

The Deposit Insurance Funding model and the implications for banks

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The South African Reserve Bank (“SARB”) recently published a discussion document “*The deposit insurance funding model and the implications for banks*” (the “**Discussion Paper**”) for purposes of public comment, the closing date of which was 16 October 2020. The Discussion Paper is rather noteworthy in that it presents a funding model which makes provision for cover to protect depositors in the event that a bank should fail. It further proposes that banks would have to become members of the Corporation for Deposit Insurance (“**CoDI**”) and will be required to make contributions to the Deposit Insurance Fund (“**DIF**”), which will be established in terms of the Financial Sector Laws Amendment Bill (“**FSLAB**”).

Once established, CoDI’s objective will be to support the SARB in fulfilling its objectives and responsibilities in order to protect and enhance financial stability. In order to do this, one of CoDI’s functions will be to establish, maintain and administer the DIF in the interest of the holders of covered deposits and it will also be required to build up a sufficiently large DIF in order to protect covered depositors should a bank fail. It is further contemplated that CoDI will require funding from its members in order to set up the DIF, which will be used by CoDI in fulfilling its mandated functions of either paying out covered deposits of a failed bank, supporting a resolution strategy or providing funding support as well as collecting levy income from members to cover operational costs.

The FSLAB contemplates various amendments to the provisions of the Insolvency Act, 24 of 1936, which includes the proposed introduction of a preference for covered deposits in the event of liquidation proceedings. It is therefore envisaged that due to the higher ranking of CoDI within the creditor hierarchy, CoDI would likely recover most of the funds paid out to covered depositors of a failed banking institution.

Currently, the envisaged funding model for CoDI comprises three tiers, namely –

1. a Liquidity Tier

This tier will, during the first five years following implementation of CoDI (the “**Initial Period**”), constitute the primary source of funds for making payment to a failed bank’s covered depositors. In essence, CoDI will utilize the liquidity tier for liquidity purposes when required to make a payment, which payment will then be recognised as an advance against the liquidation proceeds to be recovered. Following on the Initial Period, the failed bank’s own deposits as well as CoDI’s own funds will first be utilised prior to accessing funds in the liquidity tier.

The liquidity tier will be funded by way of interest-bearing deposits made by CoDI’s member banks, which will have to be maintained on a continuous basis. In terms of the Discussion Paper, it is currently envisaged that a deposit of 3% of each member’s covered deposits will be required in order to cover the simultaneous failure of a number of small banks. It is pertinent to note that the FSLAB further contemplates that members of CoDI with covered deposit balances must maintain a minimum amount in the DIF for purposes of liquidity and that any interest earned on such amounts will be paid to the relevant members. Deposits made into the liquidity tier will be rolled over on a monthly basis and will be adjusted for changes in such members covered deposit balances. Any amounts deposited by member banks will be maintained for so long as such member

remains a registered bank. Additional information in relation to further deposits required to be made for purposes of the liquidity tier is to be published at a later date.

2. a Tier consisting of the DIF's own funds

This tier will be a loss-absorbing tier comprising premiums paid by members. During the Initial Period, any shortfall in the proceeds of liquidation will be funded from CoDI's own funds. Following on the Initial Period, the liquidity tier will only be used for shortfalls after first having utilised the failed bank's own deposits in conjunction with CoDI's own funds.

It is currently contemplated under the Discussion Paper that premiums will be payable by members on a monthly basis and that the premium payable will be an amount equal to 0.2% per annum of such member's covered deposits per year. Each member will accordingly be obligated to pay the premium amount in full every month. Banks who do not have any covered deposits will not have to pay any premium.

3. an Emergency Funding Tier

It is envisaged that an emergency fund facility will be made available by the SARB. This facility is only expected to be utilised in exceptional circumstances, such as where the DIF runs out of funds to pay out covered depositors. The availability of this emergency funding will alleviate the need to maintain an excessively large and costly fund that will only be required in exceptional circumstances.

CoDI's target fund size for the DIF will be 4%, made up of 3% funding in the liquidity tier and 1% funding in their own funds. As such, the liquidity tier will be required to be in place from the date from which banks are required to maintain deposits with CoDI, whilst the contribution towards DIF's own funds will be built up over the Initial Period. It is pertinent to note that it is the intention to change the composition of the DIF over time by gradually reducing the size of the liquidity tier as the DIF's own funds increase. The funding model currently set out in the Discussion Paper will however be subject to review by CoDI pursuant to an analysis of their funding needs over time. The funding model revisions could accordingly include, amongst others, reducing or removing the liquidity tier once the DIF's own funds have built up sufficiently, adjusting the size of the premiums based on CoDI's funding and operational requirements, aligning to new principles and guidelines published or adopting differentiated funding obligations for banks with different risk profiles and/or resolution plans.

All members of CoDI will be required to make a deposit insurance submission on a monthly basis. Once CoDI's system has calculated and verified each bank's covered deposit balance, it will proceed to calculate such bank's respective financial obligations. Accordingly, all members will be invoiced at the end of the month following the month in which their submission was made, which invoice will have to be settled by the end of the following month. Any interest which may be earned by the members on their deposits held with CoDI will be paid by CoDI to the account designated for this purpose by such member. Any payment of interest due to members will be made within eight weeks of the reporting month's end.

If a member is unable to submit its deposit insurance submission within the requisite submission period, such member must apply to CoDI for an extension of the period within which to make the submission and must provide reasons for the delay. A member may then be given until the end of the month, following the month-end to which the submission relates, within which to make its submission. In the event the submission remains outstanding at the end of this period, CoDI will be entitled to impose an administrative penalty of 5% of the premium due for the specific reporting month, calculated on a weekly basis from the date that the submission was due. Any such penalties will be payable within five working days of CoDI sending an invoice to the relevant member. CoDI will however only invoice the relevant member following receipt of the outstanding deposit insurance submission from such member. It is important to note that if a member cannot submit its deposit insurance submission due to any technical and/or systems issue on CoDI's side, no penalties will be levied on such member.

Similarly, should a bank tender its monthly deposit insurance submission which contains invalid data, such member will be liable for the same penalty as applicable for a late submission to CoDI given that CoDI will not be able to use the submission and the member will be required to resubmit the deposit insurance submission for that period with the correct data.

In the event that CoDI is established on a date other than the beginning of its first financial year, a *pro rata* levy amount will be calculated for the remaining months of its financial year. In turn, any premiums payable by members will be calculated on a *pro rata* basis in relation to the remaining months of CoDI's financial year. Should a member fail or deregister as a bank, such member will however remain liable for any unpaid levies which have already been invoiced by CoDI. A *pro rata* percentage of an annual levy will be due to a member if it deregisters or fails after the payment of the annual levy.

All newly registered banks will automatically become members of CoDI and will be required to make their first deposit insurance submission at the end of their first month's operation as a bank. The covered deposit balance reported will then be used to calculate the annual levy, monthly premium and deposit to be placed with CoDI by such bank. It is also notable that upon CoDI's establishment, all local branches of foreign banks will become members of CoDI and will be subject to the same reporting and financial obligations as all other members. To the extent that a bank's licence is suspended, such bank will remain a member of CoDI until such time as the Prudential Authority ("PA") officially cancels such licence or deregisters the bank. Accordingly, any bank with a suspended licence will be required to continue to submit their monthly submissions of covered deposit data, pay any annual levy as well as monthly premiums to CoDI and maintain and adjust their deposits with CoDI.

It is further contemplated under the Discussion Paper that should a member not pay its annual levy, monthly premium, deposit adjustment or any administrative penalties which may be imposed within the prescribed payment period (namely, one month after an invoice has been issued by CoDI or a payment instruction received), such member will be liable for the outstanding levy, premium or deposit adjustment in addition to an administrative fee of 10% of the outstanding amount per day, accruing on a daily basis from the date on which the amount became due. The administrative penalty will however be capped at the original amount payable by the member, that is, the maximum administrative penalty payable will be an amount equal to the original amount payable. In the event of any non-compliance by a member with the requirements of CoDI, such non-compliance will be reported to the PA if the relevant member has not become compliant within 10 days.

We are currently awaiting further information on the proposed amendments which will have to be made to secondary legislation to CoDI following the promulgation of the FSLAB. It is further understood that additional engagements between CoDI and the banks will be taking place in relation to the deposits to the liquidity tier of the funding model as well as the taxation status of CoDI. In the interim, banks would be well advised to consider the implications of the Discussion Paper and the contemplated funding model for CoDI and the DIF as well as any possible system changes that may need to be made in order to comply with the intended obligations set out in the Discussion Paper.



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