separate prudential and market conduct regulators. This means that the effective operation of the Twin Peaks model depends entirely on appropriate and efficient cooperation and collaboration between the financial sector regulators as well as SARB. With the introduction of the new EDIS, the Corporation will also enter into memoranda of understanding (MoUs) with the other safety net participants. A formal and comprehensive framework for cooperation and collaboration and crisis management is provided by

[1282] Section 166AT and 166AU respectively, of the FSRA as introduced by the FSLAA 23 of 2021.
[1283] Paragraph 5.2.3.4.

section 26,[1284] 27[1285] and 76[1286] of the FSRA that mandates cooperation and collaboration with the SARB and with each other from all financial sector regulators. The said cooperation and collaboration are assigned to assist the Corporation in exercising its powers and performing its functions as set out in the *Financial Sector Regulation Act*. This includes providing assistance and information and promptly reporting any matter of which it becomes aware that affects or may affect the performance of any of the Corporation's powers or functions.[1287]

[1284] In terms of section 26 of the FRSA, the financial sector regulators must – "(a) co-operate and collaborate with the Reserve Bank, and with each other, to maintain, protect and enhance financial stability; (b) provide such assistance and information to the Reserve Bank and the Financial Stability Oversight Committee to maintain or restore financial stability as the Reserve Bank or the Financial Stability Oversight Committee may reasonably request; (c) promptly report to the Reserve Bank any matter of which the financial sector regulator becomes aware that poses or may pose a risk to financial stability; and (d) gather information from, or about, financial institutions that concerns financial stability."

[1285] Section 27 of the FRSA provides that "(1) The financial sector regulators and the Reserve Bank must - not later than six months after this Chapter takes effect, enter into one or more memoranda of understanding with respect to how they will co-operate and collaborate with, and provide assistance to, each other and otherwise perform their roles and comply with their duties relating to financial stability. (2) The financial sector regulators and the Reserve Bank must review and update the memoranda of understanding as appropriate, but at least once every three years. (3) A copy of a memorandum of understanding must, without delay after being entered into or updated, be provided to the Minister and the Cabinet member responsible for consumer credit matters. (4) The validity of any action taken by a financial sector regulator in terms of a financial sector law, the National Credit Act or the Financial Intelligence Centre Act is not affected by a failure to comply with this section or a memorandum of understanding contemplated in this section."

[1286] Section 76 of the FRSA mandates the financial sector regulators to "(a) generally assist and support each other in pursuing their objectives in terms of financial sector laws, the National Credit Act and the Financial Intelligence Centre Act; (b) inform each other about, and share information about, matters of common interest; (c) strive to adopt consistent regulatory strategies, including addressing regulatory and supervisory challenges; (d) co-ordinate, to the extent appropriate, actions in terms of financial sector laws, the National Credit Act and the Financial Intelligence Centre Act, including in relation to— (i) standards and other regulatory instruments, including similar instruments provided for in terms of the National Credit Act and the Financial Intelligence Centre Act; (ii) licensing; (iii) supervisory on-site inspections and investigations; (iv) actions to enforce financial sector laws, the National Credit Act and the Financial Intelligence Centre Act; (v) information sharing; (vi) recovery and resolution; and (vii) reporting by financial institutions, including statutory reporting and data collection measures; (e) minimise the duplication of effort and expense, including by establishing and using, where appropriate, common or shared databases and other facilities; (f) agree on attendance at relevant international forums; and (g) develop, to the extent that is appropriate, consistent policy positions, including for the purpose of presentation and negotiation at relevant South African and international forums." The section goes further to provide that the financial sector regulators and the Reserve Bank must, "at least annually as part of their annual reports, or on request, report to the Minister, the Cabinet member responsible for administering the National Credit Act and the National Assembly on measures taken to co-operate and collaborate with each other."

[1287] Paragraph 5.2.3.4.

In particular, the *Financial Sector Laws Amendment Act 23 of 2021* has amended section 27 of the *Financial Sector Regulation Act* through the insertion of a section 27(3A) that permits the SARB to enter into memoranda of understanding with the Corporation.[1288] This provision is further fortified by section 166AJ (b) (i) from which it is clear that the Corporation will enter into Memoranda of Understanding with the SARB. It is further clear that the Corporation will be deeply involved in crisis management when one has regard to the fact that its Board comprises of top officials from the SARB, the other financial regulators and also National Treasury.[1289]

In light of this, the South African EDIS appears well aligned with the requirements of Core Principle 4 regarding cooperation of deposit insurers with other safety net participants. As a new scheme, being able to cooperate with other financial safety-net participants, will ensure that the Corporation is able to identify emerging financial risks in banks early and hence will be able to act well in time to alert the SARB and Prudential Authority thereof and thereby assist in preventing banking crises. It will also facilitate swift depositor reimbursement or swift funding of resolution actions where necessary.

5.4.5 Core Principle 5: Cross-border Coordination

Cross-border coordination is a significant issue, given that South African banks have a systemic presence in various countries, as do some foreign banks have in South Africa, which increases the risk of inter-country financial contagion.[1290] Therefore, the new deposit insurance framework as captured in Chapter 12A of the *Financial Sector Regulation Act* also contains provisions for cross-border coordination between the Corporation and deposit insurers and safety net participants in foreign jurisdictions in which the South African banks operate as well as foreign jurisdictions with banks in South Africa.[1291] The requirement that MoUs should be in place with central banks and deposit insurers of these foreign jurisdictions for the purpose of sharing regulatory information is

[1288] Section 39 of the FSLAA 23 of 2021.
[1289] Section 166AI(2) of the FSRA as introduced by the FSLAA 23 of 2021.
[1290] Mortlock, Casal & Berg 'Financial safety nets and bank resolution frameworks in Southern Africa' (2019) *The World Bank Group* 6.
[1291] Paragraph 5.2.3.4.

thus aligned with IADI Core Principle 5.[1292] Although not stated in the *Financial Sector Regulation Act*, to be appropriately aligned with the Core Principles, these MoUs will have to undergo a regular review to ensure that they sufficiently take into account resolution-related information requirements.[1293]

5.4.5 Core Principle 6: The Corporation's role in contingency planning and crisis management

Chapter 12 of the Financial Sector Regulation Act does not allude to the exact role of the Corporation in contingency planning and crisis management as envisaged by IADI Core Principle 6. In this regard, it is thus not clear at this stage what role the Corporation will play in contingency planning and crisis management but the exact nature of this role can be expected to be clarified only once Chapter 12A is in operation and the Corporation has been established. It is likely that these arrangements will be set out in a MoU between the Corporation and other safety net participants given the emergency nature of contingency planning and crisis management that would require it to be captured in soft law instruments such as MoUs that can be changed quickly and without protracted Parliamentary intervention.

5.4.6 Core Principle 7: Membership

The South African EDIS is aligned with IADI Core Principle 7 in that membership of the Corporation is compulsory for all registered banks in South Africa.[1294] Notably the FSLAA 23 of 2021 has, through its section 35, inserted a definition of "bank" into section 1 of the FSRA which indicates that a "bank" means any of the following:

"(a) a bank as defined in the Banks Act;

(b) a branch as defined in the Banks Act;

[1292] SARB *Ending too big to fail* (2019) 49.
[1293] *Ibid.*
[1294] Paragraph 5.2.3.2.

(c) a mutual bank as defined in the Mutual Banks Act, 1993 (Act No.124 of 1993); or

(d) a co-operative bank as defined in the Co-operative Banks Act, 2007 (Act No.40 of 2007).

The Corporation intends to enforce membership by requiring that new applications for bank licenses should also meet the requirements of the Corporation.[1295] Although the Corporation will have no power regarding the granting of new licenses, it is clear that no new bank license application will be approved if a new bank does not meet the requirements for membership of the Corporation. However, the new EDIS does not appear fully compliant with Core Principle 7 as Chapter 12A of the *Financial Sector Regulation Act* does not make provision for termination of membership of the Corporation, nor does it specify what will happen to the covered deposits if a bank loses its license.

5.4.7 Core Principle 8: Coverage

The definitions of 'covered deposit' and 'qualifying deposit' in section 1 of the amended Financial Sector Regulation Act comply with the requirements of IADI Core Principle 8 that seeks clarity on coverage. As observed, the SARB in its 2017 *Discussion Paper* indicated that the Corporation will cover deposits up to a limit of R100 000.[1296] This limit has however not been prescribed in the coverage provisions in Chapter 12A of the *Financial Sector Regulation Act*. The Minister of Finance is, however, given the power to determine the limit of coverage by issuing regulations - thus it can be said that in this regard the coverage provisions are also compliant with IADI Core Principle 8. It is submitted that it is better to provide for the coverage limit to be prescribed by regulation as it will then not be necessary to amend the Act through protracted Parliamentary processes every time that the coverage is increased.

The IADI Core Principles recommend that the deposit insurance should be able to cover the majority of depositors.[1297] As such, the SARB has indicated that the level of coverage

[1295] Paragraph 5.2.3.2.
[1296] Paragraph 5.2.3.7.
[1297] Chapter 2, Paragraph 2.6.8.

by the Corporation will be sufficient to cover about 98% of the retail depositors in South Africa.[1298] Since the coverage will apply equally to all registered banks in South Africa, it is submitted that this will help avoid the competitive distortions between larger banks and smaller banks. As indicated in the 2017 SARB *Discussion Paper*, the South African EDIS will cover a wide variety of deposits, including foreign deposits held at South African banks with the exclusion of deposits from large financial institutions as well as government institutions but this is unfortunately not stated explicitly in the law. The aspects of deposit coverage are aligned with the deposit insurance system's public policy objectives and related design features but no mention is made of the regular review of deposit coverage.

5.4.9 Core Principle 9: Sources and uses of funds

As indicated, the Corporation will operate an *ex ante* EDIS funded through the payment of premiums by member banks.[1299] Since it has been recommended that banks should bear the costs of resolution without burdening public funds, the payment of premiums by Corporation's member banks will, over time, hopefully ensure that there are enough funds in the Deposit Insurance Fund to cover the costs of resolution in the event of a bank failure.[1300] This will guarantee that no or limited, public funds are used to resolve a failed bank and that the cost of resolution are largely borne by bank shareholders and other bank creditors in accordance with the bail-out mechanism included in the resolution regime. As observed, the Corporation intends to charge flat-rate premiums.[1301]

Alignment with Core Principe 9 is further achieved through the provision inserted in the *Financial Sector Regulation Act* that provides for establishment of the Fund;[1302] provides for levies to be imposed on the member banks to fund the operations of the Corporation and the administration of the Fund;[1303] provides for premiums to be collected from

[1298] SARB *Designing a Deposit insurance scheme for South Africa* (2017) 30.
[1299] Paragraph 5.2.3.5.
[1300] Paragraph 5.2.3.5.
[1301] Ellyne & Cheng (2014) 155.
[1302] Section 166BD of the FSRA as introduced by the FSLAA 23 of 2021.
[1303] Section 166BC of the FSRA as introduced by the FSLAA 23 of 2021.

member banks;[1304] deals with the application of surplus funds; and the requirement in section 166AA stipulating the ways in which the Corporation must apply the funds to ensure that depositors have reasonable access to their covered deposits as well as the limitation placed on covered deposits by section by section 166AB. Subrogation of the Corporation is also catered for in section 166AD.

The South African EDIS is thus largely compliant with Core Principle 9 although it can be expected that it will take some years to establish a sufficiently large Deposit Insurance Funds through collecting premiums from member banks hence the SARB's commitment as central bank to provide the EDIS with some initial 'seed funding'.

5.4.10 Core Principle 10: Public Awareness

Provision is made in the functions of the Corporation for the promotion of public awareness thus in principle complying with Core Principle 10.[1305] The *Financial Sector Regulation Act* however, does not specify how such public awareness should be promoted and it will most likely be determined by the committee established by the Corporation to be tasked with promoting public awareness.

5.4.11 Core Principle 11: Legal Protection

The South African EDIS is principally compliant with IADI Core Principle 11 as it provides for the legal protection of the Corporation's staff, shareholders, directors and officers.[1306] The new deposit insurance framework inserted into the *Financial Sector Regulation Act* by the *Financial Sector Laws Amendment Act* 23 of 2021 appropriately provides for immunity in relation to any loss or damage suffered or incurred by any person arising from a decision taken or action performed in good faith in the exercise of power or performance of a function in terms of a financial sector laws.[1307] As indicated this immunity inter alia

[1304] Section 166 BG of the FSRA as introduced by the FSLAA 23 of 2021.
[1305] Paragraph 5.2.3.1.
[1306] Paragraph 5.2.3.10.
[1307] Section 285 of the *FSRA* 2017 as amended by the FSLAA 23 of 2021.

extends to the Corporation; a Board member; and a staff member of the Corporation as well as a person appointed or delegated by the Corporation.

However no specific mention is made that such immunity covers current *and previous* persons in the capacities mentioned as aforementioned.

5.4.12 Core Principle 12: Dealing with parties at fault

The *Financial Sector Regulation Act, as amended by the Financial Sector Laws Amendment Act,* deals with the parties at fault in a bank failure in section 135A.[1308] This provision is titled 'Investigation into designated institutions in resolution' and states that:

'The investigator appointed to conduct an investigation in relation to a designated institution in resolution must conduct the investigation in accordance with this Chapter and, within the period specified by the Reserve Bank in the appointment, report to the Reserve Bank whether, in the investigator's opinion-

(a) the designated institution should-

(i) be wound up;

(ii) remain in resolution for a specified period or until a specified event occurs; or cease to be in resolution;

(b) any business of the designated institution was, before it was placed in resolution, carried on negligently, recklessly or fraudulently; and

(c) *proceedings, including criminal proceedings, should be instituted against any person in connection with the conduct of the business of the designated institution before it was placed in resolution*.'[1309]

The South African resolution regime thus complies with Core Principle 12.

[1308] See Section 50 of the FSLAA.

[1309] Author's emphasis. This provision basically mirrors the Commission of Inquiry into a failed bank's affairs, previously captured in the repealed section 69A of the Bank's Act 94 of 1990.

5.4.13 Core Principle 13: Early detection and timely intervention

The early detection of bank stress and accompanying early intervention arrangements are critical elements of every deposit insurer.[1310] The reason for this is because the earlier bank stress is detected and responded to, the greater is the prospect of restoring it to financial soundness, thus avoiding its ultimate failure.[1311] In South Africa the Prudential Authority is tasked with bank supervision in accordance with the *Banks Act 90 of 1994*. The PA undertakes periodic stress testing to facilitate early detection of bank stress.[1312] The *Financial Sector Regulation Act* has also given the Prudential Authority a wide range of enforcement powers in section 141 to 153, some of which can be used for purposes of early intervention in bank failure, such as removing some persons from the board of directors. Although the *Banks Act* provides for regular supervisory powers by the PA it does however not contain a provision that sets out a broad range of early intervention measures. The new resolution regime also does not contain such a provision. Accordingly it cannot be said that the South African regime is fully compliant with IADI Core Principle 13.

5.4.14 Core Principle 14: Failure resolution

As pointed out, the *Financial Sector Laws Amendment Act* has introduced a comprehensive new resolution regime as Chapter 12A into the *Financial Sector Regulation Act* and has thus greatly improved South Africa's bank failure resolution regime.[1313] This new regime inter alia requires that the SARB, as resolution authority, develop resolution planning for all designated institutions.[1314] New powers for executing a bank resolution have been introduced, including the power of statutory bail-in,[1315] the

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[1310] Mortlock, Casal & Berg (2019) 3.
[1311] *Ibid*.
[1312] IMF Financial Sector Assessment Program: South Africa; Financial Safety Net ad Crisis Management (June 2022) available at https://www.imf.org/-/media/Files/Publications/CR/2022/English/1ZAFEA2022005.ashx (accessed 11 December 2022).
[1313] See paragraph 5.2.3 above.
[1314] SARB *Ending too big to fail* (2019) 28.
[1315] Section 166R and 166S of the FSLAA 2021 empowers the SARB to write-down the shares of the designated institution, issue new shares in the designated institution, write-down the liabilities of the designated institution subject to exclusions as well as to convert debt instruments to equity.

power to establish a bridge bank institution[1316] and the power to transfer all or part of a bank's assets and liabilities to such a bridge bank.[1317] Provision is also made for the interaction between the EDIS and the new resolution regime to ensure optimal bank resolution.

From the perspective of the new explicit South African Deposit Insurance framework it is clear that alignment with Core Principle 14 has been achieved as it will be implemented simultaneously with the new bank resolution regime inserted as Chapter 12A into the FSRA. As required by Core Principle 14 the new bank resolution regime also provide for a defined creditor hierarchy which insulates covered deposits against losses and requires shareholders to take first losses through the application of the bail-in tool provided in section 166 U and section 166S, respectively, of the FSRA as introduced by the FSLAA 23 of 2021.

As appears from brief overview of the South African resolution regime that was provided in this thesis, it can be said that South Africa is largely compliant with the FSB Key Attributes and thus also with IADI Core Principle 14.

5.4.15 Core Principle 15: Reimbursements

As indicated, the Corporation will operate a 'pay-box' plus mandate.[1318] This mandate will enable the Corporation to facilitate prompt reimbursements of depositors, set the operational budgets as well as get access to information required to meet its financial obligations to depositors.[1319] The *Discussion Paper* proposed that the facilitation of depositor reimbursement be done within 20 working days but no time limit for deposit payouts is mentioned in the Act.

It is clear from the new deposit insurance framework read together with the new bank resolution framework introduced into the *Financial Sector Regulation Act* by the *Financial*

[1316] Section 166R of the FSLAA 2021 authorizes the SARB to transfer any or all of the assets and/or liabilities and to conduct a sale, merger or similar arrangement.
[1317] SARB *Ending too big to fail* (2019) 14.
[1318] Paragraph 5.3.
[1319] Paragraph 5.3.

Sector Laws Amendment Act 23 of 2021 that section 166A aims to ensure, through application of the Fund by the Corporation, that depositors have reasonable access to their deposits. Thus the South African EDIS can be said to be largely compliant with IADI Core Principle 15.

5.4.16 Core Principle 16: Recoveries

The new South African EDIS is also compliant with IADI Core Principle 16. Recoveries by the Deposit Insurance Corporation is addressed by section 166Y of the *Financial Sector Regulation Act*, as amended by the *Financial Sector Laws Amendment Act*, in relation to subrogation of claims which makes it clear that the Corporation will be substituted for depositors in respect of claims that the Fund had paid out.[1320]

5.5 Concluding remarks

The adoption of an EDIS in South Africa is a commendable move which will significantly contribute to greater depositor protection, depositor confidence and the promotion of financial stability. It will also enhance the process for resolution of banks through funding of certain resolution actions such as transferring deposits to a bridge bank or facilitating prompt payouts of deposits in the event of bank liquidation. Although not all bigger banks may welcome the new deposit insurance regime as they may be of the view that they are not as much at risk of failure as some small banks, the transition to an EDIS is definitely in the public interest as everyone benefits from a stable financial system. . As indicated in this chapter, the South African banking sector is generally stable. However, a few banks did fail in the past and in the absence of an EDIS, the government had to bear the costs of compensating depositors for their losses on a case-by-case basis. This kind of compensation was discretionary and depended on the availability of funds and has proved to be inadequate over years. Moreover, it was the ordinary taxpayer who had to fund these bailouts, many of whom who were not even depositors in the banks that failed.

[1320] Paragraph 5.2.3.9.

The regulatory journey towards the new South African EDIS was well-planned and conceptualized in the 2015 *Policy Paper* and 2017 *Discussion Document* and the two drafts of the *Financial Sector Laws Amendment Bill* which was eventually enacted in 2021.The features of the deposit insurance framework inserted into the *Financial Sector Regulation Act* as part of Chapter 12A, which comprises both the new bank resolution regime and the new EDIS, are largely compliant with the IADI Core Principles for Effective Deposit Insurance Systems. Setting up the Corporation and amassing a sizeable deposit insurance fund inter alia through collection of premiums from member banks, will be a venture that will require significant time and resources but it will clearly buttress the South African financial system against systemic collapse.

CHAPTER SIX

CONCLUSION AND RECOMMENDATIONS

6.1 Key objectives of the study

The key objectives of this thesis were to explore the features of the new South African EDIS introduced into the Financial Sector Regulation Act as part of the new Chapter 12A and the extent to which this new EDIS complies with the IADI Core Principles for Effective Deposit Insurance Systems as well as whether any guidance could be taken from the US and Australia as comparative jurisdictions with an EDIS. This objective was premised on the need to close any gaps in the design of the South African EDIS as financial safety net participant in order to provide appropriate depositor protection and promote financial stability in South Africa.

In order to achieve the objectives of this study, the following research objectives were pursued:

(a) What is the rationale for deposit insurance and why is explicit deposit protection to be preferred above implicit deposit protection?

(b) What are the international standards (good practice) for efficient explicit deposit insurance schemes and how can the issue of moral hazard be addressed optimally?

(c) What is the legislative framework and design features of the explicit deposit insurance schemes that are in place in the US as pioneer of explicit deposit insurance and Australia as a comparative jurisdiction that implemented an EDIS relatively recently?

(d) What is the legislative framework and design features of South Africa's new EDIS?

(e) Is the new South African EDIS compliant with good practice and if not, in which respects can it be reformed and what guidance can be taken from the IADI Core Principles and the US and Australia in this regard?

It is submitted that these research objectives have been adequately addressed by the study undertaken in this thesis which inter alia explained the rationale for deposit insurance, the reasons why explicit deposit protection is to be preferred above implicit deposit protection albeit that both models pose moral hazard challenges that have to be mitigated through mechanisms such as premiums levied on member banks. An in-depth discussion of the IADI Core Principles as international standard for effective explicit deposit insurance systems was provided in Chapter Two, contextualized by an overview of the key features of effective bank resolution regimes given the dynamic interaction between deposit insurance and bank resolution, which was also explained in the thesis.

The comparative study of the EDIS in the US and Australia pointed out the evolution and main design features of the deposit insurance systems in these countries, benchmarking them also for compliance with the IADI Core Principles and providing an opportunity to extract guidance for purposes of amplifying the South African EDIS framework where necessary.

6.2 Conclusions of the study

6.2.1The rationale for deposit insurance system

The study commenced with a discussion on the role of banks in society at large.[1321] In particular, the discussion focused on the vulnerability of banks as financial intermediaries and the effect of that susceptibility on the banking sector and the economy as a whole.[1322] It was indicated that when banks fail, the adverse effects of such failure are spilled externally from the failed bank through credit losses to depositors as well as liquidity losses to both depositors and borrowers.[1323] While the failure of a bank is inevitable even in the healthiest financial system, it normally leaves depositors frustrated and panicked at the thought of losing their deposits, leading to loss of confidence in the banking system. To address this, it was pointed out that governments have come up with the concept of

[1321] Chapter 1, para 1.1.
[1322] *Ibid.*
[1323] *Ibid.* See also Kauffman (2007) 56.

deposit insurance system to protect depositors' funds up to a certain limit in the event of a bank failure.

The study pointed out that through a deposit insurance system, the risk of loss of deposits when a bank fails is reduced as a deposit insurance system offers protection of those deposits, guaranteeing the value of those deposits up to a certain limit.[1324] The study further pointed out that, although the concept of deposit insurance began centuries back, it only gained popularity when it was pioneered in the US in 1933 and it has since evolved, especially post GFC when the IADI Core Principles for Effective Deposit Insurance Systems were issued as international standard for effective EDIS.[1325]

6.3 The international good practice standard for EDIS

This study indicated that the tumultuous 2008 GFC which saw the wide-scale collapse of many financial systems across the globe, reignited the debate on the topic of explicit deposit insurance system globally.[1326] In particular, the Crisis emphasised the need for depositor protection in the form of explicit deposit insurance system to avoid the use of taxpayers' money in bailing out failed institutions. As a result of the effects of the Crisis on financial markets globally, the Basel Committee on Banking Supervision (BCBS) together with the International Association for Deposit Insurers (IADI) embarked on a journey to establish a set of agreed international principles to serve as a benchmark for countries wishing to introduce explicit deposit insurance systems and for those wishing to reform their existing systems. This resulted in the *IADI Core Principles for Effective Deposit Insurance Systems* which were issued in 2009 and later revised in 2014. The 16 features of the IADI Core Principles and their essential criteria were explored in detail in Chapter 2, setting the scene for benchmarking the EDIS in the US, Australia and in particular South Africa, being the focus of this thesis, for compliance with these international good practice principles.

[1324] Chapter 1, para 1.1.
[1325] *Ibid.*
[1326] Chapter 1, para 1.4.

6.4 Guidance from the US

The first guidance from the US as a G-20 member country is, of course, to have an EDIS as it sets out the parameters of deposit insurance and provides certain and clarity on the nature and extent of depositor protection in a country. Given that, as discussed in Chapter Three, the US introduced the first EDIS as long ago as 1933 and continuously sought to make changes to refine their EDIS to it more effective and also given that it is clear that the IADI Core Principles that were issued in 2011 drew a lot from the US EDIS-model, it is submitted that, apart from acknowledging the need for an EDIS to be continuously refined to stay current and usable. Significant guidance, as pointed out in the features listed below, can be taken by South Africa as guidance for purposes of amplifying its newly introduced EDIS which is not yet in operation.

The US paved the way for using an EDIS to protect depositors, increase depositor confidence in the banking industry and, ultimately, to promote financial stability. It created an operationally independent deposit insurer when it established the FDIC and used 'seed funding' from the US Treasury in conjunction with *ex ante* deposit insurance premiums collected from member banks to establish a deposit insurance fund. By doing so it mitigated the incidence of bank failures as banks were subjected to greater market discipline. Having regard to the new South African EDIS it appears that these features of the US EDIS have been well heeded. The US also assessed bank assets to determine whether they were sufficient to ensure deposit reimbursement in the event of bank failure and depending on the adequacy of such assets, it determined the premium that a specific bank had to pay to become a member of the deposit insurance system. Although the South African EDIS will initially levy flat rate premiums it would be good to later evolve to risk-based premiums to instill more market discipline on banks.

The FDIC was very active in the resolution of failing banks and did not only have a pay-box mandate that involved reimbursing depositors in the event of bank liquidation but had extended functions that involved it in bank supervision and resolution-thus making it a risk-minimizer. South Africa's new deposit insurer, which is yet to be established, will have a pay-box plus-mandate which means that it will have some involvement in resolution, mainly through providing funding for transfer of deposits to bridge banks and making prompt payouts in liquidation, but as South Africa has the SARB as dedicated resolution authority there is no need for a risk minimizer-deposit insurer in South Africa. The US introduced the concept of a ‘new bank’ (bridge bank) to take over deposits and other critical functions from a failed bank and to manage same in an orderly manner. This resolution tool, as pointed out in the brief overview of South Africa’s resolution regime in Chapter 5, has already been on-boarded. The US EDIS guaranteed reimbursement of covered deposits and increased this protected amount at regular intervals. South Africa will do well to note the need to ensure that protected deposit coverage keeps up with the changing times. The US also introduced the concept of recovery by means of subrogation as a feature of effective bank resolution and as pointed out in Chapter Five, the new South African EDIS also provides for recovery by means of subrogation.

The US EDIS further entrenched the principle that those who willfully cause bank failures should be held accountable for their conduct and be subjected to fines or criminal sanctions. As pointed out in Chapter Five, South Africa has long acknowledged this principle and provided for it in section 69A of the *Banks Act* which has been repealed and which is now provided for in section 140 of the *Financial Sector Regulation Act*.

Notably the US acknowledged the need for an EDIS to evolve to meet the changing exigencies of keeping depositors protected and confident. Noteworthy also, is the ability of the FDIC to terminate the membership of banks that engaged in ‘unsafe and unsound practices’ and the public notification to depositors of such termination that served to further protect depositor funds. South Africa can usefully take guidance in this regard.

In its role as risk-minimizer the FDIC was also able to apply merger and amalgamation tools to facilitate the orderly resolution of a failing bank hence it created this mechanism as a useful resolution tool, as well as facilitating the use of ‘purchase and assumption’ and ‘recapitalization’ as other resolution tools. From the overview provided of the South African resolution regime in Chapter Five, it is evident that South Africa has taken heed in this regard as it has incorporated these resolution tools into its resolution regime which will allow the SARB as resolution authority to have a larger suite of resolution tools that can be applied to also protect depositors better. The US introduced periodic assessment of the ‘safety and soundness’ of banks and special examinations to determine the insurance risk posed by a member bank. Whereas the Prudential Authority as new bank supervisor in the South African Twin Peaks model also undertakes periodic assessment of banks as part of its regular supervisory duties, it would be prudent for the prudential authority and the Corporation to undertake special examinations together of banks to determine their insurance risk.

The US EDIS further introduced the concept of early intervention and timely corrective action to promote the health of the banking industry. South Africa would do well to upgrade its approach to early intervention and timely corrective action to prevent bank failures. Legislation was rolled out at regular intervals to keep abreast with the changing needs imposed on deposit insurance to safeguard the interests of depositors and promote financial stability and, as also remarked above, this would be good for South Africa to heed. The establishment of the Resolution Trust Company by the FIRREA 1989 proved to be a very positive step in managing and resolving failed savings associations through the application of a broad range of resolution tools. Another positive intervention occasioned by the FIRREA was the establishment of the Resolution Funding Corporation that provided funding for the resolution activities of the Resolution Trust Company. These developments cemented the notion that effective resolution is dependent on effective resolution funding. South Africa should be guided by this important principle and ensure that its resolution funding, especially those actions that will be funded by the Deposit Insurance Corporation are well-devised and that there are sufficient safeguards in place to prevent losses to the deposit insurance fund.

Also noteworthy is the bar that was introduced to prevent members of the FDIC Board to serve as officers or directors of member banks thus promoting the principle that members of the deposit insurer's board should not have conflicts of interest. This is a principle that can also be on-boarded by South Africa in relation to certain members of the Corporation's board. Notably the US also introduced the principle of compensating non-depositor creditors during bank resolution and as is evident from the brief overview of the South African resolution regime provided in Chapter 5, South Africa's new resolution regime has incorporated the 'no creditor worse off than in liquidation'-principle (NCWOL).

A very important feature introduced by the US EDIS framework was also the safeguards provided by cross-guarantee provisions to protect the deposit insurance funds. These provisions created liability for banks in respect of losses that the FDIC incurred due to default by a bank or any assistance provided by the FDIC to a bank likely to default and cemented the principle of recoveries during bank resolution. South Africa would do well to also provide for such cross-guarantees. The FIRREA also imposed increased capital requirements depending on how well-capitalized a bank was thus permitting intervention sufficiently early into a troubled bank's position to try and avoid failure. The less well-capitalized banks consequently had to maintain higher levels of minimum capital to ensure their safety and soundness. Lack of compliance with required capital levels resulted in the bank being required to provide a capital restoration plan (prompt corrective action) and sanctions such as suspension of FDIC membership was also imposed on non-compliant banks. As mentioned above, the South African EDIS will initially charge a flat rate but could possibly later evolve to charge a risk-based premium in which event it will be necessary to also look at the capital adequacy level of a bank.

Not being complacent about the state of deposit insurance, the US further refined their EDIS through the enactment of the FDICIA 1991 which introduced risk-based insurance premiums that would in addition to providing deposit insurance funding, also serve to curb excessive risk-taking by member banks. Banks were classified according to the adequacy of their capital and banks that fell below minimum capital requirements were visited with progressively more intrusive regulatory restrictions and requirements to ensure their 'safety and soundness'. The FDICIA aimed to encourage early resolution of troubled banks thereby also preserving equity. The lesson for South Africa in this regard is that bank resolution should be triggered sufficiently early to prevent loss of equity and to enable swift depositor protection by, for example, transferring deposits to a bridge bank.

The US EDIS further provided for a repayment agreement plan to be agreed upon by the Treasury and FDIC in the event that Treasury funds were borrowed to be use during bank resolution thus augmenting the modes of funding during resolution and availing the possibility for the deposit insurer to borrow Government funds to facilitate depositor payouts or transfers of deposits to bridge banks. A similar agreement between the South African Deposit Insurance Corporation and National Treasury is thus advisable.

The FDIRA 2005 hailed yet further amplifications of the US deposit insurance system by introducing five-yearly reviews of the coverage limit of the EDIS and setting standards for the assessment of member banks. It also replaced the fixed designated reserve ratio for the deposit insurance fund with a reserve range - thereby adding some flexibility to the level at which the Fund had to be maintained and also providing for a Fund restoration plan where fund levels dropped too low. All these reforms should be heeded by South Africa. The FDIRA further amended the mode of assessment of premiums to be paid by member banks and encouraged inter-agency consultation, which is an important aspect of coordination and crisis management during bank resolution as it is necessary in facilitating swift depositor payouts or transferring deposits to a bridge bank during resolution. South Africa would do well to consider the mode of assessment of deposit insurance premiums applied in the US to determine whether it can be usefully applied to determine the premiums imposed on South African banks, which although not risk-based, may benefit from some features of premium calculation in the US.

As alluded to in Chapter Three, the 2008 GFC proved to be yet another seismic event that impacted heavily on the evolution of deposit insurance in the US, resulting in the Dodd-Frank Act reforms in 2010. This Act, like its predecessors increased deposit insurance coverage; changed the composition of the FDIC Board; introduced a new assessment base for premiums and also changed the reserve requirements to reflect the base for assessment. It additionally, and very importantly, introduced an orderly resolution regime for systemic banks in a manner that sought to mitigate moral hazard occasioned by bank bailouts which as would be indicated in the IADI Core Principles that were issued thereafter, is a critical part of the safety net within which an effective deposit insurance system is operated. South Africa has fortunately already heeded the lesson that it needed a comprehensive resolution regime with an expanded suite of resolution tools to operate in tandem with its new deposit insurance regime and thereby to ensure appropriate depositor protection and promote financial stability.

6.5 Guidance from Australia

Other than South Africa, Australia is a developed country with a thriving economy. However, what it shares with South Africa is that in both countries, being G-20 member countries, the banking sector is robustly regulated and in both countries, no EDIS framework was in place until relatively recently (2008 for Australia and 2021 for South Africa). Given that Australia, despite its stable banking sector and the argument that stable banks do not give rise to a need for deposit insurance, nevertheless prudently decided to adopt an EDIS, it is submitted that South Africa can take guidance from the 'young' Australian EDIS as elaborated below, the first being that that adopting an EDIS is an essential step towards extending greater depositor protection, and promoting depositor confidence and financial stability.

Notably Australia had some limited form of depositor protection in place since the enactment of the Banking Act 1945 which assigned the Commonwealth Bank the explicit function of depositor protection and required banks to maintain assets not less than the amounts of their deposit liabilities in Australia. Albeit that the 'depositor protection priority'-provision in the Act, which determined that the assets of failing Australian banks were to be made available to meet the bank's liabilities in Australia in priority to all other liabilities of such bank outside Australia, did not present a comprehensive EDIS regime it at least served to instill some confidence in Australian depositors that their deposits would not be lost if their bank went bankrupt. South Africa could consider having a similar type of provision in its EDIS framework. The powers of the Commonwealth Bank to intervene in a troubled bank in order to keep it sound and safe also contributed to financial stability and the power of the Commonwealth Bank to take control of a failing bank until deposits were repaid or until suitable provision was made for repayment of deposits must surely have promoted depositor confidence. As observed in the Guidance from the US, South Africa can benefit by amplifying its approach to early intervention in troubled banks. The Banking Act 1959, which was largely a re-enactment of the 1945 Act also contained a similar 'depositor protection priority'-provision and also required banks to hold assets in Australia to a value not less than the total amount of their deposit liabilities in Australia.

The developments since 2005 with the *Study of Financial Guarantees* (*Davis Report*) leading to the Council of Financial Regulators recommending the introduction of a private limited EDIS to provide depositors with prompt access to their deposits in the event of bank failure is noteworthy. Although the Council suggested protection of retail depositors at that stage only, the reforms that followed also saw the temporary protection of wholesale depositors through the *Guarantee Scheme for Large Deposits and Wholesale Funding Appropriation Act 129 of 2008*, which is a protection that South Africa, being a developing country would not at this stage be able to take on board.

The Financial Claims Scheme, established under the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures Act) 105 of 2008*, however provides fertile opportunity for guidance. Notably this EDIS, aimed at protecting Australian retail depositors by giving them certainty regarding the recovery of their deposits and supporting their liquidity, provides for protected depositors in a failed ADI to have access to certain amounts of money to maintain their liquidity *even before* receiving deposit payouts during bank liquidation. It further currently provides significant coverage by protecting retail deposits up to a sizeable amount after initially placing no caps on such guaranteed amounts. However, as indicated in the IADI Core Principles, blanket protection of deposits is not ideal given its ability to increase moral hazard. Notable also is that the amount of deposit coverage was increased to keep up with the exigencies of changing times and as also observed in the guidance from the US, South Africa can also follow this example.

As indicated in Chapter Four, depositor payout in terms of the Financial Claims Scheme is triggered by a declaration by the Minister of Finance that APRA, as the administrator of the scheme, has applied for the winding-up of a specific ADI. Two accounts are kept, one for the funding of depositor payouts (the Financial Claims Scheme Special Account) and one for the administration of the Financial Claims Scheme (the APRA Special Account). The Financial Claims Scheme Special Account is intended for use only in the event that other resolution remedies such as transferring of deposits to another ADI or recapitalization of the failing bank are not feasible or cost-effective and it consequently has to be liquidated. It is clear from the discussion of the South African EDIS that separate accounts will in practice be kept for the deposit insurance fund and the administration and operating costs of the Corporation.

Given that Australia is an affluent country with a stable funding system the Australian EDIS is *ex post* funded, supported by a standing budgetary appropriation from Government. Even where a country is in the fortunate position that Australia finds itself in compared to South Africa that is resource-constrained, and in which position Australia would in principle be able to provide deposit protection funding *ex post*, it is submitted that it would be better for any country to at least have some *ex ante* funding available to reimburse depositors or transfer their deposits to another bank. As pointed out in this thesis, the mechanism of *ex post* funding in Australia has also been recommended by the IMF to be changed to *ex ante* funding which would enable more orderly bank resolution where funds are already available by the time that a bank fails. In South Africa where bank failures do occur from time to time although they are not rife, it is submitted that having only *ex post* deposit insurance funding would not be feasible and that by at least having some ex ante funding crisis management in the event of bank failure would be mitigated and greater depositor confidence and financial stability would be promoted.

A salient feature of the Australian Financial Claims Scheme that would be prudent for South Africa to take on board, is the obligation imposed on ADIs to identify in advance who their protected deposit holders are and developing a ‘single customer view’ for them to minimize deposit payout errors. Similarly salient is the obligation on Australian banks to provide APRA swiftly with depositor information to ensure prompt payout of deposits.

In alignment with the Core Principles the Australian EDIS also provides for APRA to be subrogated as priority creditor of the failed ADI in respect of payouts made. Recovery of funding of deposit payouts or funding provided to transfer protected deposits to another ADI during resolution, if not fully recoverable from the failed ADI, can be recovered through an *ad hoc* levy on the banking sector. This would also be a prudent approach for South Africa to consider albeit that South African banks who will already be paying levies towards the administration of the deposit insurer and premiums towards the deposit insurance fund, might not quite warm up to this mechanism.

Providing for the Australian Treasury to determine these levies in legislation on an annual basis and in varying amounts depending on whether the levies are restricted or unrestricted is also something that South Africa can take guidance on as well as to take note of the type of sanctions imposed in the event of non-compliance with such levies. Additionally, guidance can also be taken on measures implemented by APRA to facilitate the most cost-effective means for implementation of the Scheme's payments, reporting and communication and how swiftly deposit payouts will be effected under the Financial Claims Scheme.

The reforms brought about by the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* which introduced improved resolution powers to be applied to failing ADIs significantly amplified the Australian bank resolution regime thereby also ensuring swift resolution action that would prevent greater loss in equity of the already failing bank and also provide enhanced depositor protection by broadening APRA's mandate to permit the use of the Financial Claims Scheme funds to support a transfer of the failing bank's business.

6.6 Recommendations

As demonstrated in Chapter 5, the new South African EDIS is largely compliant with all 16 IADI Core Principles for Effective Deposit Insurance. However, it was also indicated that there are several respects in which the new deposit insurance regime falls short of full compliance with the Core Principles. Consequently, the following recommendations are made for reform and should ideally be implemented before the deposit guarantee framework is made operational:

6.6.1 Recommendation 1: Objectives

It is recommended that the provision in the legislation stating the Corporation's objectives be amended to clearly reflect that depositor protection and promotion of financial stability are both main objectives of the Corporation.

6.6.2 Recommendation 2: Operational Independence

As indicated, the South African Deposit Insurance Corporation will be positioned within the SARB as its subsidiary. While this may minimize the start-up costs for the Corporation, it may interfere with the operational independence of the SADC. It is thus recommended that a MOU is entered into between SARB and the Corporation to preserve its operational independence. It should further be explicitly stated in the legislation that the Corporation is a separate juristic person.

6.6.3 Recommendation 4: Deposit insurance fund

Safeguards should also be put into the legislation to guard against spending of Corporation funding on directions of the SARB or government in instances where it is not justified to ensure that the Corporation's operational independence is not compromised.

6.6.4 Recommendation 4: Premiums

Provision should however be made in the legislation for the Corporation to change the basis on which premiums are levied at a later stage should it so wish as a risk-based premium will be fairer and will instil greater market discipline.

6.6.5 Recommendation 5: Ad hoc premiums

It is recommended that, in those instances where the deposit insurance fund is not at a sufficient level to cater for all the costs of resolution funding and it is necessary to collect an additional *ad hoc* premium from the banking industry, the legislation expressly caters same.

6.6.6 Recommendation 6: Governance

It is recommended that the legislation provide that the Corporation must have sound governance practices which must include appropriate accountability, internal controls, and transparency and disclosure regimes.

6.6.7 Recommendation 7: Governance assessment

It is recommended that the legislation provide for regular assessment of the Corporation to evaluate the extent to which it meets its mandate.

6.6.8 Recommendation 8: Information-sharing

It is recommended that the legislation set out the process for sharing and on-sharing of confidential information between the Corporation and other safety net participants, financial regulators and foreign regulators.

6.6.9 Recommendation 9: Ongoing information-sharing

It is recommended that the legislation clarifies that the duty to share information is an ongoing obligation.

6.6.10 Recommendation10: Testing of contingency planning

It is recommended that the legislation obliges the Corporation to annually test its own crisis management plans and contingency planning.

6.6.11 Recommendation 11: Participation in crisis management simulations

It is recommended that the legislation obliges the Corporation to participate in regular simulation exercises and pre-and post-crisis contingency planning for system-wide crisis preparedness and management which should involve all safety net participants.

6.6.12 Recommendation 12: Membership

The conditions, process and timeframe for becoming a member of the EDIS must be explicitly stated in the legislation and must be transparent.

6.6.13 Recommendation 13: Termination of membership

The legislation must clearly state the instances in which the Corporation can terminate a bank's membership and should also indicate the effect that this will have on the said bank's insured deposits (i.e. that their deposits will still be protected until a specified deadline) and impose an obligation on the Corporation to notify depositors of the termination of a bank's membership only after sufficient and swift provision had been made to protect the said deposits in a manner that would prevent a bank run.

6.6.14 Recommendation 14: Withdrawal of licence

The legislation should provide for the Prudential Authority to immediately revoke a bank's licence upon termination of its membership of the EDIS.

6.6.15 Recommendation 15: Protection of foreign deposits

The legislation should specify that foreign retail deposits will also be protected if there are sufficient funds left after South African covered depositors have been reimbursed.

6.6.16 Recommendation 16: Review of coverage

The legislation should provide for a regular 5-year review of deposit coverage to ensure that the deposit coverage remains adequate to preserve depositor confidence.

6.6.17 Recommendation 17: Funding arrangements

The legislation should set out emergency funding arrangements for instances where the deposit insurance fund is insufficient to deal with bank resolution, including the availability of a committed line of liquidity funding from the central bank.

6.6.18 Recommendation 18: Use of resolution funding

Provision should be made in the legislation for the Corporation to expressly and in writing authorise the use of its funds for resolution of banks other than liquidation.

6.6.19 Recommendation 19: Promoting public awareness

Provision should be made in the legislation for the Corporation to inform depositors of deposit insurance levels; where, when and how they can get access to their insured deposits and the information they have to disclose in this regard as well as whether the Corporation will make advance or interim payments.

6.6.20 Recommendation 20: Monitoring of public awareness

The legislation should impose an obligation on the Corporation to monitor its public awareness activities on an ongoing basis and to have the effectiveness of its public awareness programs or activities independently assessed at least at 3-year intervals.

6.6.21 Recommendation 21: Legal Protection

The legislation should clarify that the legal protection for good faith actions taken by the Board and employees of the Corporation extends to current and former Board members and employees.

6.6.22 Recommendation 22: Dealing with parties at fault in bank failure

The legislation must extend the power to investigate and impose liability on persons who were instrumental in bank failure to insiders, related parties and professional service providers who acted for the failed bank.

6.6.23 Recommendation 23: Early intervention

The legislation should be amended to provide for a comprehensive early intervention regime before a troubled bank becomes non-viable.

6.6.24 Recommendation 24: Access to depositor information

The legislation must oblige member banks to provide the Corporation with access to depositor records and to update such information on a regular basis (guidance could be taken from the ‘single customer view’- approach in Australia)

6.6.25 Recommendation 25: Audit of reimbursement process

The legislation must provide for an independent audit of the reimbursement process after a deposit pay-out to provide confirmation that the Corporation has appropriate internal controls in place.

6.6.26 Recommendation 26: Cooperation by liquidator

The legislation should provide that the liquidator of a failed bank is obliged to cooperate with the Corporation to facilitate the process of reimbursing depositors and to provide the Corporation, in its capacity as creditor, with information it requires.

6.6.27 Recommendation 27: Review of MoUS

The legislation should provide for all MOUs entered into by the Corporation to be review at least at 3-year intervals.

6.6.28 Recommendation 28: Depositor priority

It is recommended that consideration should be given to inserting a provision similar to the Australian depositor priority provision to ensure that a failed bank assets are availed first to South African depositors.

6.6.29 Recommendation 29: Sanctions

The legislation should specify the sanctions for failure by a member bank to comply with its obligations in respect of deposit insurance levies and premiums.

6.6.30 Recommendation 30: Special examinations

The legislation should provide for the Corporation and Prudential Authority to conduct special examinations into member banks to determine their insurance risk.

6.6.31 Recommendation 31: Bar to prevent conflict of interest

To avoid conflict of interest, the legislation should specify that the two persons who can be appointed by the Governor of SARB as directors on the Board of the Corporation may not hold positions on the Boards of any member banks.

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